EB-2024-0063

ONTARIO ENERGY BOARD

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

AND IN THE MATTER OF a generic proceeding commenced by the Ontario Energy Board on its own motion to consider the cost of capital parameters and deemed capital structure to be used to set rates.

REPLY ARGUMENT OF THE

ONTARIO ENERGY ASSOCIATION ("OEA")

LAX O'SULLIVAN LISUS GOTTLIEB LLP
Counsel
Suite 2750, 145 King Street West
Toronto ON M5H 1J8

Crawford G. Smith LSO#: 42131S
csmith@lolg.ca
Tel: 416 598 8648

Tyler Morrison LSO#: 80119E
tmorrison@lolg.ca
Tel: 416 956 5100

Fax: 416 598 3730

Lawyers for the Ontario Energy Association

Table Of Contents

Introduction

1. The Board's 2009 Report on the Cost of Capital has served Ontario well since its implementation. It is now time for incremental change. This proceeding, the first of its kind in 15 years, affords the Board the opportunity to make the changes necessary to the cost of capital parameters to ensure the Fair Return Standard is met now and in the future.

2. The 2009 Report and its implements are not fundamentally flawed as some parties to this proceeding have suggested. Despite the insistence of certain parties, the Board's cost of capital requirements do not require revolutionary change, or fundamental adjustment. Rather, the OEA argues for evolutionary change to align the cost of capital parameters with modern market realities.

3. Evolutionary change is necessary, building off the strong foundations created by the 2009 Report, to ensure that the Fair Return Standard is met. There is no need to start from scratch or do away with the general structure and a number of established principles that have served the Ontario Energy industry and consumers for the last 15 years.

4. Nevertheless, the Board should recognize the important inflection point the energy industry faces. Unprecedented levels of capital investment will be required across the entire energy sector to facilitate the Energy Transition, all while ensuring safe and reliable electric and natural gas service for the foreseeable future. Setting a fair return is the lynchpin that ensures the necessary capital will be attracted at costs that are fair to consumers.

5. This reply argument responds to the evidence and arguments from each of the parties and provides the OEA's final recommendation on each of the issues. This reply should be read as being supplementary to the OEA argument in chief which the OEA repeats and adopts. This argument is framed in terms of the Board's 22 questions and aims to summarize each of the parties' positions on these issues. The remainder of this argument proceeds in that fashion.

Determination of Cost of Capital Parameters (Issues 1-3)

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

6. The Board's long-standing policy, which is consistent with the FRS, is not to differentiate by ownership type. This is consistent with financial theory providing that the cost of capital depends on the use of funds, not the source of funds.[1] This is referred to as the "Standalone Principle".

7. The Board has consistently adopted this long-established regulatory principle and adopted this approach in its 2009 Report.[2] There is no reason to deviate from this well-established principle that supports the FRS by ensuring regulated entity's return on capital meets the Comparable Return Standard regardless of the source of the entity's capital.

8. All the experts in this proceeding agree that the cost of capital parameters should not differ by ownership type.

9. Concentric, OEB staff, Pollution Probe and Vulnerable Energy Consumers Coalition ("**VECC**") all provide arguments in support of the Standalone Principle.

10. While Caldwell First Nation ("**CFN**") and Mississaugas of the Credit First Nation ("**MCFN**") and Three Fires Group ("**TFG**") and Minogi do not argue against the Standalone Principle, they do argue that meaningful Indigenous participation is required, and that the unique and specific interests of First Nations should be considered as part of this proceeding. To the extent not inconsistent with the Standalone Principle, the OEA has no concerns and supports economic reconciliation and the Board's efforts in this respect.

---

[1] Concentric Report p. 20.
[2] EB-2007-0905 Decision with Reasons at p. 140

11. The only parties who directly argue that the Standalone Principle should be disregarded are the Concerned Manufacturers and Businesses of Canada ("**CCMBC**") and Energy Probe. Their argument is that ownership matters and that the Standalone Principle is simply wrong.

12. While The Association of Major Power Consumers in Ontario ("**AMPCO**") and Industrial Gas Users Association ("**IGUA**") do not make explicit arguments against the Standalone Principle, they attempt to circumvent it in relation to the use of North American Proxy groups by arguing municipally owned utilities do not raise funds in any market and therefore do not compete with the U.S. market for capital. Energy Probe adopts a similar argument in direct opposition of the Standalone Principle.[3]

13. There is no good reason to abandon the Board's long-established adherence to the Standalone Principle.

14. First, the FRS is a legal requirement that has been interpreted on numerous occasions and has never been qualified by an entity's source of funds. It is a legal requirement that the three prongs of the FRS be met regardless of the entity's source of funds. It would be a drastic change in policy and the law to qualify the FRS by an entity's source of funds – something that has never been done by any Canadian regulator or court.

15. Second, even if it were correct that municipally owned utilities are constrained in their ability to raise equity from foreign markets, if the Standalone Principle is disregarded, that will further constrain municipally owned utilities' ability to capitalize their business on terms that meet the FRS whether by equity or debt. The Board should not take steps to encourage that outcome.

16. Third, arguments regarding the feasibility of Ontario utilities raising capital or investing in other markets are designed to confuse the issue and should be

[3] Energy Probe and CCMBC also argue that OPG benefits from being able to obtain financing from the Ontario Electricity Financial Corporation (OEFC), an agency of the Province of Ontario. This point misses the fact that, as discussed in previous OPG payment amount proceedings, the OEFC lends to OPG on market terms, based on OPG's creditworthiness, making the cost of any such borrowing comparable of OPG's public debt program (EB-2020-0290, Ex. C2-1-2).

disregarded. Investments of similar risk (e.g., U.S. utilities as comparators for Ontario utilities) provide useful and relevant information about the cost of capital for Ontario utilities, regardless of whether Ontario utilities access capital in those markets.

17. Fourth, if the Board were to determine the source of funds was determinative, or even a factor, the Board would be required to distinguish between the cost of equity from different investors. As the sources of potential investment are numerous, the administrative burden on the Board would be immense.

OEA Recommendation:

18. The OEA recommends that the Board continue to adhere to the Standalone Principle and that the approach to setting the cost of capital parameters and capital structure should not differ by ownership type.

Issue #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 economic and market conditions be considered in determining the cost of capital parameters and capital structure?

19. Concentric has provided an extensive overview of the risk factors associated with a utilities business, which include:

(a) Energy Transition Risk;

(b) Operating Expense Recovery;

(c) Volumetric Risk;

(d) Fuel and Purchased Power Costs;

(e) Capital Spending and Cost Recovery;

(f) Cyber Security Risk;

(g) Climate Change Risk; and

(h) Financial Risk. [4]

20. There does not appear to be any dispute amongst the parties that these risks exist. The key areas of dispute between the parties relate to:

(a) The timing of Energy Transition Risk and its effect on the cost of capital; and

(b) The magnitude by which regulatory mechanisms have reduced Regulatory Risk.

21. The consumer groups rely on their arguments in relation to these two areas of dispute to support their arguments with respect to Issue # 12, which asks how should the capital structure be set for electricity transmitters, electricity distributors, natural gas utilities, and OPG to reflect the FRS? The existence and relevance of Energy Transition Risk is discussed under this issue. Regulatory Risk is discussed in relation to Issue #3, below. Both discussions are referred to in relation to Issue #12.

A. Energy Transition Risk

22. Energy Transition is generally defined as the broad-scale transformation from primary reliance on fossil fuels to an increased emphasis on more clean and decentralized fuel sources and electrification in general.

23. Not a single expert denies that the Energy Transition is real. The only disputes are whether its effects are being felt by utilities now and its impact on the cost of capital. Put more simply, the dispute is whether the energy transition creates risk for utilities that should be recognized now.

24. Several parties argue that the Energy Transition Risk is not affecting parties now to any significant extent. The evidence shows otherwise.

25. The capital expenditures required to support the Energy Transition cannot be understated:

[4] Concentric Report at pages. 22-29.

(a) In its December 2023 report, the Electrification and Energy Transition Panel ("**EETP**") noted that in the medium term (i.e., 2030-2050) the Energy Transition will enter an intense transformation affecting every part, sector, and community in Ontario, leading to the establishment of a clean energy economy.[5]

(b) In its Pathways to Decarbonization report, the IESO has indicated that the bulk system expansion needed to enable decarbonization would require an investment in the range of $375 to $425 billion.[6]

(c) The Royal Bank of Canada has estimated that the total investment cost in Canada to achieve net zero is $2 trillion.[7]

26. AMPCO and IGUA, CCMBC, Consumers Council of Canada ("**CCC**") and the School Energy Coalition ("**SEC"**) argue that the Energy Transition is a business opportunity for electric utilities, not an additional risk.

27. OEB Staff argue that there is no evidence that the Energy Transition impacts either timing or recovery for regulated utilities, particularly in the forthcoming regulatory period.

28. The risks to Enbridge Gas due to the Energy Transition are of course far different representing an existential threat to the gas distribution business. Several parties have acknowledged this.

i. Concentric's Position Clarified

29. Several of the consumer groups argue that no adjustment is required to the capital structure or cost of capital parameters by virtue of any risks created by the Energy Transition. This appears to misconstrue Concentric's position.

30. Concentric does not make any independent adjustments to either its recommended ROE or capital structure because of Energy Transition Risk. Rather,

[5] Electrification and Energy Transition Panel, "Ontario's Clean Energy Opportunity," January 2024.
[6] Pathways to Decarbonization, IESO dated December 15, 2022 at page 4.
[7] The $2 Trillion Transition, RBC dated October 20, 2021.

Concentric's recommended ROE is based on market data that factors in investors' perceptions of risk. That market data is used in Concentric's methodology to determine Concentric's recommended ROE. Further, Concentric concludes, based on a peer comparison, that the existing equity thickness for regulated utilities does not meet the Comparable Return Standard at its recommended ROE. There is, however, no independent adjustment for Energy Transition Risk. Rather, while Concentric concludes that the Energy Transition has increased business and policy-related risks for all Ontario utilities, and is inevitably going to continue to do so, its recommended minimum equity ratio is based on an analysis of peer utility data, with no adjustment for Energy Transition or other risks.

31. In other words, even if the Board were to determine that there is no Energy Transition risk, which the OEA disagrees with, it would not change Concentric's recommended ROE or equity thickness.

ii. Energy Transition Risk is Real

32. Despite Concentric not making any independent adjustment for Energy Transition risk, the OEA submits it is a real and significant risk facing utilities in Ontario. The argument that the Energy Transition represents an opportunity for utilities ignores the increased risks associated with the Energy Transition.

33. The general business model of a utility is well understood. A utility invests capital in infrastructure and receives a regulated return on that investment over the life of the assets. As canvassed above, that business model includes many risk factors. When demand requires a significant increase in the infrastructure capacity, utilities must equally increase their capital expenditures to meet that demand and maintain safe and reliable service while doing so. It goes without saying that a source of such capital investment must be found and that there is a competitive market for such capital. The higher capital investment requirements amplify all the risks associated with the utilities business model.

34. In this scenario, the risks associated with regulatory lag, operational risk (including climate change risk and cyber security risk), capital spending and cost

recovery risk grow along with capital expenditure. For example, building a transformer station comes with various risks – no expert denies infrastructure projects have associated risks – building a second transformer station comes with the same risks. Building two transformer stations concurrently is riskier than building one. This simple example illustrates the perhaps obvious – raising more capital, to build more infrastructure, creates more risk.

35. There is no denying that Ontario's electricity sector will experience an increase in demand. As recently emphasized by the Minister of Energy and Electrification, "Ontario's Independent Electricity System Operator (IESO) now forecasts that electricity demand alone will increase by 75 per cent by 2050. That means Ontario needs 111 TWh more energy by 2050, the equivalent of four and a half cities of Toronto."[8] To meet this demand, the Minister has also stated that natural gas will play an important role in the energy transition. This places Enbridge Gas in the paradoxical situation of having to invest in the capital assets required to meet the Province's housing and growth objectives while at the same time being subject to the risks of asset stranding in future.

36. Whether those projections ultimately prove accurate, significant investments will need to be made to construct assets based on policy initiatives and these investments will have inherently uncertain outcomes and the possibility that they may not ultimately be necessary, or sufficient to meet the uncertainties over the next several decades. The increased capital requirements from these initiatives will in turn place pressure on the utilities' credit worthiness. Accordingly, the increased building of infrastructure will necessarily increase risk.

37. As the EDA explains, the Energy Transition will not create a windfall to utility investors. It is not a windfall to put more capital at risk and receive in return a proportionate number of dollars.[9] Put differently, investors expect an equal return on each dollar at risk. It should be recognized that increasing the level of investment in

[8] Ontario's Affordable Energy Future: The Pressing Case for More Power, Stephen Lecce, Ontario's Minister of Energy and Electrification, October 22, 2024.
[9] EDA Submissions at para 9.

projects does not decrease risk. The additional investment should therefore have the same ability to earn the same return.

