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November 10, 2009

Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street
27th floor
Toronto, ON M4P 1E4

Dear Ms Walli,

Cost of Capital in Current Economic and Financial Market Conditions
Board File No.: EB-2009-0084
Our File No.: 339583-000037

We just noticed that there are typographical errors in sub-paragraphs (a) to (e) inclusive of paragraph 19 of the Final Written Comments submitted on behalf of the Consumers Council of Canada (the "Council"), Canadian Manufacturers & Exporters ("CME") and Vulnerable Energy Consumers Coalition ("VECC").

The "Items" referenced in each of those sub-paragraphs refer to the topics discussed in the previous paragraph, being paragraph 18, and not paragraph 15. Would you please change the number "15" in each of sub-paragraphs 19(a) to (e) inclusive to the number "18".

A corrected page 9 is enclosed.

Please contact my assistant, Suzanne Castanza, if any further information is required.

Yours very truly,

Peter C.P. Thompson, Q.C.

PCT\slc
enclosure
c. Paul Clipsham (CME)
Interested Parties EB-2009-0084

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(e) The Board uses a formulaic adjustment mechanism to determine subsequent changes to ROE, although no one is bound by the "guidelines" that establish the ROE adjustment mechanism. Any party is free to apply, in rate hearings, for approval for costs of capital in rates which differ from the results of applying the ROE adjustment formula. If any specific utility, or if utilities generally, wish to seek Board approval for a ROE which is higher than that produced by applying the adjustment formula, on the grounds that the ERP method should be displaced in favour of other methods, or on grounds that the ROE adjustment formula is defective, then they must do so in either a generic or utility-specific rates proceeding.[10] Union and EGD exercised this right in 2003 when they requested that their "benchmark" ROEs be increased and that the ROE adjustment mechanism be modified to be less sensitive to changes in LTC rates; and

(f) Currently, the Board treats Government-owned and privately owned utilities in the same manner, even though Government-owned utilities do not raise equity in the capital markets.

19. The features of the current methodology that some suggest should be changed include the following:

(a) Item 18(a) – Deemed Capital Structure – Some contend that the Deemed Short-Term Debt component of the capital structure for electricity distributors set out in the December 2006 Report of 4% is no longer appropriate;

(b) Item 18(b) – Costs of Debt – Some contend that utility bond rates rather than corporate bond rates should be used to calculate the deemed long-term debt rate for electricity distributors and question the appropriateness of applying the deemed long-term debt rate to unfunded debt ;

(c) Item 18(c) – Reliance on the ERP method – Some seek to revise the ERP method on the grounds that ascribing weight to the equity returns allowed to U.S. regulated utilities is required to reflect the "comparable investment" element of the FRS;

(d) Item 18(c) – Reliance on the ERP method – Some suggest that the ERP method should be changed to operate from a "cost of utility debt" base rather than from the risk-free rate of return represented by a test year forecast of the LTC rate;

(e) Item 18(d) – ROE adjustment formula – Some contend that the ROE formula has been defective from the outset and others suggest that its sensitivity to the LTC rate should be reduced.

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[10] The December 2006 Report recognizes, at page 8, a distributor's right to seek a capital structure and/or equity risk premium at variance with the parameters specified in that Report. Our understanding is that, in principle, the Board accepts that there can be justifiable deviations from "guidelines" the Board establishes. We understand that it was this principle that prompted the Board's November 20, 2006 Decision in EB-2006-0087 to terminate the code development process then underway to review the cost of capital and to develop a 2nd generation incentive regulation mechanism, and instead, to proceed to implement its cost of capital and 2nd generation incentive regulation policies by means of guidelines, as was communicated to interested parties by Board letter dated November 23, 2006. Our understanding is that the right to seek justifiable deviations from guidelines is available to all parties and not merely to distributors.

EB-2009-0084

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

AND IN THE MATTER OF a consultation initiated by the Ontario Energy Board on the Cost of Capital for regulated entities.

FINAL COMMENTS ON BEHALF OF The Consumers Council of Canada (the "Council"), Canadian Manufacturers & Exporters ("CME"), Vulnerable Energy Consumers Coalition ("VECC")

October 30, 2009
<u>Corrected November 10, 2009</u>

Robert Warren
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Counsel for the Council

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I. Introduction

1. The Consumers Council of Canada (the "Council"), Canadian Manufacturers & Exporters ("CME") and Vulnerable Energy Consumers Coalition ("VECC"), hereinafter referred to as the "Consumer Groups", have worked together to finalize these written comments. These final comments are a joint submission on behalf of the Consumer Groups.

