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BY EMAIL and RESS

April 16, 2009
Our File No. 2090144

Ontario Energy Board
2300 Yonge Street
27th Floor
Toronto, Ontario
M4P 1E4

Attn: Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: EB-2009-0084 – Cost of Capital

On March 16, 2009 the Board sent a letter to stakeholders asking five questions with respect to the 2009 cost of capital values applicable to electricity distributors. These are the submissions of the School Energy Coalition.

Introduction

1. These submissions are organized in several sections. Prior to dealing with the specific questions posed by the Board, we consider the overall factual, policy and process issues that are raised when cost of capital is considered in this context and in these economic conditions. Then, we give specific answers to the five questions posed by the Board.

2. ***Summary of Conclusions:*** Our analysis reaches the following conclusions:

    a. There does appear to be a disjunct between the actual cost of capital faced by electricity distributors in 2009, and the values generated by the Board's formulae. The return on equity still appears to be OK, but the values of both short and long term debt do not appear to be consistent with our understanding of the current state of the financial markets as they apply to electricity distributors.

    b. The formulae cannot be expected to produce correct values every year, since the financial markets do not operate on the basis of formulaic movements. It is only reasonable for the Board to expect that, on average over the long term, the formulae will be consistent with actual market conditions, and in any given year they will not be so wildly off as to be unreasonable.

c. The Board's options are:

   i. Apply the current methdology without alteration;
   ii. Suspend the changes for 2009 (in effect continuing with the 2008 values);
   iii. Determine cost of capital on a utility specific basis based on evidence filed in each utility's rate case; or
   iv. Adopt an arbitrary set of values for 2009 that is inconsistent with the current methodology.

d. The Board has not heard and assessed any evidence on which a decision could be made that is inconsistent with its current methodology.

e. Therefore, for 2009 the Board should adopt the values derived from its current methodology, without amendment.

f. After adopting the formula values for 2009, it is not appropriate to engage in a full review of cost of capital for 2010. Market volatility will make the task more difficult, and the Board has more important priorities. A review for 2011 is more reasonable.

g. A change in the timing of the current methodology is appropriate, because the current timing sets cost of capital based on the rate year, when all other costs are based on the calendar test year.

Market Conditions

3. The Board has no evidence before it as to market conditions. Therefore, the statements of fact and opinion contained in these submissions, and in all submissions on this subject by all parties, must in law be considered – with a very few exceptions - to be statements of opinion unsupported by any evidence. Our analysis below represents our impressions of the current market conditions, but we do not put it forward as evidence of a factual nature.

4. In our view, the 8.01% value for ROE is probably very close to market (if there were an actual market for utility common equity). The values of 7.62% for long term debt, and 1.33% for short term debt, probably are well off actual debt rates, however.

5. ***Market Changes.*** It is our observation that three things are happening in the Canadian financial markets right now that are relevant to the cost of capital of electricity distributors:

   a. The price of risk has increased. While there is a debate going on between financial commentators as to whether risk was underpriced prior to the current downturn, or whether the price of risk is inflated today due to the high level of market uncertainty, the apparent fact is that today the compensation an investor expects for taking a given risk with their investment capital, is significantly higher than it was a year ago. This does not appear to be a change in perceived risk. Canadian investors consider the risk in securities to be the same today as a year ago, generally speaking (there are company and sector specific exceptions, of course, such as the auto industry), but the fee they want to be paid to bear that risk has gone up.

b. There has been a flight (perhaps "stampede" is a better word) to quality and safety. There is still a substantial amount of money looking for a home, and for the most part investors are not deciding whether to invest, but where to invest. In keeping with the repricing of risk, investors are willing to take substantially greater cuts in their return in order to reduce their risk. Regulated utilities are perceived to be very low risk, because of their reliable cash flow from regulated rates, and this perception has increased in recent months.

c. As result of the first two market realities, the relationship between the cost of capital for regulated utilities, vs. other formerly "low risk" companies, has become attenuated. The A rated bond of a regulated utility, and the A rated bond of Joe Retailer Inc., should in theory have similar risk. Our perception is that the market right now sees the second as significantly riskier than the first.

