ONTARIO ENERGY BOARD

2024 Review of Cost of Capital Parameters and Deemed Capital Structure

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

Reply Submissions

AMPCO and IGUA Position

1. As was the case leading up to the November 7th submission date herein, we have had the benefit of reviewing drafts of comprehensive reply submissions prepared by CCC and SEC, both of which we are in general agreement with, and to which we are thus able to defer in respect of many of the detailed responses to arguments by others.

2. In AMPCO and IGUA's November 17th *Written Submissions* (AMPCO/IGUA Submissions) AMPCO and IGUA recommend that:

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

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

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

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

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

3. Having considered the submissions filed by other parties, AMPCO and IGUA continue to endorse the recovery by Ontario's regulated utilities of reasonable demonstrated actual financing costs, though not through a 50 basis point (or any) adder to ROE, and are the further view:

(a) In respect of a base ROE for Ontario's regulated distributors (including EGI) and electricity transmitters, that;

(i) a base ROE of 7.1 (as of September 30th) exclusive of a financing cost adder as proposed by CCC, based on Dr. Cleary's market based Bond Yield Plus Risk Premium (BYPRP) methodology, would be appropriate.AMPCO and IGUA endorse the reasoning set out at pages 53-54 of CCC's November 7th *Submission* and further reasoning provided by CCC in Reply; and

(ii) a base ROE as proposed by SEC (7.58%) or VECC (7.73%), both exclusive of financing cost adders, would also be within a range of reasonableness premised on market expectations that regulated distribution utilities, considered to be less risky than the average company, should generate returns no higher than the average expected market return, which Dr. Cleary derived to be ~7.5%.

(b) In respect of deemed equity thickness, that if the OEB is persuaded by the OEA's position that the gas distribution business is riskier than the electricity distribution and transmission business, and given the resetting of EGI's equity thickness to 38% last year through a comprehensive process including extensive evidence from the OEA's expert in this proceeding – Concentric Energy Advisors – then SEC's position that for electricity distributors and transmitters equity thickness should be reset to 37% has merit. In this respect, AMPCO and IGUA endorse the submissions at paragraphs 3.5.4 through 3.5.12 of SEC's November 7th *Final Argument*, and SEC's further submissions on this topic in Reply.

Implementation

4. We have also considered the position advanced by OEB Staff in their November 7th filing that the OEB effectively accept all of the positions advanced by the external experts' and average the various resulting derived ROEs to land on a number close to the OEB's current deemed ROE. We are sympathetic to the concern expressed by OEB Staff, and Commissioner Sardana in his discussion with Dr. Cleary[1], as amplified by the OEA in its November 7th *Argument*[2] (OEA Argument) regarding the significance of a reduction of the current OEB deemed ROE of 9.25% to an ROE at or below an overall expected market return 7.5%.

5. In respect of determination of a proper base ROE, Dr. Cleary was criticized by the OEA for recommending a base ROE as low as 7.05%. The OEA asserts that *"[i]t defies reason"* that Dr. Cleary would make such a recommendation in light of the risk of a credit rating negative reaction to such a change.[3] It was Dr. Cleary's task in this proceeding to provide his best opinion on

[1] Transcript Volume 6, pages 184-185.
[2] OEA Argument, paragraph 162-163.
[3] OEA Argument, paragraph 163.

derivation of an appropriate cost of equity and resulting ROE, which is what he has done. We assume that the other experts have done the same.

6. The law, as asserted by the EDA[4], seems to require that the cost of equity, being a cost reasonably incurred in the provision of regulated utility service, is to be determined without moderation as a result of impacts (such as rate impacts).

7. A resetting of the ROE to better align with an overall expected market return of 7.5% would entail a reduction from the current OEB deemed ROE of ~1.75 percentage points, which is less than a 20% reduction in ROE. Taken in the context of overall rates and regulated revenue requirements, there would be a much smaller impact than that. While certainly significant (in particular for customers), this quantum would not be paradigm shifting from an overall utility earnings and credit metrics perspective.

8. In any event, as reflected in a number of the submissions filed, determination of an appropriate, cost reflective cost of equity and implementation of an ROE provision in rates to effect recovery of that cost over the long term are two different considerations.

9. The first step is to determine an appropriate, cost reflective, *"just and reasonable"* cost of equity. That is, as we are reminded by the EDA and the OEA, what the law requires.