38. A significant risk to Enbridge Gas due to the Energy Transition is one of ever-increasing declining demand while still being obligated to operate and maintain a safe and reliable natural gas distribution system. Only natural gas distributors face the risk of municipal “gas-bans” and net zero and/or carbon pricing government policies. The question of whether the Energy Transition is already impacting Enbridge Gas has already been answered affirmatively by the OEB. It has already determined that in respect to Enbridge Gas, the Energy Transition is already occurring and that the risks are real. The OEB made the following findings in its recent Enbridge Gas Rebasing Phase 1 Decision where it stated:

> The energy transition is underway, underpinned by the totality of current government policy. … The risk that arises from the energy transition results from gas customers leaving the gas system as they transition to electricity to meet energy needs previously met by natural gas. This departure gives rise to assets that are not fully depreciated but are no longer used and useful. This results in stranded asset costs that Enbridge Gas would seek to recover from the remaining gas customers. This in turn would increase rates for those gas customers, leading more customers to leave the gas system, potentially leading to a continuing financial decline for the utility, often referred to as the utility death spiral.[10]

Issue #3 What regulatory and rate-setting mechanisms have impacted risk factors, and how should they be considered in determining the cost of capital parameters and capital structure?

B. Regulatory Risk

39. Several of the consumer groups argue that regulatory risk has significantly decreased since the 2009 Report and therefore utilities are less risky than they were in 2009.

[10] Decision and Order dated December 21, 2023 (EB-2022-0200) at pages 20-21.

40. While the OEA acknowledges that certain regulatory mechanisms put in place since 2009 have helped to mitigate risk, it agrees with OEB staff that the effects on a utilities overall risk profile have been "moderate".[11]

41. Viewing utility's risk profile as a whole, the moderate reduction in risk stemming from new regulatory mechanisms does not mean that a utility's business has less risk than in 2009. That conclusion is misguided and does not account for the new risks faced by utilities since 2009, including climate change risk and cyber security risk. While it is true that regulatory mechanisms have been implemented to help reduce these risks, they have not, and cannot be eliminated.

42. The upshot is that a moderate decrease in regulatory risk does not equate to a decrease in a utility's business risk as a whole. Utilities face new and ever-growing risks that, while mitigated in some respects, continue to exist. Even before consideration of Energy Transition Risk, regulatory mechanisms have not reduced the overall risk faced by utilities. It is also appropriate to keep in mind that from the perspective of natural gas distributors, any moderate decrease in regulatory risk that new regulatory mechanisms have caused do not and were not intended to address the serious risks associated with the Energy Transition.

43. This discussion will be re-visited with respect to Issue #12.

Short-Term Debt Rate (Issues 4-5)

Issue #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?

Issue #5 If no to Issue #4, how should the short-term debt rate be set?

A. Replacement of the Bankers' Acceptance Rate

44. While OEB Staff submits that there may be multiple reasonable replacements for the Bankers' Acceptance rate, OEB Staff argues that the use of the trailing 12-month average (as of September 30th) of the Bloomberg 3-month BVCAUA3M BVLI Index to

[11] OEB Staff Submissions at p. 5.

develop the Deemed Short-Term Debt Rate ("**DSTDR**") would be the most advantageous approach from an administrative perspective.

45. The Canadian Manufacturers & Exporters ("**CME**"), SEC, VECC, Energy Probe, Pollution Probe and CCMBC agree with LEI's and Dr. Cleary's recommendation of replacing the Banker's acceptance rates with Canadian Overnight Repo Rate Average ("**CORRA** ") in determining the DSTDR.

46. CCC proposes separate approaches in determining the DSTDR in 2025 and in future years. To determine the 2025 DSTDR, CCC proposes using the average of the 3-month CORRA futures rate for the next 12-month period plus a spread from the 2023 bank survey adjusted by the historical difference between the 3-month CORRA and the 3-month Bankers' Acceptance rate. CCC proposes determining the DSTDR in future years by using the average of the 3-month CORRA futures rate for the next 12-month period plus a spread between the historical 12-month Bloomberg BVCAUA3M BVLI Index and the 3-month CORRA.

47. VECC and CCC support the continued use of embedded costs of short-term debt without a cap, with CCC suggesting that Enbridge Gas and OPG be given an option to switch to a different approach to short-term debt in the next rebasing proceeding.

Recommendation of the OEA:

48. Recognizing that Banker's Acceptance rates are no longer available after June 2024, the OEA and Concentric agree with LEI that transitioning to a measure of short-term loan rates, such as the three-month average of the CORRA is appropriate, with a spread based on an R1-low rated utility over CORRA being applied in the short-term debt rate calculation based on an annual confidential survey of 6-10 banks.[12]

49. The proposal by OEB staff to use the Bloomberg 3-month BVCAUA3M BVLI Index is not appropriate. It is a proprietary index only available to subscribers and there is nothing on the record to indicate what data is actually behind this index. It is

[12] Concentric Report, p. 33.

therefore submitted that the OEB should be wary of adopting a proprietary "black box" index which may be difficult to verify and access.

B. DSTDR as a cap

50. OEB Staff and CME support LEI's recommendation to apply the updated DSTDR as a cap on Enbridge Gas' and OPG's short-term debt. It appears that the sole justification for this is the belief that the DSTDR should be applied as a cap for all utilities, not just electricity distributors and transmitters.

51. In response to Concentric's concern about the application of a debt cap, CME has suggested that the updated DSTDR serve as a soft cap that utilities may rebut with additional evidence.

52. CCC, Energy Probe, CCMBC, AMPCO and IGUA, the Association of Power Producers of Ontario ("**APPrO**"), CFN and MCFN, the Electric Distributors Association ("**EDA**"), TFG and Minogi have not directly addressed this issue.

Recommendation of the OEA:

53. The OEA and Concentric disagree with LEI's recommendation to apply a cap on the short-term debt rate for all utilities, including Enbridge Gas and OPG. The previous model has worked well, and LEI was unable to identify any actual harm its approach tries to mitigate.[13] The actual costs of borrowing can deviate from the deemed debt rate for reasons that are outside of the control of the utility and the OEA does not believe a change to the OEB's current practice is warranted or necessary.

54. While the deemed debt rate can inform the OEB's assessment of utility-specific debt rates, the rote application of a cap could result in utilities not being provided the opportunity to recover prudently incurred costs. Concentric specifically disagrees with the extension of the cap to Enbridge Gas and OPG under LEI's proposal. The continued use of the forecasted rates by the utilities will allow the utilities, in circumstances where their cost of debt is expected to exceed the cap, for reasons of risk differentials (e.g.,

[13] OEA Argument at para 54.

due to timing differences or if a utility faces risk differentials to a R-1 rating) to demonstrate why their utility-specific debt cost is reasonable.[14]

55. OEB Staff argue, without evidence, that a cap may incent utilities to "negotiate better borrowing terms". In practice however, short-term debt costs are set by commercial paper market prices, which mean they are effectively set through an auction.

56. Furthermore, specific to OPG, the OEB reflects a forecasted embedded short-term debt amount in its capital structures (i.e., without an unfunded portion of short-term debt). As VECC points out, it would be counterintuitive to on one hand allow for an embedded amount of short-term debt as supported by utility-specific evidence, but then to impose an artificial limit on the cost arising from such debt.[15]

57. Please also see the comments made by the OEA in response to the proposal by several parties that the Long-Term debt rate should be applied as a cap as those comments may be applicable here as well.

Long-Term Debt Rate (Issues 6-9)

Issue #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?

Issue #7 If no to Issue #6, how should the long-term debt rate be set?

58. The competing approaches to creating the deemed long-term debt rate (DLTDR) center around using forecasted or actual bond yields. OEB Staff and Pollution Probe support LEI's approach, which uses the 30-year bond yield forecast from the seven major Canadian banks. CCC, CCMBC, CME, Energy Probe, and SEC state that the OEB should make use of the Long Canada Bond Forecast based on the actual 30-year Government of Canada bond yield to establish the DLTDR because it is easier to implement and produces less biased estimates.

[14] Concentric Report at pp. 33-34.
[15] VECC Argument at para 61.

59. CCMBC, Energy Probe, CME, Pollution Probe and CCC recommend that the OEB apply the DLTDR as a cap for all regulated utilities, including Enbridge Gas and OPG.

60. The OEA notes that in respect of the application of a long term debt rate cap, the position taken by OEB Staff is unclear. OEB Staff first argues that the cap should be applied to all utilities in certain circumstances, but which are not explicitly set out and which the OEA assumes are those listed on page 84 of the LEI's report. However, OEB Staff also submits that the "OEB's historic approach is reasonable to continue"[16].

61. SEC submits that that as long as the OEB uses a deemed capital structure, the appropriate approach is to apply a utility's actual weighted average cost of debt, rather than DLTDR, to any notional (unfunded) portion of deemed long-term debt.

62. AMPCO-IGUA, APPrO, CFN – MCFN, EDA, and TFG & Minogi did not comment on these issues.

Recommendation of the OEA:

63. The OEA and Concentric do not recommend changes to the current approach whereby, in general, the long-term cost of debt for ratemaking purposes is based on embedded costs, subject to the use of a deemed long-term cost of debt in certain circumstances for electricity distributors and transmitters. Where the deemed cost of debt applies, Concentric recommends certain modifications to the inputs to the deemed rates. The OEA and Concentric agree with LEI's approach, which uses the 30-year bond yield forecast from the major Canadian banks vs. the current approach that relies on the Consensus 10-year forecast plus a 10-30 spread. While LEI recommends seven banks, Concentric recommends three (RBC, TD Bank, and Scotia Bank), as utilized by the AUC in its revised formula, to be a reasonable approach.[17]

64. There are fundamental problems with utilizing the deemed long-term debt rate as a cap for all utilities. as recommended by several intervenors and possibly OEB Staff.

[16] OEB Staff Submission, p. 12.
[17] Concentric Report, pp. 38, 95 and OEA Argument at para 66.

First, there is no evidence in this proceeding that the current practice has been at any time problematic, and there is an absence of any material comments suggesting that the status quo should be revised. Second, the uncontradicted evidence is that the impact of applying a cap to Enbridge Gas and OPG could result in a material under recovery of their actual cost of Long-Term debt, denying the opportunity to recover prudently incurred costs.[18] Third, capping all utilities at the deemed debt cost would also not be reflective of the spectrum of credit ratings assigned to regulated utilities.[19] Finally, this recommendation would be contrary to the Board's 2009 Report which emphasized that utilities are expected to evolve over time and converge with the process used by the Board to determine the amount and cost of long-term debt for Enbridge Gas and OPG.

65. To the extent OEB Staff's recommendation is to continue the OEB's historic approach, then this approach is supported by the OEA.

66. Finally, while some parties support giving Enbridge Gas and OPG an opportunity to seek approval for a debt rate different than the DLTDR, none spell out the test or evidentiary onus that should be applied and how that test is different than the current standard. For example, would the utilities have to prove the unreasonableness of the DLTDR cap in addition to proving the reasonableness of their forecasts? In general, this recommendation will create additional regulatory burden and increase the risk to Enbridge Gas and OPG of not recovering in rates prudently incurred costs.

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

67. OEB Staff, CCC, EDA, SEC, and VECC recommend that the OEB continue with the current methodology of recovering transaction costs associated with long-term debt through the embedded cost of long-term debt. Actual debt-related costs are currently recovered as a component of interest expense, amortized over the life of the debt instrument using the effective interest methodology. SEC notes that the irregularity

[18] $13.09 million for the years 2022 and 2023 in respect of Enbridge Gas and $6.2 million for the years 2019 – 2024 in the case of OPG, Exhibit K1.1, pages 86 & 87.
[19] This is further discussed in the OEA's argument paragraphs 55-78.

associated with the frequency and amount of debt issuance, which LEI references in its report, is a reason to amortize transaction costs as an interest expense over the term of the debt instrument.

68. CCMBC, CME, and Energy Probe support LEI's recommendation to add transaction costs as operating expenses in the revenue requirement. The actual costs incurred by a utility would be tracked, allowing for compensation from the transaction to match the costs of the transaction.

69. AMPCO-IGUA, APPrO, CFN – MCFN, and TFG & Minogi did not comment on this issue.

Recommendation of the OEA:

70. There should be no change to the current approach that was adopted in the 2009 Report and used for years prior. Debt issuance costs are a legitimate cost of funding the operations of the utilities and should be recovered in rates through the embedded cost of long-term debt as is the OEB's current practice. LEI's approach, as adopted by several of the intervenors, is at odds with their own principles of "transitioning away from the status quo only if the associated benefits are material" and "fairness in approach to consumers and utilities". LEI does not present any compelling reason to deviate from the status quo.

71. LEI's recommended approach also violates sound ratemaking and accounting principles. Recovering issuance costs over the life of the associated debt is consistent with the principle that costs follow benefits, by spreading the cost to all ratepayers who benefit from the debt. Recovering lumpy issuance costs could lead to intergenerational inequity with customers paying for costs they don't benefit from. This is also the appropriate treatment under generally accepted accounting principles (GAAP).[20] Finally, there could be implementation complexities in transitioning from the existing method in a manner that ensures that unamortized balances associated with past transaction costs continue to be recovered.

[20] OEA Argument at paras 79-82.

Issue #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?

72. OEB Staff, CCMBC, and Pollution Probe state that they agree with continuing the status quo approach, i.e., considering the deemed capital structure in setting the cost of capital regardless of the actual capital structure. Energy Probe did not submit a response specifically on this issue but states that it agreed with CCMBC's submissions.

73. SEC submits that if the OEB uses a deemed capital structure, the appropriate approach is to apply a utility's actual weighted average cost of debt to any notional debt, subject to prudence considerations of the actual cost, consistent with the OEB's decision in OPG's 2011-2012 payment amounts proceeding (EB-2010-0008).