6. ***Return on Equity.*** With respect to the equity rate, through the formula it has dropped from 8.57% to 8.01%. However, it is important to note that this is a nominal rate of return, not a real rate of return. Through the bond rate component of the formula, the rate is adjusted for changes in the inflation rate that are reflected in market returns.

7. In this situation, we know that the inflation rate on which the 8.57% was based was about 2.0%, and the current Canadian inflation rate (ie. GDP deflator) is about 1.4%. Thus, a drop of 60 basis points in inflation over the last twelve months is offset by a drop of 56 basis points in ROE, leading to a net increase in the real ROE of about 4 basis points.

8. We do not pretend that a simple inflation adjustment "proves" that the equity rate is still correct. Rather, it is our submission that the ROE net of inflation has changed negligibly over the last year, suggesting that the narrowing of the gap between long term debt and equity rates in the formula is not the result of an ROE problem. The ROE appears to be essentially unchanged. One might legitimately ask why the long term debt rate went up when the inflation rate went down, which is not normal, but that is a separate issue. The narrowing spread does not suggest in any direct or indirect way that the ROE value is inappropriate.

9. ***Long Term Debt.*** The Board's methodology for determining the market price of long term debt is based on market yields for investment grade debt. Normally, this is likely to generate reasonable numbers, but from time to time market perceptions and risk pricing will have anomalies that make the methodology wrong. The current time is a case in point.

10. The Board has only limited evidence on what electricity distributors actually have to pay right now for long term debt. CME, in their submissions, have quoted long term rates for Union Gas of 6.0% based on statements by them on April 8th. In IR responses, Greater Sudbury Hydro has quoted long term rates given to them by their bank on March 16, 2009 of 4.9-5.6%, using a swap

to guarantee the long term rate (EB-2008-0230, SEC IRs App. 20), which is consistent with rates that many utilities have been receiving by their banks in late 2008 and early 2009. Anyone who is speaking to banks today about borrowing is aware that for companies with "undoubted" credit seeking long term fixed rate money, banks are offering 6% or less.

11. However, the few examples we have are insufficient for the Board to conclude that a fairer long term rate is, say, 6% or 5.5%. That would require more evidence than the Board has before it. The Board may well suspect that 7.62% is considerably higher than the rate electricity distributors really need to pay for commercial long term debt in 2009, but that is not good enough. Evidence would be required to reach this conclusion.

12. Therefore, our conclusion is that the Board has no basis on which to use any rate other than 7.62% for long term debt.

13. ***Short Term Debt.*** The Board's rate for short term debt is 1.33%, reflecting the depressed yields of treasuries due to the flight to safety we discuss above.

14. In our view, the 1.33% rate is lower than the short term debt costs of electricity distributors. While there may be some that are in a position to access public markets on favourable terms, it is submitted that most would have to access commercial banks, where short term rates are not likely to be less than 2.5% today, probably higher. CME in their submissions quote Union as using a 3.5% rate for 2009, which appears somewhat high to us, but below 2.5% would seem to us to be too low.

15. That having been said, once more the Board has little or no evidence on which to reach a conclusion on this point. Therefore, our conclusion is the same as we reached for long term debt, i.e. without evidence it is inappropriate to change the rate for short term debt.

Assessment of the Board's Options

16. Having concluded that we don't believe the debt numbers reflect market conditions, that does not imply that the Board's current methodology is flawed. The methodology and its formulae are derived from statistical information over a period of time, and if the statistical relationships hold true should continue to reflect reality over a similar period of time.

17. What the methodology cannot be expected to do is calculate accurately the market returns appropriate for electricity distributors at a given point in time. There is no simple causal relationship or correlation between market factors at any given point in time. Many factors will be at play, and a particular relationship or correlation will be more or less accurate at any point in time depending on what factors are strongest at that time.