10. Once so determined, the law indicates that shareholders must be provided a reasonable opportunity to recover such cost *"over the long run"*[5]. That is, the law provides the regulator with considerable latitude in implementing rates to achieve, ultimately, a just and reasonable outcome. The Canadian Federal Court of Appeal specifically contemplated a phase in over time to balance the interest of investors in proper compensation on the one hand with reasonable rate stability and fairness to consumers on the other hand.[6]

11. A range, <u>for implementation purposes</u>, defined on the high end by the current ROE provision included in Ontario regulated utility rates (9.25%) which the OEB would be moving from, and on the low end by determination in this proceeding of an appropriate cost of equity[7] which the OEB

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[4] EDA *Closing Submissions*, paragraph 28.
[5] OEA Argument, paragraph 11.
[6] EB-2009-0084 *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities*, December 11, 2009, page 19; citing *TransCanada Pipelines Ltd. v. National Energy Boad*, 2004 FCA 149.
[7] We have argued for 6.45%, CCC has argued for 7.1%, Dr. Cleary has indicated an overall expected market return "cap" on reasonableness of 7.5%, SEC has derived an ROE of 7.58%, and VECC has proposed an ROE 7.73%, all based on sound analytical principles)

would be moving towards if its accepted the positions of the customer representatives in this proceeding, would provide the OEB with significant implementation flexibility.

12. A number of parties have suggested that consideration could be given to an interim, partial reduction in ROE towards a level determined appropriate.

13. Most parties have also recommended implementation through successive utility rebasing applications over the coming several years.

14. All parties have recommended continued monitoring, and several have recommended that such monitoring include consideration of actual debt and equity issuances, utility credit metrics, and ratings reviews, all of which would allow the OEB to monitor the impact of its determinations in this proceeding through an appropriate implementation phase (as CCC has suggested[8]).

15. In respect of determination of a proper base ROE (as distinct from consideration of implementation), Dr. Cleary was criticized by the OEA for recommending a base ROE as low as 7.05%. The OEA asserts that *"[i]t defies reason"* that Dr. Cleary would make such a recommendation in light of the risk of a credit rating negative reaction to such a change.[9] It is Dr. Cleary's task in this proceeding to provide his best opinion on derivation of an appropriate cost of equity and resulting ROE, which is what he has done. We assume that the other experts have done the same. Implementation, as already noted, is a different question.

Some Common Sense

16. The AMPCO/IGUA Submissions urged a healthy does of common sense in sifting through all of the evidence, calculations, data sets, and expert judgements applied. Having considered the submissions of others, we reiterate this point of departure. Another way to say this is that the OEB should undertake a purposeful and practical, and avoid a circular, consideration of the views advanced by the experts and the parties.

Consideration of the Ontario Energy Sector

17. For example, one of the "signposts" cited by the EDA is the importance of *"taking into account the financial markets from which Ontario utilities attract capital"*. We note, however, as do others

[8] CCC Submission, page 65.
[9] OEA Argument, paragraph 163.

including OEB Staff, that the vast majority of Ontario regulated utilities do not in fact attract capital from either Canadian or U.S. capital markets.

18. At paragraph 22 of its *Final Submissions* (EDA Submissions) the EDA asserts that the focus of the Fair Return Standard (FRS) is on the generic investor, in support of the proposition that (emphasis in original) "[t]*he exercise is* ***not*** *to consider what should be the ROE for, for example, a municipally owned utility as compared to a privately owned utility."*

19. The OEA also addresses this point[10]:

> *Consistent with longstanding Board policy and the FRS, the approach to determining the authorized ROE or capital structure should not differentiate by ownership type. As described by Concentric, financial theory provides that the cost of capital depends on the use of funds, not the source of funds.*

20. What the law, as cited by the EDA in the next paragraph of its submissions, actually says is that "the exercise" is to ensure that the utility, over the long run, is given the opportunity to recover its costs, including its costs associated with the utility's invested capital, so as to protect both shareholders and customers.

21. It would make no sense, and would ignore salient facts (which would arguably be contrary to law), for the OEB to set its cost of capital parameters on the artificial assumption that an Ontario municipality requires the same return, and therefore necessarily drives the same cost of capital, as a private investor, in order to allocate capital to its regulated distributor. Ignoring the jurisdiction specific factual and legal context is not a requirement of the FRS.

22. Two of the 3 FRS *"standards"* – the capital attraction standard and the financial integrity standard – actually focus on <u>the utility</u>. Most of the electricity utilities in Ontario are municipal utilities, and what is relevant is their ability to attract capital and thus maintain their financial integrity.

(a) In respect of capital attraction, as explained in the AMPCO/IGUA submissions Ontario's municipal utilities are effectively constrained to capital from their municipal owners.

(b) In respect of maintaining financial integrity, there is no evidence of a debt or equity related problem in this respect. Further, as CCMBC argues in its November 7th submissions (page 8), the shares of municipally owned Ontario utilities do not trade on an market, and the only investors in municipally owned utilities are municipalities who *"do not have a choice of making other investments. They must invest the amounts required to maintain the state of good repair and the quality of service expected by the residents of the municipality"*.

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[10] OEA Argument, paragraph 18.