74. VECC submits that ratepayers "should not be at risk for utilities with significant variance between the actual and rate making capital structure". In addition, VECC submits that the OEB should adjust the policy for pricing notional debt and it should always be assumed that ratepayers receive the benefit of the optimum portfolio of debt, with any risk of deviating from regulated capital structure borne by shareholders; i.e., if a utility has more debt, the highest-cost debt should be prorated and eliminated until it meets the regulated amount; conversely, the OEB should price any variance below the regulated amount at the price of the lowest cost of debt in the portfolio. VECC finally submits that the OEB should choose a band of 5-10% for the deviation from regulated debt ratio, to apply the current policy of how to price notional debt.

Recommendation of the OEA:

75. OEA and Concentric recommend that variances from the deemed capital structure should not be taken into account when setting a utility's cost of capital. The OEA agrees with OEB Staff, LEI, CCMBC, and Pollution Probe on this matter. As Concentric points out, the deemed capital structure should determine the debt and equity costs that are recovered in rates, and Ontario's regulated utilities should continue to be given the discretion to manage their actual capital structure within reasonable bounds. This is particularly important for periods between rebasing of the capital

structure, and important for the utilities to be given latitude in managing their credit profiles and accessing the debt and equity markets when conditions warrant.[21] OEA also generally agrees with SEC's position that notional debt should be costed at the actual weighed average cost of debt. However, utilities should be allowed to come forward with alternative proposals in their rates applications.

76. VECC's argument that the utility should bear any risk of deviating from the deemed capital structure is arbitrary and ignores the fact that utilities require discretion in managing their capital structures to maintain credit ratings and take advantage of favorable markets, which ultimately benefits the ratepayers. Plus, the OEB has a mechanism to assess whether debt costs are prudently incurred, and a broad proclamation in this proceeding that all deviations from the deemed capital structure are borne by shareholders is not necessary or appropriate. Furthermore, VECC's argument is at odds with the OEB's historical practice for entities such as OPG, whereby the weighted average cost of actual debt has been consistently used to price notional debt. In fact, together with OEB Staff and SEC, VECC took the position in OPG's EB-2010-0008 proceeding that "the rate used for the notional debt should, all else equal, attract the same rate as OPG's actual long term debt".[22] As such, the OEA disagrees with VECC's position.

Return on Equity (Issues 10-11)

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

77. The parties vary widely on their suggested methodologies and inputs to those methodologies for determining a return on equity ("**ROE**") that meets the FRS. In general, the parties are divided amongst consumer groups and utility groups. OEB Staff has not picked any one expert's methodology but instead provided a middle ground suggestion to the Board on the recommended base ROE.

---

[21] Concentric Report p. 40, OEA Argument at paras 83-85.

[22] EB-2010-0008, Final Submissions of Vulnerable Energy Consumer Coalition, December 6, 2010, p. 6. Furthermore, it may not even be practically possible to apply VECC's proposal to an entity such as OPG that operates regulated and unregulated businesses within the same entity given that the entity's actual capital structure is managed as a whole.

78. There are disputes both on the methodology of reaching a recommended ROE and the resulting ROE. The discussion below begins by reviewing the disputes on methodology including the critical inputs with respect to each methodology. Following that is a discussion of the parties' ultimate conclusions with respect to base ROE recommendations.

A. The Use of Multiple Models

79. At the highest level there is some, but little, dispute with respect to the models that should be used to determine the base ROE. There are three models considered by the parties and their experts. The Capital Asset Pricing Model ("**CAPM**"), the Discounted Cash Flow Model ("**DCF**") and the Risk Premium model.

80. All experts except for LEI propose an averaging of the results of each model. LEI instead proposes that only the CAPM model be used – it is an outlier in this respect.

81. SEC, CCC, OEA, EDA and VECC, agree that the ROE should be set using the average of all three models.

82. While AMPCO and IGUA do not comment specifically on the use of multiple models, they proffer and advance the evidence of Dr. Cleary who uses multiple models. Further, AMPCO and IGUA reference and endorse the submissions of the SEC and CCC which endorse the use of multiple models.

83. The following entities did not specifically address the appropriateness of using multiple models: CFN, MCFN, CCMBC, TFG and Minogi, APPrO and Energy Probe.

84. CME argues that Dr. Cleary's Risk Premium model should be preferred. They are the only party to do so. Not even Dr. Cleary himself supports this position. Rather, Dr. Cleary maintains that an averaging of the three models should be used. While CME argues that the CAPM and DCF models have vulnerabilities, this is consistent with Concentric's view and is precisely why Concentric recommends an averaging of three different models – each model has its limitations and so a review of the three models

and averaging of their results assists in accounting for each individual models' inherent limitations.

85. Despite proffering LEI as an expert witness – the only witness to advance a singular model theory – OEB staff takes the position that 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."[23] As a result, not a single party argues for LEI's approach of using solely the CAPM to determine the recommended base ROE.

86. There is virtual consensus that the use of multiple models is the most appropriate methodology for determining the base ROE.

B. Proxy Group Composition

87. A key input in each of the methodologies is the selection of proxy groups. Of the four experts, only Dr. Cleary argues that a proxy group should be made up exclusively of Canadian companies. All the other experts agree that it is appropriate and a necessary component of meeting the FRS to use proxy companies from across North America. This is consistent with the Board's 2009 Report and other Canadian jurisdictions.

88. The OEA and EDA support the use of North American Proxy groups and endorse their respective experts', Concentric and Nexus use of North American Proxy Groups. This view is consistent with the Board's 2009 Report and that of other Canadian Regulators:

(a) In the 2009 Report, the Board was among the first regulators in Canada to find that the use of U.S. companies and U.S. data to set the authorized returns for Canadian electric and gas utilities is appropriate.[24]

[23] OEB Staff Submissions at p. 17.
[24] 2009 Report at p. 21-23.

(b) Both the BCUC and the AUC have also accepted the use of a North American proxy group comprised of utility companies in both Canada and the U.S. to set authorized ROE for utilities in their jurisdiction.[25]

(c) The AUC also recently developed a set of screening criteria for purposes of selecting a proxy group of companies that could be used to estimate the cost of equity for Alberta's electric and gas utilities. The large majority of companies chosen by the AUC for the comparator group (28 out of 33 companies, or almost 85 percent) were either U.S. electric or U.S. gas utilities (or both).[26]

i. OEB Staff

89. OEB Staff does not take an explicit position on the use of North American proxy groups. However, it proffered the evidence of LEI who agreed that it was appropriate, and in fact, necessary to use North American proxy groups. OEB Staff acknowledges that the 2009 Report confirmed that:

(a) "like" does not mean the "same" and that 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"; and

(b) The 2009 Report specifically rejected the suggestion that US data be ignored, finding instead that "the US is a relevant source for comparable data."

ii. SEC Submissions

90. SEC concedes that it is appropriate to use North American proxy groups. It argues for a modified Concentric proxy group that removes companies with generation assets and material unregulated operations. This group uses North American

[25] British Columbia Utilities Commission, Decision and Order G-236-23, September 5, 2023, p. 16; AUC Decision 27084-D02-2023, October 9, 2023, at para 99-104.
[26] AUC Decision 27084-D02-2023, October 9, 2023, at para 99-104.

companies.[27] While the OEA does not concede that it is appropriate to eliminate these companies from the proxy group, the evidence is that this adjustment would only move the average ROE results for the North American combined proxy group from 10.1% to 9.7% based on a 45% equity thickness.[28] As Concentric noted in its report, re-levering its CAPM results to a 40% equity thickness resulted in a required increase of 138 to 163 basis points, which would increase a 9.7% ROE to between 11.08 percent and 11.33 percent.

91. The removal of companies with generation assets or material unregulated assets from the proxy group is inappropriate. No expert in the proceeding agrees with this approach. Even Dr. Cleary's evidence includes companies with a wide variety of assets including, U.S. assets, generation assets, and unregulated assets. Removing these entities from Dr. Cleary's proxy group would eliminate all but one company.

92. Most importantly, from an investor's perspective, these are regulated utility companies. Using an operating income measure, Concentric's Electric proxy companies range from 94% - 100% regulated; the gas proxy companies range from 83% to 100%, and the North American electric and gas proxy groups range from 88% – 102% regulated.[29] It is inappropriate for SEC, who did not provide any expert evidence in this proceeding, to advance an argument based on an assumption that none of the experts advance or support.

iii. IGUA and AMPCO Submissions

93. AMPCO and IGUA appear to distance themselves from their own expert, Dr. Cleary, who opines that U.S. comparators are not appropriate. In its argument, they state that while it would be reasonable for the Board to use only Canadian comparators,

[27] SEC Submissions at p. 42.
[28] Concentric's analysis using the CAPM model determined that an upward adjustment to the allowed ROE of 0.64% to 1.63% is required if the OEB were to retain the existing allowed equity ratios of 38% (Gas), 40% (Electric) and 45% (Electric Generation).
[29] Concentric Exhibit CEA-2.

it should at the very least exercise caution in placing significant weight on U.S. capital market considerations.[30]

94. IGUA and AMPCO's primary argument against U.S. proxy groups is an end-run attempt around the Standalone Principle. As explained above in relation to Issue #1, AMPCO and IGUA take the position that because municipally owned utilities cannot issue more than 10% of their own equity to foreign third parties without attracting negative tax consequences, it is not appropriate to compare them to U.S. entities.

95. First, if the Board accepts the position of the vast majority of parties that the Standalone Principle should remain in place, this argument must be rejected. Changing the comparator group on the basis of who owns the utility is in direct conflict with the Standalone Principle. The result would be that the recommended ROE would be dependent on the source of capital and type of ownership.

96. Second, it is not for IGUA and AMPCO who have not provided any evidence on the tax consequences to municipally owned utilities, to advance an argument that the tax consequences of an equity raise in the U.S. would be prohibitively expensive. Further, IGUA and AMPCO did not put this proposition to any of the experts on examination. While there would be tax consequences to a foreign equity raise above 10%, it remains possible for utilities to do so, and AMPCO and IGUA's speculation on this issue should be given no weight.

97. The Board should resist AMPCO and IGUA's end-run around the Standalone Principle.

iv. OEA Conclusion on Proxy Groups

98. Concentric described its process for assembling six groups of comparable companies in its report at pages 45-50. Concentric's proxy groups were screened to provide groups that in Concentric's expert opinion are sufficiently comparable utilities with which to make inferences about the cost of capital for Ontario utilities. As Concentric states in its report, "[t]he companies in the North American Electric, North

[30] IGUA and AMPCO Submissions at p. 8.

American Gas and North American Combined proxy groups were selected as being the most risk comparable to Ontario's regulated electric and gas utilities." Those groups included Canadian gas and electric companies and U.S. gas and electric companies. Importantly, all utilities in Concentric's proxy groups have predominantly rate-regulated operations, and all the utilities were also investment grade utilities (with the U.S. companies being further required to have BBB+ or greater credit ratings).

99. It is a requirement of the FRS that the return on capital should be comparable to the return available from the application of the invested capital to other enterprises of like risk.

100. In terms of the use of North American proxy groups, the evidence indicates that significant capital flows between Canada and the U.S. It would defy the FRS to limit the Comparable Return Standard to only Canadian entities when there are entities in the U.S. of like risk that are utilizing some of the same sources of capital.

101. There is ample evidence that the Canadian and U.S. economies and capital markets are highly integrated:

(a) According to the U.S. Department of State: "The United States and Canada enjoy the world's most comprehensive trading relationship, which supports millions of jobs in each country. Canada and the U.S. are each other's largest export market and Canada is the number one export market for more than 30 U.S. States." The magnitude and significance of trade between the two countries reflects the high degree of integration between the two economies.[31]

(b) As Concentric's analysis shows, several measures of the overall economic and investment environment in Canada and the U.S. show that, on balance, the economic and business environments of the two countries

[31] Concentric Report at p. 54; Citing U.S. Department of State, https://www.state.gov/u-s-relations-with-canada.

are highly integrated and exhibit strong correlation across a variety of these metrics, including GDP growth and government bond yields.[32]

(c) Concentric's experience suggests that equity analysts perceive the U.S. and Canada as part of an integrated North American market for capital. This is demonstrated by a March 2019 report by equity analysts at Scotiabank indicating that they view the regulatory environments in Canada and the U.S. as being similar for regulated utilities. In explaining why, they expect the valuations of Canadian and U.S. utilities to converge, Scotiabank observed: "Canadian and U.S. valuations should converge. Historically, the Canadian utilities have traded at a premium to their mid-cap U.S. peers. We attribute this to the historical view that Canadian regulation was superior to U.S. regulation (***we no longer have that view***) as well as to strong earnings growth in part due to M&A."[33]

(d) Concentric has provided evidence of significant sums of Canadian capital being used to acquire U.S. Utilities. Between 2001-2024, Concentric observes at least $61 billion in Canadian capital flowing to the U.S. utility markets.[34] A specific recent example of this is the acquisition by Enbridge Inc. from Dominion Energy Inc. of three natural gas distribution companies in the U.S. Enbridge Gas is therefore now competing for capital directly with its U.S. affiliates. There should therefore be no question of the relevance of these U.S. utilities as appropriate proxies as combined they are comparable in size to Enbridge Gas.