18. What the formula assumes is that, over time, the dominant correlation will be the one expressed by the formula, so that deriving value A (e.g. utility ROE) from value B (e.g. Bank of Canada bond rate) will on average be reasonable if a series of calculations are made over time.

19. We therefore believe that a conclusion that the debt values derived from the formulae are not consistent with market reality is not fatal to either the methodology, or the values. In general, ALL values derived from the formulae will be wrong to a certain extent. They are not expected to be perfect. Most of the time they will be fairly close, but once in a while they will not be. That does not invalidate them. That is simply the nature of the beast. Like the ebb and flow of revenues due to weather, variations of the derived values around the market reality even themselves out over time.

20. It is therefore our conclusion that having two values that appear to be less than perfect does not call for a change.

21. That having been said, it is appropriate for the Board to consider the range of options it has available to it. It would appear to us that the Board has four choices for dealing with the 2009 cost of capital for electricity distributors.

22. ***Current Methodology.*** The Board can, as noted above, continue with the current methodology and the values derived from it, without revision.

23. ***No Change in Values.*** Instead, the Board could decline to apply the methodology this year, thus retaining the 2008 values of 8.57% ROE, 6.01% LTD, and 4.47% STD. The justification for this might be that the current methodology has not been tested in unusual economic circumstances such as those we are experiencing today, and so the Board questions whether it is sufficiently robust to produce useful values in this situation. We have the following comments on this option:

    a. The proposed justification is, in fairness, very weak. Lacking evidence, and relying only on its impression of the situation, does not appear to us to be a sufficient reason to change a stated Board policy on which utilities and ratepayers have relied.

    b. Any deviation from the current methodology produces winners and losers. In this case, the winners are those utilities that have third party (non-affiliate) debt, or have long term fixed rate affiliate debt. They benefit from the higher ROE. The losers are those utilities have have demand or alterable affiliate debt, because they will have a lower deemed rate for that debt. These resulting winners and losers are probably a good thing, because LDCs should be encouraged to seek market debt, and to fix their rates long term to match the long term nature of their assets. However, this does not appear to us to be a sufficient reason to select this option.

24. ***Utility Specific Cost of Capital.*** The Board could suspend the use of the generic methodology, and instead determine the cost of capital for each cost of service filer this year the same as they do with any other cost, by considering utility specific evidence. This option is impractical for three reasons:

    a. At this late date, with no cost of capital evidence filed for most 2009 cost of service filers, this choice would inevitably mean delays in implementing May 1, 2009 rates.

b. Even if the delay issue could be resolved, the amount of hearing time and effort required to achieve this result would be substantial, and is not a good use of the Board's time in light of its many other priorities.

c. Multiple proceedings to consider cost of capital would be duplicative and wasteful of time and resources, and would also produce the serious possibility that the cost of capital decisions for this year's filers would not be consistent with each other.

25. ***Set New Arbitrary Values.*** In the interests of completeness, it is true that the Board could simply pick numbers that seem reasonable to it, and use them on a temporary basis in 2009. Those numbers would not have any evidentiary basis, of course, and so would be less reliable than those coming out of the current methodology. In addition, arbitrary ratemaking is something that this Board does not condone, and it would be a surprising turnaround for this Board to jettison its reliance on evidence and the rule of law. Therefore, this option cannot really be considered a serious one.

The Prospects of a Full Review

26. Our comments above do not consider the possibility of a full review of electricity distribution cost of capital, with sworn and tested evidence and a full debate on the issues. While that is always an option, it would take too long to provide results for 2009 cost of service rates.

27. The question then arises whether one of the above options could be selected today for 2009, but the Board could then initiate a generic hearing process to deal with cost of capital for 2010 rates. Without commenting on whether a full review of the cost of capital of electricity distributors is appropriate at some point, carrying out such a review this year is not a good idea.