23. The 3rd FRS standard – the "comparable investment" standard - is investor focused. With respect to this standard the EDA preposterously asserts that *"it is irrelevant whether utilities actually raise capital, how and at what cost.. It is the opportunity cost to investors that matters when setting the deemed cost of capital."*[11] That is, the EDA effectively posits a "the generic investor" that does not actually invest equity in Ontario's municipal utilities is the relevant focus of the analysis. Here we need to re-inject some "common sense".

24. The fact is that there is only one significant source of equity for Ontario municipally owned electricity distributors; municipalities. What is the opportunity cost for Ontario's municipal investors in Ontario's municipally owned utilities? Is it, as the EDA asserts[12] [paragraph 42], *"the opportunity cost to the marginal investor who is willing to move their investment from one asset to another in a market if prices were to vary"*? Of course not. Municipalities invest in municipal services for the benefit of municipal citizens.

25. In contrast, when discussing flotation costs, the EDA asserts[13]:

> *The cost of capital reflects the 'actual cost that needs to be recoverable' in order for utilities to raise capital and investors to keep their funds invested.*

26. In discussing U.S. comparators and the notion of an integrated north American capital market in the context of determining the cost of equity for Ontario distributors, the EDA asserts[14]:

> *… investors have options. In an integrated North American market, it is clear that such investors will not accept a lower rate of return from an Ontario utility when they could achieve a higher rate of return from a B.C. utility or a U.S. utility.*

27. Ontario's municipal LDCs cannot, and do not, seek investment from such investors. They do not incur *"an actual cost"* of equity to attract investment that would otherwise go to a B.C. utility or a U.S. utility. There is no realistic possibility that municipal shareholders are going to withdraw their equity from their municipal electric utilities to chase higher North American market returns.

28. CCC has noted in its November 7th *Submission* (CCC Submission) that Ontario municipalities have more actual equity invested in their electricity distribution utilities than contemplated by the OEB's deemed equity thickness, implying that these shareholders are prepared to make, and have made, additional equity investments in their companies at the OEB's current ROE.[15]

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[11] EDA Submissions, paragraph 27.
[12] EDA Submissions, paragraph 42.
[13] EDA Submissions, paragraph 35.
[14] EDA Submissions, paragraph 24.
[15] CCC Submission, page 10, first full paragraph.

29. In this reality, we could argue that <u>no</u> return is required in respect of Ontario's municipal utility investors. We are not arguing that, which might be "a bridge too far" in the context of "corporatized" Ontario electricity LDCs and given the debt market in which they do actually participate. However, we <u>are</u> arguing against the assertion that U.S. capital markets and the ROEs awarded to other economically regulated utilities are relevant, and, as the EDA (wrongly) asserts, legally required considerations in assessing an appropriate cost of equity for Ontario municipal owned electric utilities. They are not.

Betas

30. Another area that commends the injection of some common sense is betas.

31. In arguing in favour of the use of expected betas, the OEA asserts that *"current stock prices reflect expected risk"*, yet continues <u>in the same sentence</u> to assert that *"one must use an expected beta to appropriately reflect investors' expectations"*.[16] That paragraph then immediately continues, citing Concentric's report: *"A raw bets reflects only where the stock price has been relative to the market historically and is an inferior proxy for the expected returns when compared to the adjusted beta."* Despite reading this paragraph several times, it makes no sense to us. If current stock prices already reflect investor's expectations, why should actual observed betas be adjusted?

32. Further, despite accepting that *"current stock prices reflect expected risk"*, Concentric[17] and the OEA repeatedly criticize Dr. Cleary for commending the use of actual market data rather than forecasts that are, in Dr. Cleary's view (which view is supported by third party studies), upwardly biased.

33. Still on the topic of betas, both the OEA and the EDA continue to argue the need to adjust (i.e. increase) beta risk premiums for regulated utilities in CAPM derivations. As do their respective experts, they argue this on the basis of Marshall Blume's study of a broad cross-section of publicly traded companies[18], which sample, <u>by definition</u>, will converge over time to the market average. This despite also readily conceding that regulated utilities are less risky than the average company. As both Dr. Cleary and LEI assert, as was argued in the AMPCO/IGUA

[16] OEA Argument, paragraph 131.
[17] Transcript Volume 3, page 128, lines 2 to 4. See also Exhibit N-M2-AMPCO/IGUA-7, part h).
[18] Exhibit N-M2-10-AMPCO/IGUA-9, part b).

submissions, and as supported by a study that actually looked at public utility betas rather than samples from across the market[19], to quote from the submission of OEB Staff[20];

> *… it defies logic to presume that utilities, which are inherently lower risk than the typical competitive enterprise, are inching inexorably towards the market-average risk level.*

34. Again, AMPCO and IGUA commend that the OEB consider positions advanced, including those repeatedly advanced by the same experts over many years in multiple regulatory filings, with a healthy dose of common sense. Repeating something doesn't make it any more true, or any less illogical.