(e) Several Canadian based utilities trade on U.S. centralized exchanges, showing that these companies are competing against U.S. based companies on the same exchanges for capital.[35]

[32] Concentric Report at p. 54; See also Concentric Exhibit CEA-3.
[33] Exhibit N-M2-12-OEB Staff-19 at p. 2 of 3.
[34] Exhibit N-M2-10-AMPCO/IGUA-5 at p. 3 of 4.
[35] See for example, Fortis Inc.,

102. SEC explicitly accepts "that there is an integrated Canadian-U.S. capital market, and that investors will look to both Canadian and U.S. companies to deploy their capital.[36]

103. The Board should not change its long-standing methodology of using a North American proxy group. The North American utility industry is integrated in such a way that both U.S. and Canadian investors are critical to an analysis of Ontario utilities' ROE. In order to meet the FRS, the Board must take into account the comparable returns of U.S. participants in the North American utility industry.

104. Further, contrary to the submissions made by SEC and other parties, the base ROE established in this proceeding should presumptively apply to all regulated Ontario utilities. This presumption is not altered by Concentric's recommendations that should OPG bring forward a proposal and evidence in its payment amounts application regarding whether and what amount of additional risk premium should be applied to its authorized ROE that the OEB consider. This recommendation for the additional risk premium is meant to address the fact that OPG's risk profile does not have direct comparators in the proxy groups based on its pure play rate regulated generation operations. It is therefore an inappropriate reason to exclude any utilities from the proxy group analysis.

105. In addition, VECC is misled in its argument that Concentric's (and other experts') proxy groups incorrectly did not distinguish between "electric utilities that are primarily involved in generation vs. those that are primarily involved in electric transmission and distribution" because none of the utilities in any of the experts' proxy groups are "primarily" involved in regulated electric generation. Rather, the utilities in Concentric's proxy groups that own generation assets are still primarily involved in electric transmission and distribution because they are "vertically integrated" utilities that generate, transmit, and distribute power. While they have exposure to generation-

[36] SEC Submissions at p. 15.

related risk, they are subject to regulation, which is a primary consideration for utility investors.[37]

106. The error in attempting to overly engineer the proxy groups was demonstrated in cross examination of Dr. Cleary, where it was demonstrated that Dr. Cleary's proxy group of companies, which "met those criteria that were deemed desirable,"[38] included utilities with significant generation exposure, significant non-Canadian operations, and significant unregulated operations. Eliminating companies with generation and unregulated operations would result in a proxy group of two,[39] which no expert supported in this proceeding and that intuitively does not provide a sufficient basis on which to determine the cost of capital for Ontario's diverse utilities.

107. This point is further accentuated by the fact that no intervenor party sought to eliminate natural gas companies for establishing the ROE for electric T&D companies and visa-versa. Such parsing of the proxy groups runs counter to the underlying premise of a generic base ROE and should be rejected by the Board.

C. The CAPM

108. The CAPM estimates ROE by adding a utility risk premium to a risk-free rate. The utility risk premium is calculated by multiplying a beta (a measure of risk relative to the overall market) by the market risk premium ("**MRP**") (which represents the average return above the risk-free rate that investors typically require).

109. Each of the three inputs, the risk-free rate, beta and the MRP are debated amongst the parties.

i. Risk-Free Rate

110. SEC, AMPCO and IGUA, and CCC argue that each of the approaches used by LEI, Concentric and Nexus to calculate the risk-free rate is flawed. The debate hinges on the use of forecasted bond-yields or actual bond-yields. Each of these parties

[37] VECC Submission, at page 32.
[38] October 10, 2024 transcript, at page 121.
[39] AMPCO/IGUA Response to Undertaking J6.1.

endorses Dr. Cleary's approach of using the actual 30-year Government of Canada bond yield.

111. All of the remaining experts use a forecasted risk-free rate. The logic is simple – returns are inherently forward looking and so too are investors when they assess potential returns. Forecasts seek to harness known information to project future rates of returns, just as investors do, and investors consider forecasted information when making investment decisions. The exercise of ensuring utilities achieve a fair return is also forward looking. The Board's goal in this proceeding should be to, as best it can, ensure the FRS is met between now and the next cost of capital review. In doing so it should use the forward-looking tools available to it – forecasts.

ii. Betas

112. First, each party used their respective peer group to source their betas. The parties' position on the appropriateness of doing so mirrors the discussion above with respect to the use of North American proxy groups. While the entire discussion need not be repeated here, SEC, AMPCO and IGUA and CCC take the position that the use of North American proxy groups to source betas is flawed and endorse Dr. Cleary's view that only Canadian companies should be used.

113. For the same reasons outlined above, it is appropriate and necessary to use North American proxies to determine an ROE that meets the FRS.

114. Second, SEC, AMPCO & IGUA and CCC criticize Concentric's and Nexus' use of Blume adjusted betas. The Blume adjusted beta is meant to address the empirical evidence that betas migrate towards 1.0 over time and do indeed exceed their long-term unadjusted averages. Given that the CAPM is intended to estimate the forward-looking cost of capital, it is important to reflect a forward view of beta and its tendency to migrate towards the market mean over time, which is not limited to the long-term historical average of the industry beta.[40]

[40] Concentric Report at p. 67.

115. Finally, the consumer groups favour Dr. Cleary's beta estimates because it is "a more rigorous approach."[41] A simple review of Dr. Cleary's evidence shows that no rigour at all was applied to his beta estimate, and it was in fact a judgement call based on a ballpark reference to market data.

116. Dr. Cleary contends that historical evidence establishes a range of reasonable beta estimates for Canadian utilities with a lower bound of 0.30 and an upper bound of 0.60. Then he recommends, with no explanation, that the Board "make a simple judgment based on current beta estimates".

117. Dr. Cleary reviews the weekly and monthly beta estimates as of December 31, 2023, and over the last seven years. As of December 31, 2023, the weekly and monthly beta estimates for 2023 were 0.668 and 0.581 respectively. The last year's weekly and monthly beta estimates were 0.658 and 0.513. The average of these four betas is 0.60. Despite this, and with his only reasoning being that these figures are too high, Dr. Cleary concludes that he will use his usual estimate of 0.45.[42]

118. Dr. Cleary's results lack rigour and defy observable beta metrics. There is no empirical evidence for the use of a beta of 0.45. The Board should be highly skeptical of Dr. Cleary's use of such a low beta, which lacks empirical support, especially when his own evidence shows that unadjusted betas have increased for utilities in recent years. To be clear, it is submitted that there is no evidentiary basis for Dr. Cleary's "usual" recommendation of 0.45 and therefore no justification for its acceptance.

iii. The Market Risk Premium

119. SEC criticizes Concentric's use of historical average MRP for both Canada and the U.S because "they are unreasonably high." The only support for this conclusion is Dr. Cleary's view that Concentric's use of the arithmetic average and income-only returns for bonds instead of total returns does not align with standard practice.

---

[41] SEC Submissions at p. 32.
[42] Cleary Report at p. 92.

120. Contrary to SEC and Dr. Cleary's views, the use of arithmetic averages and income only returns are standard industry practice for calculating historical equity returns. The historical MRP is based on the arithmetic mean of the equity market returns for large company stocks over the income only return on long-term government bonds, based on data from Kroll (formerly Duff & Phelps). This source of market returns is widely used by investors and provides a conservative (low) estimate compared to currently projected market returns.[43]

121. SEC, APMCO and IGUA and CCC endorse Dr. Cleary's view that an MRP of 5% is appropriate as it represents the midpoint of the 4-6% range that Dr. Cleary asserts is typically used by market professionals. Again, Dr. Cleary's estimate lacks analytical rigour and amounts to an approximation and judgement that results in a lower estimate than any of the other experts. LEI utilized an MRP between 7.28% - 10.16%, Nexus estimated an MRP of 8.8%, and Concentric estimated an average U.S. and Canadian MRP of 6.42%.[44] Dr. Cleary's MRP is an outlier that should be given no weight.

D. Discounted Cash Flow Model

122. The DCF model requires the input of a growth estimate. This is the primary driver of differences in the expert's conclusions and the key area of dispute amongst the parties as it relates to the DCF model.

123. Concentric's growth estimates are based on analysts' estimates of earnings growth for companies in its proxy groups but revert to long-term GDP growth in order to mitigate any concerns for optimism bias. SEC, AMPCO & IGUA and CCC adopt Dr. Cleary's criticism that relying on analysts' growth rates is inappropriate due to what he claims is a well-documented bias. As Dr. Cleary surmises, analysts generally represent seller of securities, not buyers, who fall victim to optimism bias which inflates growth rates.

124. This surmised bias is without basis. Concentric addressed this concern in an answer to an undertaking by stating the paper that Dr. Cleary relies on as evidence for

[43] Concentric Report, p. 69.
[44] LEI Report p. 120, Nexus Report p. 63, and Concentric Report p. 69.

this bias was published in 2006, using data from 1993-2004, which precedes the regulatory reforms addressing potential conflicts of interest in equity analyst opinions. Further, Concentric points out that in a textbook authored by Dr. Cleary and Dr. Booth, they explain that the two-stage DCF model mitigates concerns about analyst bias. This is the approach Concentric utilizes in its analysis and recommendations in this case.[45]

125. There is no reason to believe that the analysts' growth rates used by Concentric in this proceeding are the product of bias or are artificially inflated.

E. Flotation and Financial Flexibility Costs

126. It is common practice for Canadian regulators to account for a utility's equity transaction cost (flotation) and their need for financial flexibility, with a 50 basis points addition to the ROE. The Board included this adjustment in the 2009 Report. LEI is the only expert who is recommending that the authorized ROE for Ontario's utilities should not be adjusted for flotation costs and financial flexibility.

127. The parties' position on flotation and financial flexibility costs are generally split between the consumer groups and the utility groups. SEC, CCC, VECC and CME argue that flotation costs should be separately sought for recovery, for example through a deferral account, while the utility groups support the continued inclusion of flotation and financial flexibility costs as part of the base ROE. CFN, MCFN, TFG and Minogi do not take a specific position on this issue.

128. OEB Staff takes the primary position that there should not be an "adder" for flotation costs to the ROE. However, it acknowledges "another option" between the consumer groups and utility groups of reducing the adder to reflect actual transaction costs more closely. OEB Staff state: "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."[46]

---

[45] Exhibit N-M2-10-AMPCO/IGUA-6, see answer (a).
[46] OEB staff Submissions at p. 26.

129. Pollution Probe suggests that the OEB could decide to leave the 50 basis point ROE "adder" in place for convenience or use a 25 basis point adder and allow utilities to come forward with evidence in their rates proceeding should they want to request approval of a higher value.

130. OEB staff and the SEC point to the BCUC's recent decision which stopped the historical practice of a 50 basis points flotation cost in the ROE. However, as SEC acknowledges, the BCUC did not do away with the concepts of flotation and financial flexibility generally. Instead, the BCUC ruled that Fortis (a utility regulated by the BCUC) may recover actual costs incurred for flotation by providing supporting documentation ***and*** that financial flexibility should be accounted for through in its consideration of equity thickness.[47] This was a factor in the BCUC's decision to raise Fortis' equity thickness.

131. OEA's position remains that a 50 basis points addition to the ROE is justified, administratively efficient and is required to meet the FRS. The OEA submits that the best evidence is, as noted by Concentric[48], Dr. Roger Morin's text: "New Regulatory Finance" wherein he cited a 1996 study by Lee et. al., which found that the average flotation costs for regulated utilities are equal to approximately 5% of the gross proceeds of the equity issuance, with smaller issues tending to have a higher percentage. This is consistent with recent research by the Enbridge Treasury team, which found that the average flotation costs for a sample of Canadian and U.S. utilities were also equal to slightly more than 5% of the gross proceeds.

132. A flotation and financial flexibility adjustment to the ROE is required to meet the FRS because to eliminate that adjustment would reduce utilities' access to capital and would put them at a relative disadvantage to peers, failing the comparability standard of the FRS. The key takeaway from the BCUC decision is that even where an adder is removed for flotation, an adjustment remains necessary to account for financial flexibility. That adjustment could be made to the deemed equity thickness or the ROE, but it must be accounted for, particularly given Energy Transition risks related to capital

[47] British Columbia Utilities Commission, Generic Cost of Capital Proceeding (Stage 1), Decision and Order G-236-23, September 5, 2023, pp. 125-126.

[48] Exhibit N-M2-10-OEB Staff-16.

requirements. For example, each 25 basis points reduction in ROE is equivalent to an approximate increase of 2.5%-3% of equity thickness. Neither OEB Staff nor any of the opposed consumer groups address this issue.

F. The Risk Premium Model

133. The Risk Premium model estimates ROE by determining a risk premium and adding it to a bond yield to measure the additional return an investor requires for investing in equity rather than debt.

134. SEC, AMPCO and IGUA and CCC criticize Concentric's method of determining the risk premium on the basis that it uses allowed ROEs in other jurisdictions and that using U.S. data is inappropriate because it mainly comprises vertically integrated utilities.

135. First, this criticism ignores the fact that Concentric conducted a risk premium analysis using 60 Canadian ROE authorizations from 1994 through 2023. That analysis provided further support for Concentric's use of the figures derived from the U.S. proxy group as they were not materially different.[49]

136. Second, all experts but LEI rely on a risk premium approach. The approach used by Concentric is intuitive and values the extensive track record of regulatory decisions in both the U.S. and Canada (Concentric estimated both US and Canadian versions of the model). Investors have access to this same data and would clearly be influenced by these decisions in forming their views of expected returns.