28. There are three main reasons to defer a full review:

a. The current market volatility makes the analysis of long term cost of capital components more difficult. If the current market situation is the reason for the review, that implies that change is occurring. If the market is in a state of change and uncertainty, that means past relationships and correlations between factors may also be changing. This creates the potential that conclusions based on past data will in fact be less applicable today than they were a year ago. If those past relationships and correlations are not changing, of course, then by definition a review is not called for.

b. The US economy and its markets, and in particular the credit markets, do not appear to be reacting the same way as the Canadian markets. The impact of those differential US changes on Canada are not yet known, and few economists have been prepared to predict that interaction, because it is unusual. Analysis of the cost of capital in Canada in these circumstances could be particularly challenging.

c. The Board has a very busy agenda this year, with important regulatory and government priorities to address. A review of the cost of capital would have to be supported by a compelling case of urgency for this Board to consider it a priority. We have not heard anything suggesting that such urgency has been demonstrated.

29. For these reasons, we believe that the Board should not consider a full review of the cost of capital for electricity distributors before 2010 (for 2011 implementation). Even that may be unnecessary, but that should be the earliest timing, in our view.

Timing of Application of the Current Formulae

30. The Board has asked the question whether the timing of the use of the current methodology should be altered, to take place in November rather than later. Given our comments on the main issues, this issue does not appear to be related, but we will provide a brief comment in any case.

31. We see it as a flaw in the current methodology that the cost of capital is calculated after the test year has started. There are pros and cons to this issue, but in our view the cost of capital should be calculated on a forecast basis for the test year, which is the calendar year, just like all other costs. The fact that the costs for the test year are actually collected over a different period, the rate year commencing May 1st, should not change the period for which the cost of capital is calculated.

32. Of course, the current methodology does have some built-in lags, and the timing is thus not exact in either case. However, it appears to us that the current methodology assumes a May 1st commencement of the year, which is not consistent with the other costs for the test year. It would therefore be better, we think, to calculate cost of capital, in future years, in November rather than later.

Answers to the Board's Questions

33. Based on the above analysis, we would therefore answer the Board's questions as follows:

1. How do the current economic and financial conditions affect the variables (i.e., Government of Canada and Corporate bond yields, bankers' acceptance rate, etc.) used by the Board's Cost of Capital methodology?

Please see our analysis above under the heading "Market Conditions".

2. In the context of the current economic and financial conditions, are the values produced by the Board's Cost of Capital methodology and the relationships between them reasonable? Why, or why not?

In our view, the ROE value continues to reflect market. As noted in our discussion above, we do not believe that the values for long term and short term debt correctly reflect current market prices faced by Ontario electricity distributors. However, values do not have to be correct to be reasonable. Weather normalized values are used all the time, and they are not correct, but in the context in which they are used, they are reasonable. In this situation, the Board's methodology produces values that will be correct on average over a period of time.

It is therefore reasonable to use those values each year, even though in any given year they will not be completely accurate relative to the market. Please see our analysis in para. 16-20 above.

3. What adjustments, if any, should be made to the Cost of Capital parameter values to compensate or correct for the current economic and financial conditions?

The Board should not adjust its values for 2009. When the range of options available to the Board is considered (see para. 21-25), no change in the values is, in our opinion justified.

4. Going forward, should the Board change the timing of its cost of Capital determination, for instance, by advancing that determination to November?

A change in the determination of the values to align them more closely to the forecast cost of capital in the test year (the calendar year) would be an improvement on the methodology.

5. Are there other key issues that should be considered if the Board were to adjust any or all of the Cost of Capital parameter values produced by the application of its established formulaic methodology?

The submissions of CME deal with the question of retroactive ratemaking and the need for proper evidence if any change to cost of capital values is to be made. We support those submissions.

Conclusion

34. We thank the Board for the opportunity to comment on these matters, and hope that our input is useful. We would like to continue to be involved in any additional proceedings of the Board related to this subject.

35. We request that the Board order payment of our reasonably incurred costs of participation in this proceeding.

All of which is respectfully submitted.

Yours very truly,
SHIBLEY RIGHTON LLP

Jay Shepherd

cc: Bob Williams, SEC (email)
Wayne McNally, SEC (email)
Interested Parties (email)