Dr. Cleary as Outlier

35. Dr. Cleary was repeatedly criticized by Nexus and Concentric as "an outlier", and the theme continues in the submissions of the OEA and the EDA.

36. Dr. Cleary is an outlier.

37. Unlike the habitual utility experts, Dr. Clearly is repeatedly pointing out that – to use the colloquial – *"the emperor has no clothes"*.

38. It is interesting that the EDA criticizes Dr. Cleary's opinions as *"untethered to current and expected market conditions"*[21] when he is the expert most "tethered" to actual market data in his approach, in contrast to the various rather academic approaches of the other experts.

39. The utility representatives assert that as Dr. Cleary has only testified at the instance of customers (at whose instance neither Nexus nor Concentric have ever testified), his views are thus partisan and arbitrary. Dr. Cleary no doubt has strong views on these matters, as do the other experts in the opposite direction. In the end, Dr. Cleary's 1008 page, fully and transparently reasoned report speaks for itself, and should be the basis to judge whether his approaches have merit and basic common sense.

40. For example, the OEA asserts[22]:

> *Dr. Cleary is once again an outlier. Dr. Cleary, unlike any of he other experts, uses a judgmental beta which has no empirical support.*

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[19] Undertaking J4.5.
[20] *OEB Staff Submission*, page 22, first full paragraph.
[21] EDA Submissions, paragraph 7 (top of page 3).
[22] OEA Argument, paragraph 133.

41. First, Dr. Cleary is no different from any of the other experts in using “judgement”. As all of the parties’ submissions recognize, in fact emphasize, all of the experts have used multiple judgements resulting in a broad range of recommendations, in particular regarding ROE. Concentric and Nexus have, for example, judged it appropriate to adjust their betas. They have also made judgements regarding data sets to use in deriving their betas, whether to use historical betas or forecast betas, and numerous other judgements along the way.

42. In respect of Dr. Cleary’s *“judgmental beta”*, his discussion of betas is found at section 5.2.4 (pages 90 through 95) of Exhibit M4, and includes the sample data set out in Table 8 at pages 93-94. This discussion is, in turn, supported by further detailed data and discussion found in Appendix C (pages 132 through 139) to Exhibit M4. To say that Dr. Cleary’s recommended beta has “no empirical support” is simply wrong.

43. For example, while the OEA specifically criticizes Dr. Cleary for using a beta that is below a 7 year average, Dr. Cleary explains this, in full, in his evidence[23] (emphasis added):

> *The top portion of Table 8 provides both weekly and monthly beta estimates for the Canadian utility sample as of December 31, 2023, as well as the seven-year average of beta estimates over the 2016-2023 period. [Footnote: The working papers for Table 8 are appended as Attachment 1 to my evidence.] The December 31, 2023 weekly beta estimate average is 0.668, while the average for monthly betas is 0.582, both of which are well above the long-term average beta estimate of 0.35 discussed above, and also the 0.45 bet estimate I have used during previous proceedings. The seven-year average weekly beta for the Canadian sample is 0.658, while the seven-year average monthly beta estimate is 0.513 – with both estimates lying well above the historical average of 0.35. The average of all four beta estimates provided for this sample is 0.60, well above the long-term average beta estimate of 0.35, and my usual beta estimate of 0.45, which lies slightly above the mid-point of these two figures. In my 2023 Alberta GCOC evidence, I obtained the same bet estimates using December 31, 2022 available Bloomberg data, and the average of the four averages at the time was 0.355, well below the average of 0.60 using December 2023 data. <u>This illustrates that beta “estimates” for companies can change dramatically through time, and therefore why it is appropriate to reference long-term averages and use judgement since beta estimates at any given point in time based on historical data may not represent the best estimates of “future” betas, which is of course what we are trying to estimate.</u> I would further note that during 2023, I continued to use my estimate of 0.45, rather than adjust it downwards based on the average estimate of 0.355 and despite the fact that this was almost identical to the long-term average Canadian utility beta estimate. Therefore, I would judge my 0.45 estimate [to] be a conservative and appropriate estimate for low-risk regulated operating utilities.*

44. Agree or disagree with its conclusions, this evidence reflects both rigour and consistency. To assert otherwise, as the OEA and the EDA have, is unfair and irresponsible.

[23] Exhibit M4, page 92, lines 6-26.

45. This evidence is also conceptually consistent, by the way, with Concentric's reliance in its MRP analysis which uses very long-term data going back to 1919.[24]

46. The OEA and the EDA both emphasize that Dr. Cleary's cost of capital recommendations have not been accepted by any regulators.[25]

47. In response to an interrogatory from the OEA (M4-0-OEA-1), Dr. Cleary provided a table listing his recommendations as a cost of capital witness, and the recommendations of other cost of capital experts involved in the same proceedings as he has been, including Concentric. That table shows that:

(a) Several of Dr. Cleary's equity ratio recommendations have in fact been accepted.