137. Several parties, including IGUA and AMPCO, CCMBC, SEC and Energy Probe rely on Dr. Cleary's risk premium analysis.

138. Dr. Cleary's risk premium analysis is void of any empirical evidence. Dr. Cleary simply asserts that an appropriate risk premium range is 2-5%. Then he asserts that 3.5% is commonly used for average risk companies and because Canadian utilities are

[49] Concentric Report at p. 79.

"low risk" the best estimate is 2.5%. These suppositions should not be accepted by the Board.

139. The only support Dr. Cleary cites in his expert report for this analysis is an excerpt from the "CFA Curriculum" where "a risk premium of 2.75% is added to cost of IBM's debt" and "[c]learly IBM is riskier than a regulated A-rated utility, so 2.5% is very reasonable by comparison."[50]

140. As shown on cross-examination this source is simply an example question from a CFA textbook intended to help students understand how to apply the risk premium method – it is not empirical evidence of IBM's risk premium or, more importantly, the risk premium relevant to Ontario utilities today. This is another example of the lack of rigour brought to Dr. Cleary's report. This is inappropriate and should be rejected for the purposes of setting the cost of capital for Ontario utilities.

G. Conclusion on Recommended ROE

141. The parties take varying approaches to argue for a recommended base ROE. They are not all consistent with the recommendations of the four experts. The merits of these arguments are addressed below. However, the discussion above and the OEA's previous written submissions about the differences in each experts' methodologies makes clear that Dr. Cleary's analysis should not be given the same (or any) weight as the other experts in the Board's determination of the base ROE.

142. As seen below, Dr. Cleary's recommendation is an outlier:

Concentric	Nexus	LEI	Dr. Cleary
10%[51]	11.08%	8.88%	6.95%

[50] Cleary Report at p. 106, footnote 66.
[51] In response to an undertaking request from the Panel, the experts have updated their recommendations. Both Nexus and Concentric found that the updated figures did not materially affect their recommendations.

143. Dr. Cleary's recommendation appears to have been designed in anticipation of the Board conducting an averaging of each recommendation – it is not a standalone figure that meets the FRS on its own.

144. APMCO and IGUA advance the argument that Dr. Cleary's recommendation is the only recommendation that is below the expected average Canadian equity market return, and because utilities are widely considered less risky than the market, the base ROE should be less than the expected average Canadian equity market return. This argument is fundamentally flawed.

145. The argument relies on Dr. Cleary's own evidence that the expected average Canadian equity market return is 7.5%.[52] There is no evidence supporting this market return, besides Dr. Cleary's supposition. In fact, Dr. Cleary's supporting evidence shows that the average total return for the Canadian market from 1938-2023 was 10.97% and the median was 11.05%.[53]

146. Dr. Cleary has not provided any explanation as to why the average return in the future will be 3.5% lower than the long-term historical average over the past 85 years, and, even if his judgement were accepted, how this market return applies to a regulated return for Ontario's utilities.

147. When put into perspective, the average historical return of 10.97% is consistent with Concentric's recommended base ROE of 10% and accounts for the fact that utilities are generally considered to be less risky than the overall market.

148. The Board should not place any weight on Dr. Cleary's outlier opinion because he compares his recommended base ROE favourably to his own supposition about the future returns of the Canadian market.

i. OEB Staff's Approach

149. OEB Staff argue that the Board does not need to select a single expert, or a single methodology or even critically assess the inputs of each model. Instead, OEB

[52] Cleary Report at pp. 80-84.
[53] Cleary Report Attachment A, Table 6, Rows 92-93 of column B on Sheet 1.

Staff argue for a “triangulation” of the recommended base ROE by making certain adjustments to each experts’ recommendation and applying a weighted average.

150. OEB Staff’s starting point is the simple average of the experts’ recommendations, which equals 9.27%.[54] However, OEB Staff recognizes that this would be an oversimplification, so they make several adjustments:

(a) First, they adjust Concentric’s recommendation based on the fact that it reflects a 45% equity thickness. Specifically, OEB Staff relies on Concentric’s statement that the maintenance of deemed equity ratios of 38.0 percent for Enbridge Gas and 40.0 percent for Ontario’s electric transmission and distribution utilities would necessitate an upward adjustment to Concentric’s recommendation, which Concentric estimates at 138 to 163 basis points. As such, OEB Staff adjusts Concentric’s ROE based on the midpoint of that range to 11.51%, and then calculates a simple average across experts of 9.65%.[55]

(b) Second, OEB Staff’s position is that the 50 basis points adder for flotation costs should be removed from each experts’ recommendation. So, OEB Staff simply removes 50 bps from each of the recommendations (except for LEI who does not apply an adder). Based on that adjustment, OEB Staff calculates an average of 9.32%.[56]

(c) Third, OEB Staff argues that because the utility experts outnumber the consumer experts 2-to-1, they should use a composite of Concentric and Nexus’ recommendations as a single figure in the averaging exercise. This produces an average of 8.79% (when the 50 basis points adder is excluded).[57]

[54] OEB Staff submissions at p. 17
[55] OEB Staff submissions at p. 18.
[56] OEB Staff Submissions at p. 19.
[57] OEB Staff Submissions at p. 19.

151. The result is that OEB staff recommend a base ROE between 9.32% and 8.79% - the difference being whether Concentric and Nexus' recommendations are used as a composite in the averaging exercise.

152. The Board should resist OEB Staff's approach. OEB Staff's averaging methodology lacks any analytical utility or critical assessment of the experts' varying approaches. Under OEB Staff's approach, there is no way for the Board to disagree with a certain expert's methodology or inputs. Instead, the Board should take a more detailed and analytical approach to the assessment of each expert's recommendation. Further, if OEB Staff's averaging approach is adopted by the Board, it could incentivize extreme positions by parties in future cases to "game" the outcome.

153. While the OEA does not endorse an averaging exercise and continues to endorse Concentric's base ROE recommendation of 10%, if the Board is inclined to accept OEB Staff's approach, it should do so with the following flaws addressed.

154. First, it is not appropriate to simply reduce Concentric's final recommendation by 50 basis points to reach an average without flotation and financial flexibility costs. In Concentric's calculation the flotation and financial flexibility cost adjustment is only added to the CAPM and DCF models; it is not added to the Risk Premium model. While the OEA does not accept that the 50 basis points adder should be removed, to do so properly requires removing it only from the two models it was added to in the first place, and re-averaging all three models. Staff recognizes this need.[58] Removing flotation and financial flexibility costs from Concentric's analysis, as OEB Staff recommends, reduces the average result by approximately 34 basis points, not a full 50 basis points.

155. Second, it is not appropriate to calculate an average using a composite of Nexus' and Concentric's recommendation. Nexus and Concentric are wholly independent and came to their conclusions and recommendations separate and apart from each other. If anything, the fact that two experts separately arrived at similar recommendations should give the OEB greater confidence in the recommendations made. As explained above, Dr. Cleary's evidence is an outlier and should not be given any weight, and especially

[58] Staff Argument, p. 18, footnote 82.

should not be given more weight by virtue of counting Concentric's and Nexus' recommendations as a single value in the average.

156. The record supports a determination that Dr. Cleary's recommended ROE would clearly not meet the FRS. As it is consistent with his recommendations made before other regulators, this undoubtedly explains why his recommendations in respect of regulated ROE's have not been accepted in any jurisdiction in Canada. The OEA therefore finds it surprising that OEB Staff would propose an averaging exercise where one of the figures it proposes to use does not meet the FRS. It is submitted that using Dr. Cleary's outlier figure would taint the exercise and make the resulting average more open to the argument that it is also in breach of the FRS.

157. The table below shows the average of the experts' recommendations making those two adjustments to OEB staff's figures. Note, while Concentric's recommendation is a 10.0 percent base ROE using a 45% minimum equity ratio, OEA has reflected Staff's recalculation of Concentric's recommendation based on re-leveraging to a lower equity ratio of 40% so as to show the corrected version of OEB Staff's proposal.

Expert	**ROE (with 50 bps addition)**	**ROE (without 50 bps addition)**
Concentric	11.51	11.17
Cleary	7.05	6.55
Nexus	11.08	10.58
LEI	9.45[59]	8.95
Average	**9.77**	**9.31**

158. Further, as explained above, it is the OEA's position that Dr. Cleary's evidence should be rejected and given no weight. The table below illustrates the average of the remaining experts' recommendations:

[59] LEI's recommended ROE is 8.95 percent, excluding flotation costs. However, to put the experts' recommendations on a like-for-like basis, OEA has added 50 basis points to LEI's recommendation in the "with 50 bps adder" column.

Expert	ROE (with 50 bps adder)	ROE (without 50 bps adder)
Concentric	11.51	11.17
Nexus	11.08	10.58
LEI	9.45[60]	8.95
Average	**10.68**	**10.23**

ii. Specific ROE Recommendations

159. Several parties make specific ROE recommendations which are summarized and discussed below.

(i) SEC's Recommended ROE

160. SEC recommends a base ROE of 7.58%. This recommendation is endorsed by CME. It does so based on the use of all three models, but by hand selecting the models' inputs. SEC reviews each of the experts' inputs and decides for itself, without any expert of its own, which inputs it will use in its own calculations.

161. Based on the position SEC takes above regarding the Risk Free Rate, Betas, MRP, Growth Rates and flotation and financial flexibility costs, it derives its own conclusions with respect to a recommendation.

162. As explained above, the SEC's position on these inputs is flawed, and ultimately designed to drive its recommended ROE figure down. The Board should be skeptical of this approach and recommendation that is unsupported by any of the experts in this proceeding.

(ii) AMPCO and IGUA's Recommended ROE

163. AMPCO and IGUA disagree with their own expert's recommended ROE. Dr. Cleary recommended the inclusion of a 50 basis points adder for flotational costs.

[60] LEI's recommended ROE is 8.95 percent, excluding flotation costs. However, to put the experts' recommendations on a like-for-like basis, OEA has added 50 basis points to LEI's recommendation in the "with 50 bps adder" column.

AMPCO and IGUA disagree and remove that amount from its recommended ROE. As such IGUA and AMPCO present the lowest recommended ROE of all the parties:

(a) 6.55%, if effective June 30; and

(b) 6.45%, if effective September 30.

164. Additionally, as outlined in the OEA's written submissions and above with respect to Dr. Cleary's inputs, there are clear and obvious flaws with Dr. Cleary's analysis. Dr. Cleary's evidence is that he views himself as an advocate for consumer groups and a necessary balancing presence.[61] That is not the proper role of an expert.

165. None of the other experts believe that Dr. Cleary's recommendations meet the FRS.[62] IGUA & AMPCO make no attempt to argue that its recommendation meets the FRS.

166. A reduction in the base ROE of this magnitude would cause a chilling effect across the Ontario utility industry, with unknown and potentially unprecedented implications. Dr. Cleary readily admits that his recommended ROE of 7.05% (50 basis points higher than AMPCO and IGUA's recommendation) could have a broad negative impact to the industry's credit ratings resulting in higher financing costs for the sector.[63] AMPCO and IGUA make no attempt to dissuade the Board that its recommendation would cause a chilling effect on the sector or that its recommendation does not meet the FRS.

(iii) CCC's Recommended ROE

167. CCC recommends a base ROE of 7.1%. CCC derives this figure by arguing that the Board should fundamentally change its approach to establishing the base ROE by transitioning away from a proxy-group based approach.[64] CCC argues that there are so few truly comparable companies that are publicly traded, which makes the use of proxy groups problematic.

---

[61] Transcript Oral Hearing Volume 6 at pp. 113-114.
[62] Transcript Oral Hearing Volume 1 at p. 88; Transcript Oral Hearing Volume 4 at p. 142.
[63] Transcript Oral Hearing Volume 6 at pp. 184-185.
[64] CC Submissions at p. 58.

168. In doing away with proxy groups, CCC argues that Dr. Cleary's CAPM and Risk Premium models are preferable because they do not use proxy group inputs. CCC then states that it "prefers" Dr. Cleary's risk premium model and adopts the results of that model as its conclusion. This conclusion is flawed and should be rejected.

169. First, all the experts in the proceeding, including Dr. Cleary in his DCF model, use proxy group inputs. The use of proxy groups is a well-established norm in economics and valuation, as well as in establishing regulated utility ROEs. The goal of proxy groups is not to find perfectly comparable companies but to find like comparators. CCC's conclusion that there are not enough comparable companies is incorrect and not based on any expert evidence. The Board should be skeptical of a recommendation provided not only in the absence of expert evidence, but in contradiction of all the expert evidence provided in this proceeding. All the experts in the proceeding, and in other proceedings across North America on the same topic area, use proxy groups to inform evaluation and assessment of market data.

170. Second, the frailties in Dr. Cleary's risk premium model have already been discussed above. The model lacks the necessary rigour and relies on crude sources such as example questions in the CFA textbook to arrive at his risk premium. It should not be relied upon in this proceeding.

171. Third, similar to Dr. Cleary's recommendation, a reduction in the base ROE of this magnitude would clearly not meet the FRS and could have significant and broad negative effects on the Ontario utility sector.

(iv) VECC's Recommended ROE

172. VECC recommends a base ROE of 7.73%. It reaches this conclusion by averaging certain expert's methodologies. In doing so VECC makes certain adjustments to some methodologies and entirely disregards other methodologies and experts which it disagrees with. For example, VECC removes Nexus from its averaging exercise entirely. It also removes the 50 basis points addition for flotation and financial flexibility costs.

173. The Board should be skeptical of VECC's adjustments and filtering of certain experts. VECC has not provided any expert evidence in this proceeding yet uses its judgement to subvert and alter the expert evidence in the record.

174. An example of the error in substituting VECC's judgment for expert judgment is VECC's determination that utility growth rates of 1.46 percent to 2.17 percent are "reasonable values as they have a basis in actual market data."[65] Such levels of growth are at or significantly below reasonable expectations for inflation. For instance, even assuming forward-looking inflation as low as 2.0 percent, VECC's "reasonable values" for growth rates would produce negative to barely-break-even real growth, which would clearly be untenable to investors.

175. Further, the simple averaging of disparate results, as VECC does in its CAPM analysis, lacks analytical usefulness. Specifically, VECC averages CAPM results that are different by more than 400 basis points, yet still concludes that both results are "the appropriate ones for the OEB to consider."[66] This again demonstrates the flaw in relying on VECC's substituted judgment.

(v) EDA's Recommended ROE

176. The EDA adopts Nexus' evidence and recommends a base ROE of 11.08%. This recommendation is based on a deemed equity ratio of 40%. While certain inputs and analysis differ from Concentric, when Nexus' recommendation is re-levered to a 45% equity thickness, it is not materially different from Concentric's recommendation of 10%.

(vi) OEA's Recommended ROE

177. In general, with a number of parties proposing a decrease in the base ROE, the OEA is concerned that a reduction in ROE will negatively impact the investment climate for Ontario utilities. The consequences of a reduction in ROE can be drastic, including credit rating outlook reductions or downgrades, and reductions in access to capital markets, both of which would ultimately increase costs to ratepayers. The above would be further amplified by and could hinder Energy Transition.

---

[65] VECC Submission, at page 41.
[66] VECC Submissions, at page 52.

178. The OEA continues to recommend a base ROE of 10% based on Concentric's evidence and a recommended minimum deemed equity ratio of 45%.

179. Simply put, Concentric's experience in regulatory policy, rate making, and cost of capital is unmatched in this proceeding and in the North American market at large. Concentric is the only expert in this proceeding that provided evidence in the Board's 2009 Cost of Capital proceeding and has framed its opinion by using the parts of the 2009 Report that have worked well, while proposing certain subtle evolutionary adjustments to better represent the market realities of today.

180. Concentric's recommendation was arrived at by making thoughtful and rigorous analytical decisions including at times a conservative approach which ultimately resulted in a more conservative ROE recommendation.

181. The OEA further submits that if the Board does not increase the minimum equity ratio to 45%, then its recommendation should be re-levered to a 40% equity thickness. The result is a recommended ROE in the range of 11.38-11.63%.[67] Further, if the Board concludes that there should be no change to the deemed equity ratio and that an averaging exercise is appropriate to determine the base ROE, which the OEA disagrees with, it should use the mid point of that range in any averaging calculation, which is 11.51%.

H. Ontario's ROE Formula

182. The current OEB formula is expressed as:

$$ROE_t = BaseROE + 0.5 \times (LCBF_t - BaseLCBF) + 0.5 \times (UtilBondSpread_t - BaseUtilBondSpread)$$

183. And it was implemented with the following starting values:

$$ROE_t = 9.75\% + 0.5 \times (LCBF_t - 4.25\%) + 0.5 \times (UtilBondSpread_t - 1.415\%)$$

[67] Concentric Expert Report, July 19, 2024, p. 71; Oral Hearing Transcript, September 26, 2024, p. 96 & 97

184. The Ontario formula began to produce returns that deviated from authorized returns elsewhere in Canada and the U.S. as yields on Canadian government bonds declined to historically low levels in 2020-2021. Because the Ontario formula is tied solely to changes in government bond yields and utility credit spreads, it did not reflect the uncertainty and volatility in capital markets that impacted equity investors more than debt investors. For example, the OEB's formula return in 2020 was 8.52 percent (or 20 basis points below the average authorized ROE for electric distribution companies in Canada) and 8.34 percent in 2021 (the lowest authorized ROE in Canada and 36 basis points lower than the average for electric distributors in Canada). As previously noted, these returns can last in rate plans for up to five years.[68]

185. Concentric's recommendations, which the OEA has adopted, with respect to the ROE formula are:

(a) Re-base the authorized ROE to 10.0 percent (assuming a 45% minimum equity thickness);

(b) Should OPG propose and provide evidence for an ROE risk premium applicable to its pure-play regulated generation operation in its payment amounts application, the OEB at its discretion consider that proposal as part of that proceeding;

(c) Adopt the AUC's methodology for setting the LCBF. Specifically, Concentric recommends that the LCBF be computed based on a weighted average of the projected 30-year GOC bond yield for the subsequent year as reported by RBC, TD Bank, and Scotia Bank (assigned 75% weight) and the current average 30-year GOC yield for the 90 days ending September 30 of each year (assigned 25% weight);

(d) Update the average credit spread between the 30-year GOC bond yield and the A-rated utility bond yield as of September 30, based on a 90-day average;

[68] Concentric Report at p. 93.

(e) Update the LCBF adjustment factor from 0.50 to 0.40; and

(f) Update the utility credit spread adjustment factor from 0.50 to 0.33.[69]

i. The LCBF

186. The OEA has adopted Concentric's recommendation for the LCBF, which is calculated based on a weighted average of 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 (75% weight) and the current 90-day average 30-year Government of Canada bond yield (25%) weight.

187. OEB Staff adopt LEI's recommendation which is to use the 30-year bond yield forecasts from the seven major Canadian banks.

188. While the recommendations differ slightly, OEB Staff and the OEA agree that the proper approach is to use a forecasted figure in the Ontario ROE formula.

189. SEC argues that the Board should abandon the use of the LCBF in the ROE formula and instead adopt the prevailing 30-year government of Canada bond yields. SEC suggests using the average of the last five days in September.

190. It makes little sense to base the inherently forward-looking ROE formula on actual bond yields without any consideration of forecasted bond yields. Investors' decisions are inherently forward looking – they want to know what they will earn in the future. The ROE formula should be consistent with investor expectations and, at least in some respect, be based on forecasts. Further, Concentric's suggested approach takes into account the actual bond yield averaged over the last 90 days by assigning it a 25% weighting in its formula. This was the same approach adopted by the AUC in October 2023 and is more representative of sound corporate finance and investment principles.

[69] Concentric Report at p. 103.

ii. Utility Bond Spread

191. The status quo to arrive at the utility bond spread is the average spread between a 30-year A-rated Canadian utility bond yields and the 30-year government of Canada bond yield for the month of September.

192. OEB Staff endorse LEI's proposal to keep the current formula but take the trailing 12-month average of Government of Canada bond yield as of September 30.

193. The OEA adopts Concentric's recommendation, which maintains the status quo but suggests the trailing 90-day average of the Government of Canada bond yield. This will help to smooth the results, and not place too much emphasis on a single market day, while also being a better representation of current market conditions.

iii. Adjustment Factors

194. OEB Staff agrees with Concentric's recommendation with respect to the adjustment factors in the formula and acknowledges that this is because the relationship between ROEs and government bond yields has weakened over the past fifteen years.[70]

195. SEC argues that the current adjustment factors should remain in place. It takes the position that the current factors are necessary to balance the impact of macroeconomic and market changes with the need for year-over-year stability. SEC does not address the OEA's position (supported by OEB Staff) that the relationship between ROEs and government bond yields has weakened since 2009. Instead, SEC argues that Concentric's regression analysis is flawed because it compares U.S. ROE decisions in part to U.S. government bond yields, and its regression fit measures are "weak".

196. The adjustment factors are designed with the consideration that the ROE does not move in lockstep with changes to the LCBF and the bond spread. Concentric's regression analysis shows that the relationship between utility ROEs and government bond yields has weakened over the past fifteen years. SEC has not, nor has any expert,

[70] OEB Staff Submissions p. 28.

provided evidence that this is false. And so, it follows that the adjustment factors should recognize this weakened relationship by being adjusted downward. The use of U.S. data in the regression analysis is a principled and analytical way of achieving that adjustment.

197. OEB Staff provides another way of recognizing the weakened relationship between ROEs and government bond yields by averaging the adjustment factors from the 2009 Report and LEI's proposal. The results are consistent with Concentric's recommendation:[71]

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

198. Dr. Cleary recommends adjustment factors of 0.75 but fails to provide any research or conduct an analysis of any type to support his position. OEB Staff agrees that "this is a valid reason to reject Dr. Cleary's recommended adjustment factors."[72]

Capital Structure and Risk Assessment (Issues 11-13)

Issue #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?

199. The OEA's view is 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. OEB Staff agrees with this position.[73]

200. APPrO, CFN and MCFN, TFG and Minogi do not specifically comment on this issue.

[71] OEB Staff Submissions at p. 29.
[72] OEB Staff Submissions at p. 29.
[73] OEB staff submissions at p. 30.

201. CCMBC and Energy Probe argue that debt and equity investor perspectives are only relevant in investor-owned utilities. This approach ignores that debt and equity investors, even if focused on investor-owned utilities, provide relevant information regarding the investment community's perspectives on investing in utility infrastructure, which are relevant to all Ontario utilities. Further, as described above, this approach attempts to circumvent the Standalone Principle and should be disregarded. The capital structure should be determined on the basis of the use of funds, not the source of funds.

202. Pollution Probe argues that the Board should not mistake the perspectives of U.S. debt and equity investors for those of investors in Ontario regulated entities. As detailed above, there is ample evidence that the North American capital markets are integrated and that investor perspectives across North America are relevant.

203. VECC argues that debt and equity investor perspectives are relevant to the setting of the cost of capital parameters but that these perspectives are best taken into account using market data in determining the ROE.

204. AMPCO and IGUA agree that debt and equity investor perspectives are relevant in setting the cost of capital parameters and capital structure. However, it endorses Dr. Cleary's supposition that the expected Canadian equity market returns are 7.5%. As outlined above, this figure has is not consistent with historical data or consistent with market-related data regarding investor expectations for market returns. Dr. Cleary's own evidence suggests that the Canadian equity market returns have been approximately 11%. While the OEA agrees that returns expected by investors are a relevant consideration, it would be a mistake to accept Dr. Cleary's 7.5% return expectation as factual.

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

205. There is no disagreement amongst the parties that the ROE and capital structure must be assessed together to determine whether the FRS is met. Put differently, the Board should not look at the capital structure in isolation to determine whether the FRS is met.

206. The status quo is to account for the FRS through the ROE and only adjust the capital structure where a utility can show that there has been a material change in its risk profile requiring such an adjustment.

207. As Concentric described, however, whereas in a rates application the analysis of equity thickness could be described "going from A to B," in this proceeding the Board is "establishing whether A is the correct starting point to begin with."[74] The evidence brought forward by Concentric indicates that the sector is not at the correct starting point, and adjustments are required to meet the FRS.

208. The approach taken by Concentric and adopted by the OEA is to set the minimum equity thickness at 45% based on a review of relevant risks and authorized returns in North America, as set out in OEA's earlier written submissions. Concentric derives a recommended base ROE from market data for the proxy groups. Concentric conservatively adopts a 45% equity ratio for the Ontario utilities, even though the proxy group companies' regulated operating subsidiaries have more than 45% equity, on average, on their balance sheets.[75] In this second step there are no adjustments made for risk or perspectives of investors – those are represented in the market data.

209. In short, the OEA's position is that as part of this generic proceeding it is appropriate and necessary to adjust the capital structure on the basis that the current structure does not meet the comparable return component of the FRS, irrespective of whether a material change in risk profile has occurred. Put another way, the OEA recommends that, in order to meet the FRS, the deemed capital structure for Ontario utilities must be evaluated relative to the proxy group companies, in addition to considering changes in business risk over time. With that said, as Concentric has opined, the risk profile of Ontario utilities has increased over time, warranting a change to the capital structure under the Board's existing policy.[76]

[74] Oral Hearing Transcript, September 26, 2024, p. 127.
[75] Concentric Exhibit CEA 10.5, page 1 of 4.
[76] Concentric Report at p. 112.

210. However, if the Board determines that it is not going to make a change to the deemed capital structure as recommended by Concentric, an upward adjustment to Concentric's recommended base ROE is required in order to ensure that the FRS is met. That is because Concentric's recommendation of a base ROE that meets the FRS is based on a 45% minimum equity thickness.

211. For OPG, Concentric's recommendation as adopted by the OEA is to increase the equity ratio above the current 45%, with a specific determination to be made by the OEB as part of OPG's next payment amounts proceeding, taking into account the company's higher risks relative to the proxy group.[77]

I. Other Parties

212. APPrO, CCMBC, Nexus, Energy Probe, OEB Staff, and Pollution Probe recommend that the Board maintain the status quo.

213. CME does not offer a specific recommendation with respect to capital structure or the underlying approach but suggests that the Board should "review the different categories of utility risk and determine whether the equity thickness should be lowered based on the evidence tendered for each category." No further analysis was provided.

214. AMPCO and IGUA do not make a specific recommendation with respect to capital structure. Rather they endorse the submissions of the SEC and CCC which are discussed below.

215. CCC submits that the Board should maintain the current 40% equity ratio for electricity distributors and transmitters if the Board agrees with its proposal to determine natural gas utilities' and OPG's ROE separately (i.e., not as a single figure applicable to all regulated entities). If the Board disagrees with that proposal, CCC takes a similar position as SEC that risks have decreased and the equity ratio for electricity distributors and transmitters should be reduced to 36%.