(b) None of the experts' ROE recommendations, including Concentric's, have been accepted in any of these proceedings.

(c) The recommendations of various cost of capital experts, including those of Dr. Cleary and Concentric, have generally displayed very large ranges, with the final decisions of the subject regulators generally being very close to the mid-points and/or averages of these ranges.

(d) Concentric's recommendations, all commissioned by regulated utilities, have consistently been at the high end of the range.

(e) Dr. Cleary's recommendations, all commissioned by consumer interests, have consistently been at the low end of the range, consistent with his assertion, supported throughout his evidence (see, for example, exhibit M4, section 5.1) that the allowed ROEs in Canada (and the U.S.) have simply been too high for several years.

(f) Nexus was not engaged in any of these proceedings.

48. It is apparent from the evidence in the instant proceeding that there are two basic reasons why Dr. Cleary's cost of capital recommendations are habitually at the low end of the range often defined by Concentric at or towards the high end of the range:

(a) Dr. Cleary eschews the use of U.S. data, for both financial and utility comparators.

(b) Dr. Cleary places his emphasis on actual market data, rather than forecasts or regulatory determinations.

49. In respect of the latter point, the EDA criticizes Dr. Cleary for not placing much stock in ROEs awarded in other jurisdictions as representative of "comparable investments":[26]

[24] OEA Argument, paragraph 137.
[25] OEA Argument, paragraph 51, EDA Submissions, paragraph 121.

[26] EDA Submissions, paragraph 127, footnote omitted.

Contrary to each of the other experts who acknowledge the need to authorize an ROE that is comparable with jurisdictions considered comparable to Ontario, Dr. Cleary does not even agree that is a relevant inquiry. He stated: "I don't use [authorized ROEs in other jurisdictions] as a starting point and say to satisfy a comparable investment component of the fair return standard, we just have to set them in line with everyone else. I look at it objectively and look at the data and say, if I was new to this world, which I was over a decade ago, what would my estimate of the cost of equity be for these types of businesses." [Footnote omitted.] In other words, he tries to find the ROE that is "correct", even if not comparable".

50. Following is the subject testimony <u>in full</u>[27], in which Dr. Cleary clearly explains his view of what is *"correct"* versus what is, as Ms. Stothart sought to emphasize with reference to other regulatory findings, *"comparable"*:

MS. STOTHART: Right, and conceptually what the other regulators in Canada are doing is trying to model what the cost of capital is, what the return on equity is required to be in those jurisdictions; right?

DR. CLEARY: That's my understanding of, again, my experience in Alberta and Newfoundland directly, but --

MS. STOTHART: Yes.

DR. CLEARY: -- I do know indirectly, like in Québec and BC, that that is their objective, as it is in Ontario.

MS. STOTHART: Right, so, when you're comparing to those jurisdictions and what the regulators set as the authorized ROE, which is attempting to model and replicate what the cost of capital should be or is, I should say, your proposed number is not comparable to that but it's comparable to what you say it should be in those jurisdictions?

DR. CLEARY: Well, I don't use it as a starting point and say, to satisfy the comparable investment component of the fair return standard, we just have to set them in line with everyone else. I look at it objectively and look at the data and say, if I was new to this world, which I was over a decade ago, what would my estimate of the cost of equity be for these types of businesses, just as I have done for other types of companies in my work and academia, academic work as well, so that's the basis that I come with this. And unfortunately, and I think I had the discussion with somebody from that study from Haas Energy Institute, and they come with the same conclusion, and so did a couple of the other studies, Sikes, and I can't remember the name of the other people. That if you look at capital market conditions the allowed ROEs in the US -- they are looking at the US, I look at Canada -- are too high relative to other investments in capital markets.

So, I don't, I don't totally disregard those allowed ROEs, but I am just -- my job is to provide what I think is the correct ROE, required return on equity for utilities, and those are the required return on equity that I think they would be able, be financially, maintain financial integrity, ability to attract capital at reasonable rates which there is strong evidence they do in the debt markets, it's always hard -- so you can't really estimate it in the equity markets, but there are also frequent issues, and that they are able to do so

[27] Transcript Volume 6, pages 42-44.

because they are comparable investments. Nobody is going to pay, you know, what is it now, it's about 4.51 now is the A-rated spread and Hydro One is 4.6. So, if they think that they are not a comparable investment why would they buy their bonds at the going market rate? Why wouldn't they demand a higher rate of return on it? So the two are related as is the integrity, so the three prongs are all important but they are always all related.

MS. STOTHART: I agree with you on that last statement there. So, I just want to be very clear about your position. Your position is not that this Board -- your position is that this Board should not be seeking to be comparable to the authorized ROEs in any other jurisdiction?

DR. CLEARY: That should not be the ultimate objective.

MS. STOTHART: Okay. And your position, by extension, is that these ROEs authorized in every other jurisdiction are too high?

DR. CLEARY: That's correct. Well, sorry. I don't know about every other jurisdiction, but the ones that I am aware of.

51. The EDA asserts that the fair return standard (FRS) *"**requires** comparison with like utilities"*[28]. That is not, as a matter of law, true. What the FRS requires is that the ROE be set at a level equivalent to the return that can be earned on investments of comparable risk. If the conclusion, based on market data (including average expected market return), is that awarded ROEs are generally too high, it would in fact be an error to use those as a benchmark.

52. If what the EDA is arguing is that this Board should follow other regulators, whether those other regulators are right or wrong, we strongly disagree, both as a matter of fairness and as a matter of law.

53. Dr. Cleary brings real world finance experience to these matters. While Concentric may well be more knowledgeable in results of U.S. utility cost of capital hearings, and the higher ROEs thereby set, Dr. Cleary's evidence relies on the financial market, where his expertise lies. It is from those markets, which he understands through direct involvement, from which he repeatedly cites and relies on a long history of data and the views of those firms and individuals operating in the that world of mainstream finance and managing many trillions of dollars of investors' money.

54. A number of parties have also critiqued Dr. Cleary's limited, and imperfect, "Canadian" proxy group (for example, see the OEA Argument at paragraph 101-103). We acknowledge that these are valid criticisms. That is why Dr. Cleary looks to market data, rather than other awarded ROEs, to assess a *"fair return"*. His evidence provides an important, we say determinative, marker for

[28] EDA Submissions, paragraph 128.

the OEB to consider against the other, more circular, self-fulfilling (some might even say incestuous) analyses.

55. As does the EDA, the OEA[29] asserts that *“[i]n order to meet the FRS, the Board must take into account the comparable returns of U.S. participants in the North American utility industry”*. As argued above, that is not, in fact or in law, true.

56. The OEA also asserts[30] (our emphasis):

> *Ignoring the U.S. market ensures a result that does not meet the Comparable Return Standard <u>because Ontario utilities are competing with these companies, directly or indirectly, for capital</u>.*

57. As detailed in the AMPCO/IGUA Submissions, and in those of other parties, and further addressed above, that is also not correct.

58. OEB Staff addressed this point (in the context of discussing transaction costs):[31]

> *… very few [Ontario] utilities depend (or have ever depended) on the public equity markets, and even then, it is typically the corporate parent that is listed, not the regulated utility itself (e.g. Enbridge Inc. rather than Enbridge Gas Inc., or Hydro One Limited rather than Hydro One Networks Inc.). [Footnote: Transcript Volume 3, pages 184-187]*

59. In its submissions CCC has provided a comprehensive review of the modelling used by each of the 4 experts. CCC has identified and discussed significant assumption and application weaknesses in particular in the approaches of Concentric, Nexus, and (to a lesser extent) LEI. CCC`s review also underscores, on the other hand, the sensibility of Dr. Cleary’s approaches, in particular the use of the two approaches that Dr. Cleary uses without direct reliance on an imperfect proxy group; CAPM and Bond Yield Plus Risk Premium (BYPRP).

(a) In respect of Dr. Cleary’s CAPM approach, CCC concludes[32]:

> *Dr. Cleary’s approach reflects the only derivation of beta in this proceeding that recognizes the shorter-term volatility in beta that can lead to poor beta forecast (and thus an inaccurate CAPM-derived ROE).*
>
> *CCC also submits that it is the only beta result that incorporates common sense.*
>
> *…*
>
> *Finally, similar to the determination of the beta, Dr. Cleary looks at multiple data sets of Canadian market returns (both historical and forecast) from various*

[29] OEA Argument, paragraph 105.
[30] OEA Argument, paragraph 159.
[31] OEB Staff *Submission*, page 25, 2nd last paragraph.
[32] CCC Submission, page 51 bottom through page 53.

sources to derive an appropriate MRP. He also considers finance literature and practices of finance professionals.

…

Overall, Dr. Cleary takes a thoughtful approach to determining the risk-free rate, beta and MRP in his CAPM model. He considers multiple data points in each determination and ensures that the input is reasonable based on various considerations.

(b) In respect of Dr. Cleary's BYPRP approach, CCC concludes[33]:

Dr. Cleary's approach does not rely on authorized returns for other utilities in various jurisdictions.

…

Considering the much lower risk of Ontario's electricity distributors and transmitters relative to the average risk of publicly traded companies in the market, CCC agrees with Dr. Cleary that it is appropriate to apply a risk premium of 2.5% for these firms.

… Dr. Cleary's BYPRP approach is logical as it allows for the establishment of the base ROE in a straight-forward manner that directly considers the deemed cost of utility long-term debt (as reflected by the market-determined utility bond yield) and the premium over the bond yield that investors require due to the higher risk of equity investments.