---

[77] Concentric Report at p. 137.

216. SEC submits that there should be a downward adjustment of the equity thickness for electricity distributors and transmitters to 37% to reflect the decreasing risks since the last review, and to retain Enbridge's current 38% equity ratio (to be determined on a case-by-case basis).

217. Under their respective recommendations, APPrO, OEB Staff, Pollution Probe, CME, AMPCO and IGUA, CCC, VECC and SEC support determining OPG's capital structure separately from this generic proceeding.[78]

218. VECC supports the existing capital structures for Enbridge Gas, electricity transmitters and distributors, but recommends a reduction to 36 – 38% for Hydro One Networks, supporting Dr. Cleary's recommendation.

i. Reply to SEC and CCC

219. No expert supports SEC and CCC's position as it relates to electric distributors. Moreover, neither party put their proposal – or anything remotely close – to a single witness. In brief, there is no evidentiary support for their position.

220. The FRS requires the OEB to set a return that (1) is sufficient for the utilities to maintain their financial integrity, (2) allows the utilities to attract equity and debt capital on reasonable terms, and (3) enables the utilities to compete for capital by offering a comparable return as investments of similar risk. Concentric opines that Ontario deemed equity thicknesses, by being lower across the board than their U.S. peers, do not meet the Fair Return Standard.[79]

221. The FRS must be evaluated in light of both the capital structure and the ROE. SEC fails to explain whether there would be any effect on its recommended ROE in light of the proposed downward adjustment to the equity ratio.

---

[78] CME misconstrues Concentric's recommendation when it states that Concentric suggested retaining OPG's deemed equity ratio at 45%. As noted, Concentric recommended to increase OPG's equity ratio above the current 45%, with a specific determination to be made as part of OPG's next payment amounts proceeding (Concentric Report, p. 137).
[79] Concentric Report at p. 136.

222. SEC's and CCC's arguments are based on the purported reduction of risk caused by regulatory initiatives but neither presents a principled analysis with respect to why those regulatory initiatives have reduced risk in such a way that a 3-4% decrease in the equity ratio is appropriate. Instead, the SEC claims that "the OEB has sufficient evidence in this proceeding to lower the equity ratio of electricity distributors and transmitters to 37%"[80] and CCC simply opines that electrical utilities are less risky than gas utilities to support its 4% reduction.[81]

223. As described by OEB Staff, these regulatory initiatives have moderately reduced the risk of utilities. Importantly, Concentric performed a detailed comparative regulatory risk analysis, concluding that "the aggregate business risk profiles of the North American proxy groups reflect similar risk as the Ontario electric and gas utilities, other than OPG.[82] It does not follow that a moderate reduction in risk caused by regulatory initiatives is sufficient to reduce the equity ratio by 3%, particularly when peer groups with similar risk have higher equity ratios.

224. Further, this ignores the increased risks faced by utilities, which include the Energy Transition (as discussed in issue #2), climate change risk and cyber-security risk. These risks have not been mitigated by regulatory initiatives to a significant degree and should be taken into account.

225. A decrease in the equity ratio as proposed by SEC and CCC would result in the reduction in Ontario's approved cost of capital by hundreds of millions of dollars. This downward adjustment should not be taken lightly. SEC and CCC have not attempted to justify this immense effect and have not led any evidentiary support, from experts or otherwise, to support such a drastic position.

[80] SEC Submissions at p. 23, para. 3.5.4.
[81] CCC Submissions at p. 68.
[82] Concentric Report at p. 127.

i. Enbridge

226. AMPCO and IGUA argue that there is no new information in the current proceeding that would justify revisiting the OEB's recent Rebasing Phase 1 Decision regarding Enbridge Gas' equity ratio. This submission is incorrect.

227. One obvious and important change since the Phase 1 Rebasing decision is the fact that Enbridge Gas has been placed on a negative outlook by Standard & Poor's as a result of concerns around the risks of Energy Transition. This change was undoubtedly driven by the additional risks that the Phase 1 Rebasing Decision has imposed on the Company including: (1) rejecting a depreciation methodology which would accelerate depreciation and lower the risk of stranded costs; (2) increasing the average useful lives of several harmonized asset classes which increases the likelihood of these asset classes becoming stranded; (3) approving a materially reduced capital budget that challenges the ability to continue to operate reliably and safely and to meet customer growth demands over time; and (4) the approval of a deemed equity of only 38% (which approval remains under appeal to the Divisional Court) when the OEB Decision and Order acknowledged that the customer weighted average equity ratio used by LEI for the Canadian peer group (which LEI relied upon to recommend an increase to 38%) would increase to 40.5% when updated to include the 45% deemed equity ratio for Fortis approved by the BCUC in September 2023.[83]

228. The further suggestion these parties made that the passage of Bill 165 has reduced risk is also simply wrong. While it removed an impediment to Enbridge Gas growing its business and restored the pre-decision revenue horizon, the fact that the OEB made the majority decision which it did to reduce the revenue horizon for small volume customers to zero and the subsequent involvement of the Government of Ontario gives rise to investor uncertainty about the regulatory environment in Ontario. The evidentiary record therefore supports the recommendations made by Concentric and for the adjustment to the equity ratio proposed for Enbridge Gas.

[83] OEB Decision and Order dated December 21, 2023 in EB-2022-0200, page 66.

ii. Hydro One

229. VECC supports Dr. Cleary's recommendation to reduce Hydro One's equity thickness to 36 – 38%. Dr. Cleary bases his recommendation on Hydro One's credit ratings, cost of debt, and its historical earned returns. Dr. Cleary's analysis, however, is backward looking and ignores direct evidence from the investment community. Further, neither Dr. Cleary nor VECC address the effects of such a drastic change to Hydro One's capital structure and whether it would meet the FRS. This recommendation should be rejected.

230. First, a reduction in Hydro One's equity thickness would ensure that the FRS is not being met. Concentric has opined that a minimum 40% equity thickness for all utilities, including Hydro One, does not meet the Comparable Return Standard. Concentric ultimately recommends a minimum 45% equity thickness for all utilities, including Hydro One, which is a conservative recommendation considering the comparable equity thickness of its peer group. Accepting Dr. Cleary's recommendation would mean that Hydro One's equity thickness falls 7-9% short of Concentric's conservative recommendation and would ensure that the FRS is not met.

231. Second, Dr. Cleary cites credit reports to justify his recommendation but fails to address parts of those reports that are inconsistent with his analysis. For instance, in a July 2024 Credit Opinion update, Moody's notes "[Hydro One's] relatively weak financial metrics are primarily the result of its low authorized equity layer in the capital structure (currently 40%) that is established by the OEB."[84]

232. Third, Dr. Cleary references that the yield on Hydro One's long-term bonds was less than or equal to the average of Canadian A-rated utility yields to support his position that Hydro One's equity ratio should be reduced. This fails to consider that the yields for Hydro One's debt reflect that it is partially owned by the provincial government. The same Moody's report indicates that Hydro One's credit profile reflects its baseline credit assessment of baa1 with a one notch uplift attributable to the moderate probability of extraordinary support from the Province of Ontario, which

[84] Exhibit N-M2-2-OEB Staff-3.

indirectly owns 47.1% of HOI."[85] Given that bond yields are lower because of partial ownership by the Province of Ontario, it would run contrary to the Standalone Principle to site those yields as a reason to reduce Hydro One's equity thickness.

233. [redacted]

234. Finally, the purpose of a generic proceeding is to establish the generic cost of capital, it is not the venue to reduce a single utility's equity thickness. Whether a single utility's cost of capital should differ from the generic structure established in this proceeding should be determined on an individual basis and on a full record applicable to that utility. It is not appropriate in the context of a generic proceeding to make drastic reductions to a single utility's cost of capital.

iii. OPG

235. As noted, there is general agreement among the parties that OPG's capital structure should be considered as part of OPG's payment amounts proceeding.

236. CME claims that Concentric's views on the risks faced by OPG "failed to grapple with how those risks interact with OPG's unique regulatory assurances of recovery". While a detailed discussion of this claim does not appear to be necessary in the context of this proceeding, this statement is not accurate.

[85] Exhibit N-M2-2-OEB Staff-3.

[redacted]

237. Concentric provided evidence in each of OPG's last two payment amounts applications, EB-2016-0152 and EB-2020-0290, in each case performing detailed analyses of OPG's regulatory framework. Its analysis in this proceeding has the benefit of that prior work as a foundation. There has been no substantial change in OPG's regulatory framework since Concentric last reviewed it in detail in EB-2020-0290. Among other things, Concentric's review outlined that mechanisms similar to those applicable to recovery of OPG's prudently incurred costs for large nuclear construction projects under O. Reg. 53/05 are found in other jurisdictions and are necessary to enable such projects given their unique and heightened risk profile; and that the majority of OPG's deferral and variance accounts are subject to a prudence review at disposition.

238. In addition, Concentric, discusses in its report in this proceeding the views of credit ratings agencies S&P Global and Moody's regarding OPG, which both note the risks associated with OPG's capital programs despite OPG's regulatory framework.[87]

Issue #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?

239. CME, CCC, OEB Staff and Pollution Probe take the position that the same approach should be applied to both single versus multiple asset transmitters. TFG and Minogi ask that the Board provide a risk premium for single-asset transmitters in case of Indigenous equity participation that satisfies a "reasonable materiality threshold." OEB Staff agrees with Concentric that a risk premium differential could be proposed in the context of utility-specific rates applications with respect to the equity ratio.

240. CCMBC and Energy Probe agree with Dr. Cleary on reducing Hydro One's allowed equity ratio to 38% and consider reducing it further to 36% over the next 2-3 years.

241. SEC and VECC argue that single-asset transmitters have lower risk because their assets are newer and receive a fixed portion of the overall transmission revenue,

[87] Concentric Report p. 124

and should be accorded a slightly lower equity ratio. However, they do not provide a recommendation on what the equity ratio should be.[88]

242. The OEA adopts Concentric's view that in the course of this generic proceeding a minimum equity ratio of 45% be adopted for all transmitters (and other utilities) and any individual risk be addressed in the context of a utility-specific rates application. The OEA's argument provides the OEA's response to the recommendation to reduce Hydro One's equity ratio, which would be premised on a faulty and backward-looking analysis and ignore statements like the one from Moody's that "[Hydro One's] relatively weak financial metrics are primarily the result of its low authorized equity layer in the capital structure (currently 40%) that is established by the OEB."[89] Reducing Hydro One's equity ratio from its already "low equity layer" would clearly reduce Hydro One's financial metrics and should be rejected.

Mechanics of Implementation (Issues 14-19)

Issue #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?

Issue #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?

243. CME, CCMBC, Energy Probe, EDA and VECC argue that the Board's current approach of quarterly monitoring be continued.

244. OEB Staff and Concentric recommend that this reporting be done on an annual basis. Concentric specifically recommends that the OEB track and compare the following key utility and broader macroeconomic parameters:

(a) Authorized ROEs and equity ratios in other Canadian jurisdictions (individually) and the U.S. by industry segment (electric, gas);

(b) 10 and 30-year Treasury Bond Yields (Canada and the U.S.);

[88] SEC Submissions at pp. 27-28.
[89] OEA Argument at para 237.

(c) A- and BBB-Rated Utility Bond Yields (Canada and the U.S.); and

(d) Betas for the North American Proxy Group as defined in Section V of the Concentric Report.

245. APMCO and IGUA, APPrO, CFN, MCFN, TFG and Minogi do not specifically address this issue.

246. OEB Staff argue that whether the monitoring is performed quarterly or annually it should remain internal to the OEB. Several parties, including the OEA, argue that the monitoring reports should be made available to the public. Making these reports available to the public for their review, however, will increase regulatory transparency and enabling users to be active participants in the monitoring process.

247. CCC and SEC argue that monitoring should also include a review of actual debt and equity issuances of the Ontario utilities as suggested by LEI. The OEA recommends rejecting CCC's and SEC's proposal, as there is insufficient evidence to support the need for this type of information and its provision would lead to an increased level of administrative burden. As nearly every party recommends, a robust cost of capital review should be conducted every five years, at which time the utilities will provide details of their debt and equity issuances as they have done in this proceeding (in addition to such information being provided in the respective utility proceedings where applicable). As Concentric points out, such retrospective reporting on its own would not provide sufficient indication of future costs of capital or business risks on the horizon.[90] In short, a yearly or quarterly requirement would be burdensome and not provide offsetting value or lead to the achievement of regulatory goals.

248. OEB Staff agrees with this position. They state that "while there may be some value in annually gathering the information proposed by LEI, it would not justify the regulatory burden on the utilities."[91]

[90] Concentric Report, p. 138.
[91] OEB Staff Submissions at p. 38.

Issue #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?

249. The OEA recommends the OEB should continue to update its cost of capital parameters in October, using data as of September 30th, except where forecasts are utilized and recommends trailing 90-day averages where historical data are utilized to avoid inherent volatility in single month's data. VECC agrees.

250. 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.

251. CCMBC and Energy Probe suggest that the status quo be adjusted to use October data instead of September data to update the ROE if it does not cause disruption to the current OEB processes and procedures.

252. SEC, EDA, AMPCO and IGUA, CME, Pollution Probe, CFN, MCFN, TFG and Minogi do not specifically comment on this issue.

Issue #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?

253. There is virtual consensus amongst the parties who commented on this issue that the Board should implement a policy of holding a full cost of capital review every five years.