60. CCC recommends jettisoning imperfect proxy group based methods given limited if any robust proxies and the perils of circularity inherent in basing Ontario base ROE on regulator authorized returns in other jurisdictions. AMPCO and IGUA agree.

61. In addition to his discussion of the BYPRP methodology in his prefiled evidence (Exhibit M4), Dr. Cleary provided further evidence, including 6 external citations, in support of the methodology and its results in Exhibit N-M4-EDA-5.

62. CCC recommends adoption of the 7.1%, without transaction costs, resulting from Dr. Cleary's BYPRP approach as the base ROE for Ontario. While we maintain that the evidence in this proceeding would support a base ROE as low as 6.45%, we also agree with CCC that the 7.1% ROE resulting from application by Dr. Cleary if the BYPRP methodology would be a reasonable outcome, considered against the 7.5% expected average Canadian market return derived and explained by Dr. Cleary.

[33] CCC Submission, pages 53 and 54.

Flotation Costs

63. The EDA argues that the OEB's current approach of adding 50 basis points to ROE to account for financing costs *"… should not be discarded absent compelling and convincing evidence that they are not costs incurred in association with a deemed cost of capital (which evidence has not been adduced)".*[34]

64. To start with, it is not clear how there could be actual costs incurred *"in association with a deemed cost of capital"*. What the EDA says in the passages that follow elucidates (sort of) (emphasis in original, footnotes omitted);

> *The cost of capital reflects the "actual cost that needs to be recoverable" in order for utilities to raise capital and investors to keep their funds invested…. They are validly included in a **deemed** cost of capital. The question is not what costs are **actually** incurred.*[35]
>
> *…*
>
> *The fact that some utilities will never incur traditional equity "costs" because they are municipally owned does not mean the cost does not exist in a principled sense as part of an artificially modelled reality."*[36]
>
> *… flotation costs 'are essentially incurred and essentially become a permanent part of the utility capital structure'.*[37]

65. There is absolutely no evidence that has been produced to support any such costs (whether "exist[ing] in a principled sense as part of an artificially modelled reality", whatever that means, or otherwise). As we (and others) noted in earlier submissions, the evidence that has been provided indicates a much lower cost for EGI and some U.S. utilities that Mr. Coyne commented on related to previous analyses that he has undertaken, the particulars of which were not tendered in evidence. On this topic, we agree with OEB Staff's view[38]:

> *OEB Staff is not persuaded that utilities who do not actually incur transaction costs should get the benefit of the adder. Indeed, very few [Ontario] utilities depend (or have ever depended) on the public equity markets, and even then, it is typically the corporate parent that is listed, not the regulated utility itself (e.g. Enbridge Inc. rather than Enbridge Gas Inc., or Hydro One Limited rather thatn Hydro One Networks Inc.). [Footnote: Transcript*

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[34] EDA Submissions, paragraph 85.
[35] EDA Submissions, paragraph 85.
[36] EDA Submissions, paragraph 89(a). Despite several readings, we have no idea what this means. This paragraph was cited by the EDA to page 34 of Dr. Cleary's report, though we have been unable to find any related statements on that page and are unaware of any such statements anywhere else in Dr. Cleary's evidence.
[37] EDA Submissions, paragraph 89(b), quoting Mr. Zarumba. While this statement is contradictory to those which precede it, it is more in line with what Dr. Cleary did say in his report.
[38] OEB Staff *Submission*, page 25, 2nd last paragraph.

Volume 3, pages 184-187] OEB Staff fails to see why transaction costs should be considered to be part of the cost of capital for a utility that does not incur any.

66. OEB Staff also note that the 2009 OEB Cost of Capital report, which is apparently the origin of the 50 basis point adder for financing costs, provides no rationale for embedding such costs in ROE, nor for how the adder was set at 50 basis points.[39] It further appears that other Canadian regulators have adopted this adder on the basis that the OEB includes it.

67. OEB Staff concludes that it is time to revisit this aspect of OEB policy, and that on the evidence now before the Board on this topic *"whatever justification there may have been for the 50 basis point adder in 2009, it is not needed today"*.[40] We agree.

68. On the record in this proceeding, we submit the continuation of a 50 basis point adder on account of financing costs should not be continued, in particular absent (to quote from the EDA) *"compelling and convincing evidence"* that that there <u>are</u> such costs actually incurred. AMPCO and IGUA have recommended that when incurred actual transaction costs should be recoverable, as have several other parties.

Equity Thickness

69. Dr. Cleary has repeated in the instant proceeding the conclusion that he presented in EGI's recent rebasing proceeding (EB-2022-0200) that EGI's equity thickness could be reduced to 36%.