254. The OEA agrees with this submission.

Issue #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)?

Issue #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?

255. AMPCO and IGUA, CCMBC, Energy Probe, CCC, OEB Staff, SEC and VECC endorse a policy of implementing any changes to the cost of capital parameters and/or capital structure at each entity's next rate basing.

256. OEB Staff also submits that in the event of "significant changes" to these elements approved by the OEB in this proceeding, a two-factor test such as that proposed by LEI based on the size of the relative impact of the changes would be appropriate.

257. APPrO, CFN, MCFN, CME, EDA, TFG and Minogi do not specifically comment on this issue.

258. Pollution Probe suggests that the OEB could require changes in the cost of capital parameters or capital structure to be implemented via a utility rate case no later than two years following the issuance of the OEB decision in this proceeding.

259. OEA submits that changes in the cost of capital parameters (ROE, long-term debt and short-term debt rates) should take effect for all utilities in the rate year following the OEB's decision in this proceeding (subject to any settlement agreements and each utility submitting a compliance filing demonstrating how the change would be implemented within the context of its specific IR plan), and in subsequent periods where the parameters are updated. This is especially important given the passage of time since the Board's last full review in 2009. In Concentric's view, which the OEA adopts, it is not necessary to wait for rebasing, and any delays in implementation would not serve the public interest or meet the Fair Return Standard if the Board determines that updated parameters are justified.[92]

260. Depending on the magnitude of change in the deemed capital structure, as recommended by Concentric, the Board may want to consider implementing changes in

[92] Concentric Report at p. 148.

capital structure over a period of up to three years. This incremental approach would serve two purposes: 1) to allow the utility treasury functions to manage the transition (e.g., retiring debt and investing new equity as appropriate), and 2) to mitigate the effects of any rate impacts.[93]

Prescribed Interest Rates (Issues 20-21)

Issue #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?

261. OEB Staff recommends that: (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 the status quo, specifically the FTSE Canada (formerly DEX) Mid Term Bond Index All Corporate yield; and c) instead of the OEB approving a WACC on 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 current OEB policy.

262. CME, CCMBC, Energy Probe, CCC, Pollution Probe, and VECC support the status quo approach; i.e., that for DVAs, the deemed short-term debt rate should be used, and for CWIP, a mid-term debt rate should be used.

263. SEC agrees with the above positions, and further states that to address concerns regarding the methodology for CWIP being a barrier to Indigenous equity participation, the OEB should convene a dedicated process to look at regulatory, jurisdictional, and fairness issues that may arise.

264. Minogi/TFG disagree with the above parties and instead submit that the Board adopt a WACC applicable to CWIP balances for large, multi-year projects and investments, under the premise that this approach would better reflect the full participation costs for investors, particularly Indigenous investors who typically do not have access to large pools of capital and must borrow the funds necessary to

[93] Concentric Report at p. 148.

participate in large infrastructure projects. Minogi/TFG also request that the Board confirm the ability for Indigenous equity participants to access accelerated cost recovery mechanisms to recover costs for CWIP in advance of a project's in-service date for large, multi-year projects and investments. CFN and MCFN agree with Minogi/TFG on this topic. OEB Staff submits that TFG/Minogi's recommended approach of concurrent cost recovery for its projects is outside the scope of this proceeding and any unique First Nations issues can be addressed in a rate application by a First Nations-owned utility.

Recommendation of the OEA:

265. The OEA disagrees with OEB Staff and the intervening parties on this matter, with the exception of the Minogi/TFG, CFN and MCFN, as the OEA supports the application of WACC to both DVAs (other than short-term DVAs that the OEA agrees should continue to attract the short-term debt rate) and CWIP because this approach is most consistent with regulatory and corporate finance principles as recommended by Concentric.[94] The OEA proposes that short-term DVAs be defined as those that will clear within one year or that are categorized as current assets or current liabilities on the utilities' balance sheets.[95]

266. The OEA's recommendation aligns with LEI's apparent position expressed during hearings on the application of the WACC to CWIP balances for projects lasting more than one year[96], but without the one year limitation.

267. OEB Staff and opposed intervenors make several countervailing arguments, which should be rejected by the OEB. Among them, CME and VECC argue that a WACC return on CWIP would somehow violate the used and useful test. That is simply not the case. Investments placed in rate base would remain subject to the used and useful test; it is the cost of financing those investments prior to placing them in rate base which is at issue. There is nothing in the used and useful test that prevents the Board

[94] Concentric Report at 151-155, OEA Argument at paras 275 – 285.
[95] Ex. N-M2-21-OEB Stsaff-27 (a).
[96] OEA Argument at para. 288 citing to Transcript Oral Hearing Volume 1 at p. 48.

from recognizing the more accurate cost of financing, which is a mix of debt and equity. The OEB's present approach of applying carrying charges on CWIP by at a debt-only rate ignores that utilities also employ retained earnings and equity issuances to fund construction.

268. CME further argues that "Many CWIP projects are completed within one year, meaning that many utilities use short term financing for CWIP. Allowing utilities to charge the WACC would therefore allow them to over recover the carrying cost of short-term financing and provide unwanted arbitrage opportunities." SEC argues similarly "For many utilities that implement projects that take more than a year to complete, they fund at least the construction costs through construction loans." These arguments assume that the utilities somehow use only or predominantly short-term financing, or even construction loans, to finance their investments. This is simply not true. As Concentric explains "While certain smaller and more routine construction projects can be completed within a year, many are larger, long-term projects, and the period between when construction costs are first incurred and when those assets go into service can span multiple years. Over those periods, the utilities are financing construction on their balance sheets at the WACC, which includes an equity component."[97] Furthermore, in practice, it is typically not feasible to trace one source of financing (e.g., short-term debt, long-term debt or equity) to individual assets. Rather, the utility's overall capital structure (comprised of various financing sources and durations) supports its overall asset base (comprised of assets of various lives, including CWIP), which is what the OEA's proposal reflects.

269. SEC and CCC also argue that application of the WACC to CWIP balances would somehow provide a "double" return on the utilities' invested capital. This argument ignores the fundamental rate of return principle that allows a utility to recover the prudently incurred costs of its investments, including its financing costs. There would be no double counting of the return whatsoever, but only the recovery of costs to place the asset in service which includes a financing component. To the contrary, "disregarding the WACC for certain financings but applying it for others would double-count certain

[97] Concentric Report at pp.153-154.

debt issuances in the cost of capital and undermine the overall regulatory financing assumptions upon which rates are determined and investors are compensated."[98]

270. CME argues that there may be increased administrative burden for utilities using IFRS to apply a WACC financing cost to CWIP because of the IFRS requirement to capitalize carrying costs at a debt-only rate. The OEA observes that this concern may be addressed by the upcoming IFRS Standard *Regulatory Assets and Regulatory Liabilities.*

271. With respect to the proposal for long-term DVA accounts to attract a CWIP return, SEC and CCC suggest that that OEB may be deterred from approving new DVA accounts as a result. CCC also claims that there would be a "perverse incentive" for utilities to seek to record operating costs in DVAs as opposed to seeking recovery in rates. In addition to ignoring the practical fact that the financing cost would be symmetrically applied to both debt and credit DVA balances, these are inappropriate arguments. The setting of rates is subject to the just and reasonable standard, and the establishment and recovery of balances of DVAs requires OEB approval. The Board considers the relative merits for each DVA proposal, and the benefits for both customers and the utility, using well established regulatory principles including causation, materiality and prudence. None of this would be affected by using a more representative carrying cost for the DVAs.

272. SEC and CCC argue that there will be some loss of regulatory efficiency because Group 2 accounts may need to be disposed of an annual basis, rather than with a rebasing application if a WACC carrying cost is applied to longer-term DVAs.

273. SEC also raises a concern about applying a WACC carrying cost to pass-through accounts in Group 1. They argue that it would be inequitable for these accounts to attract a WACC carrying cost because these accounts carry virtually no risk regardless of balance duration. SEC also argues that there is no evidence that DVA balances are funded through long-term debt and equity.

[98] Concentric Report, p. 153.

274. The above arguments misconstrue the basis for the OEA's recommendation. The OEA's recommendation is rooted in the recognition that, just like its assets, a utility's financing resources comprise a mix of shorter- and longer-term sources and that, as noted, to draw a line that traces one source of financing to one asset (such as DVA balance) is neither practical nor consistent with the application of WACC to each utility's rate base.[99] The OEA's recommendation is also not based on the level of risk associated with a particular DVA.

275. In summary, the OEA and Concentric's recommendations on the WACC return for long-term DVA accounts and CWIP balances would bring Ontario into greater alignment with other North American regulators, and be more consistent with regulatory and corporate finance principles. Ensuring that utilities recover the full cost of equity borne during asset construction and for long-term DVAs is particularly important to supporting the increased capital requirements for the Ontario sector during the Energy Transition. Finally, carrying charges at WACC send the appropriate price signal as it reflects the actual costs of the utility rather than understates them.

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

276. In terms of the specific mechanics of the rates described in Issue #20, the parties generally support LEI's position that for the DSTDR, a revised methodology (using CORRA as a base rate, estimated as the average of 3-month CORRA future rates over the next 12 months, added to the spread determined by sampling 6-10 banks to determine the appropriate R1-low rated utility spread) should be used, and that for the mid-term debt rate, the FTSE Canada (formerly DEX) Mid Term Bond Index All Corporate yield should be used.

277. CCC proposed slightly different approaches to the DSTDR explored in more detail in its response to Issue #5.

[99] As noted in Ex. N-M2-21-OEB Staff-27, (b), if the OEB were to determine that it is appropriate to distinguish between Group 1 and Group 2 DVAs such that Group 1 DVAs attract the short-term debt rate and Group 2 and other DVAs attract a WACC carrying cost, this could represent a reasonable alternative to the OEA's proposal.

278. OEB Staff differs by submitting that for the DSTDR, the Bloomberg ticker BVCAUA3M BVLI Index (3-month) is the preferred method due to ease of implementation.

OEA Recommendation:

279. Consistent with the OEA positions articulated in response to Issues 4 and 5 on short-term debt rates, the OEA agrees with LEI that transitioning to a measure of short-term loan rates, such as the three-month average of the CORRA is appropriate, with a spread based on an R1-low rated utility over CORRA being applied in the short-term debt rate calculation based on an annual confidential survey of 6-10 banks. This is the rate OEA recommends be used for the short-term DVAs.

280. For the long-term DVAs and CWIP, the OEA recommends that the utility-specific WACC, inclusive of short-term debt, long-term debt and equity and their corresponding cost rates set in the manner described elsewhere in this submission, should be used. The WACC should be that reflected in the rates approved in the most recent rate proceeding for each utility.

Cloud Computing Deferral Account (Issue 22)

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

281. AMPCO and IGUA, APPrO, CFN and MCFN, CME, EDA, TFG and Minogi, and VECC do not address this issue.

282. OEB Staff, Pollution Probe, SEC, CCMBC and Energy Probe take the position that the Cloud Computing deferral account should be treated like any other deferral account: the carrying charge should be the prescribed interest rate for DVA, which as discussed under issues 21 and 22, they recommend being a short-term debt rate.

283. OEA adopts Concentric's view that it is important from a regulatory policy perspective that utilities are not disincentivized to pursue cloud computing solutions, and further that utilities are incentivized to consider the best operational outcomes (and therefore lowest long-term customer cost). As such, the OEA recommends that cloud

solutions be treated on par with in-house capitalized IT systems, appropriately removing the aforementioned disincentive. This is further warranted by the fact that DVAs more typically account for pass-through items or items that are beyond the control of the utility, while the Cloud Computing Deferral Account is differentiated because it involves utility choices, and thus the incentives behind those choices should be considered in setting the carrying cost rate.[100]

284. LEI believes a deemed WACC is necessary as a means of aligning incentives for utilities to transition to cloud computing solutions and recommends that the OEB employ a deemed capital additions approach, which allows deemed WACC on unamortized portions of the cloud computing contracts.[101] OEA and Concentric agree with this recommendation.[102]

285. OEB Staff and SEC assert that the establishment of a deferral and variance account provides sufficient incentives to transitioning to cloud-based solutions, with SEC stating "The OEB's establishment of the account removes the disincentive utilities may face during an IRM term in choosing cloud computing solutions over traditional capital IT investments."[103]

286. The OEA disagrees. The return on "traditional capital IT investments" is at each utility's WACC, not the prescribed interest rate. Providing a substantially different return than available on traditional investments does not remove the disincentive. The OEA agrees with Pollution Probe that cloud computing has become a standard approach.[104] That does not reduce the need to properly balance utility incentives. Therefore, the OEA continues to recommend that LEI's suggested approach be adopted.

[100] Concentric Report at pp. 156-157.
[101] LEI Report at p. 175.
[102] Concentric Report at p. 157.
[103] SEC Submissions at p. 58.
[104] Pollution Probe Submissions at p. 22.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 28th day of November 2024.

Crawford Smith

LAX O'SULLIVAN LISUS GOTTLIEB LLP
Counsel
Suite 2750, 145 King Street West
Toronto ON M5H 1J8

Crawford G. Smith LSO#: 42131S
csmith@lolg.ca
Tel: 416 598 8648

Tyler Morrison LSO#: 80119E
tmorrison@lolg.ca
Tel: 416 956 5100

Fax: 416 598 3730

Lawyers for the Ontario Energy Association