70. CME in its November 7th submissions (CME Submissions) indicated agreement with Dr. Cleary that nothing has changed since that proceeding, and also agreed with Dr. Cleary's recommendation in the instant case that EGI's equity thickness should be reduced to 36%.[41]

71. Nonetheless, CME acknowledged that following a comprehensive review and consideration of the topic (we commend in particular paragraphs 108 through 115 of the CME Submissions in this respect), the OEB determined that an increase to EGI's equity thickness from 36% to 38% was warranted, and thus concludes that *"accordingly … the Board should retain EGI's 38% equity thickness"*. AMPCO and IGUA agree that absent compelling evidence of a significant change in relevant circumstances, regulatory stability commends not revisiting that determination less than a year later.

[39] OEB Staff *Submission*, page 24, 2nd paragraph.
[40] OEB Staff *Submission*, page 24, 3rd paragraph.
[41] CME Submissions, paragraphs 114 and 115.

72. As indicated at the outset of this Reply, if the OEB is persuaded by the OEA's position that the gas distribution business is riskier than the electricity distribution and transmission business, and given the resetting of EGI's equity thickness to 38% last year through a comprehensive process including extensive evidence from the OEA's expert in this proceeding – Concentric Energy Advisors – then SEC's position that for electricity distributors and transmitters equity thickness should be reset to 37% has merit. In this respect, AMPCO and IGUA endorse the submissions at paragraphs 3.5.4 through 3.5.12 of SEC's November 7th *Final Argument*, and SEC's further submissions on this topic in Reply.

73. CME argues that there is good evidence to support a reduction in Hydro One's equity thickness to 38%, and the OEB should do so now.[42]

74. The OEA asserts that Dr. Cleary's analysis in respect of sufficiency of Hydro One's capital structure *"is backward looking and ignores direct evidence from the investment community"*. In support of this assertion the OEA cites one credit opinion reference from Moody's which reportedly notes 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"*.[43]

75. In contrast, the evidence relied on by Dr. Cleary, from the investment community and otherwise, is listed at paragraph 93 of the AMPCO/IGUA Submissions, is as follows (referencing Exhibit M4, pages 116-121):

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

(b) Hydro One shows strength in all key credit metrics[44];

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

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

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

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

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[42] CME Submissions, paragraphs 119 and 120.
[43] OEA Argument, paragraph 237.
[44] See Exhibit M4, page 120.

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

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

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

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

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

(k) Hydro One’s observed price to book (P/B) ratio is 2.04, compared to an average market determined price to book ratio of 1.45 for Canadian publicly traded utilities in 2023, *“which suggests the market feels that it is comfortably earning a more than adequate return based on its current equity base, as discussed in Section 5.5.”*[45]

76. In his evidence Dr. Cleary references current credit rating reports from three reputable agencies and current “market determined’ bond yields for Hydro One’s debt. This evidence is forward-looking, market based, and representative of the investment community.

77. The AMPCO/IGUA Submission noted, in addition, that:

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

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

78. AMPCO and IGUA have taken the position that the evidence adduced in this proceeding indicates that Hydro One’s equity thickness should be reduced, though we also indicated that such a reduction should be considered at the time of its next rebasing. AMPCO and IGUA have not changed their position in this respect, but note that the evidence before the Board in this proceeding certainly indicates that it would be wholly inappropriate to increase Hydro One’s equity thickness as urged by Concentric.

79. Finally in respect of capital structure, we note, and agree with, APPrO’s submission that[46]:

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[45] Exhibit M4, page 121, lines 7-10.
[46] APPrO *Submissions*, page 4, bottom.

If a regulated entity is encountering difficulties with financing, raising capital or any other issuer related to capital structure, all regulated Ontario utilities are already able to request such a change to their capital structure on a case-by-case basis.

We note that none have done so, and there is no indication that the OEB's current deemed capital structure is imposing any limits on Ontario's utilities.

Monitoring

80. CME has submitted that the OEB should make its internal cost of capital monitoring reports public.

81. OEB Staff have submitted that those reports should remain internal to the OEB, though have not provided any rationale for why these reports could not be made public.

82. We are not aware of any reason not to make such reports public. We understand that such reports entail collecting and collating otherwise publicly available information, which the OEB then relies on in exercising its mandate.

83. In its *Practice Direction on Confidential Filings* the OEB states (page 1, second paragraph):

The OEB's general policy is that all records should be open for inspection by any person unless disclosure of the record is prohibited by law. This reflects the OEB`s view that its proceedings should be open, transparent, and accessible. The OEB therefore generally places materials it receives in the course of the exercise of its authority under the Ontario Energy Board Act, 1998 and other legislation on the public record so that all interested parties can have equal access to those materials.

84. Absent demonstration of concerns regarding information that may be of a confidential nature and should be protected as such (of which none have been stated), AMPCO and IGUA submit that such reports should be publicly available.

ALL OF WHICH IS RESPECTUFLLY SUBMITTED by:

Gowling WLG (CANADA) LLP, per:
Ian A. Mondrow
Counsel to AMPCO and IGUA
November 28, 2024

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