2. The limited scope of this consultative process is described in the Board's letters of March 16, June 18, July 30 and August 20, 2009, as follows:

- March 16, 2009 letter
  - The Board noted that it "is initiating a consultative process to help determine whether current economic and financial market conditions warrant an adjustment to any of the Cost of Capital parameter values ... set out in the Board's letter of February 24, 2009." wherein the spread between the Return on Equity ("ROE") and the Long-Term Debt Rate had declined to 39 basis points.
  - The Board noted "the deterioration in economic and financial market conditions during 2008 and 2009" and stated that as a consequence, the Board "is considering whether these circumstances warrant the Board exercising its discretion to adjust any or all of the values produced by the application of its established formulaic methodology."
  - The Board emphasized that its "established formulaic methodology itself is not in issue" and that "the objective of the consultation is not to re-consider that established methodology but rather to test whether the values produced, in relationship among them, are reasonable in the context of current economic and financial market conditions."
- June 18, 2009 letter
  - Following receipt of comments from interested parties on specific questions in its March 16, 2009 letter pertaining to issues raised by the proposed consultative process, the Board indicated that it "is not persuaded that there is a sufficient basis to vary in a timely manner the 2009 parameter values for 2009 rates. Nevertheless, the Board is satisfied that further examination of its policy regarding the cost of capital is warranted to ensure that, on a going forward basis, changing economic and financial conditions are accommodated if required."
- July 30, 2009 letter
  - The Board reiterates that "an ERP approach remains the most appropriate in the current circumstances" but that in the consultative process, "the Board will review the application and derivation of the current ERP approach to determine whether it is sufficient robust to guide the Board's discretion in applying the Fair Return Standard ("FRS").

- The Board identified the three areas where further information is needed and enclosed as Appendix B, a list of 19 questions entitled "Issues for discussion at Stakeholder Conference."

- August 20, 2009 letter

  - In responding to a letter dated August 13, 2009, from Robert Warren, counsel for the Council, the Board confirmed, *inter alia*, that this consultation process "is prompted by the state of the financial markets" and that "the focus of the Board's review is on the application and derivation of the current ERP approach to determine if it is sufficiently robust to guide the Board's discretion in applying the FRS.

3. The Consumer Groups and others sponsored written comments from Professor Laurence D. Booth. Dr. Booth's comments were structured to respond to the 19 questions posed by the Board. Dr. Booth appeared and made an oral presentation to the consultative on October 6, 2009. Other consultative participants filed materials that addressed matters well beyond the limited scope of this consultative process.

4. At the outset, we wish to emphasize that the market crisis of late 2008 and early 2009 that prompted this consultative has now abated. There is no need to consider changing the cost of capital methodology to respond to conditions that no longer exist.[1] Undaunted by this turn of events, the proponents for change have reverted to grounds of challenge to the Board's current cost of capital policy or methodology that have been raised and rejected in prior proceedings.[2] For reasons which follow, we submit that prior decisions rejecting these challenges cannot be overturned as a result of a consultative.

5. In these final comments, we provide our analysis of the nature, scope and possible outcomes of this consultative process. This analysis postulates that findings with respect to disputed matters of fact and opinion pertaining to investor behaviour and the current state of the capital markets can only be made in an adjudicative process.[3] The analysis attempts to demonstrate that the elements of the Board's current cost of capital policy or methodology are based on Board findings in utility-specific or generic adjudicative proceedings with respect to matters of fact and opinion pertaining to the appropriate methodology to apply and the behaviour of capital markets and investors.

6. In these circumstances, we suggest that the possible outcomes of this consultation are limited to a Board report which evaluates whether any of the information presented during the course of the consultative is sufficient to call into question the continued appropriateness of any element of the Board's current cost of capital methodology.

7. We then evaluate information the Board has received with respect to the following:

   (a) the robustness of Board's Equity Risk Premium ("ERP") approach;

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1 See para.35 of these comments where we specifically respond to the case for change based on the recent financial crisis.

2 Those challenging the current methodology appear to place the greatest emphasis on the deficit or "gap" between higher equity returns U.S. regulators allow compared to Canadian regulators. They contend that the existence of the "gap" indicates non-compliance with the "comparable investment" feature of the FRS. Our responses to this and other criticisms of the current approach are found in Section III.

3 See paras.11 to 17 of these comments.

(b) whether the results of applying the ROE formula adjustment mechanism continue to be reasonable; and

(c) the Board's discretion to adjust the results of applying the ROE adjustment mechanism.

8. Our evaluation of information the Board has received pertaining to these items prompts us to suggest that objective information[4] pertaining to investor behaviour with respect to existing and new investments in Board regulated utilities convincingly establishes that there is no justification for an adjudicative proceeding to consider either:

(a) a departure from the current ERP approach for determining the initial utility-specific ROE;

(b) possible changes to the ROE adjustment formula; or

(c) factors guiding an exercise of discretion to adjust the results of applying the ROE adjustment formula.

9. The focus of these comments is primarily on the equity return element of the Board's current cost of capital methodology. We have been provided with and have reviewed a draft of the final comments prepared by Mr. Aiken on behalf of the London Property Management Association ("LPMA") and the Building Owners and Managers Association of the Greater Toronto Area ("BOMA"). Mr. Aiken provides a number of comments on the cost of debt capital set out in the Board's December 2006 Report on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors (the "December 2006 Report"). Mr. Aiken's comments include recommendations with respect to the 4% Short-Term Debt component of the deemed capital structure for electricity distributors, as well as the appropriateness of allowing electricity distributors to recover interest costs materially in excess of their actual costs. We support and adopt Mr. Aiken's recommendations pertaining to the costs of debt recoverable in the rates of electricity distributors Mr. Aiken is suggesting that his recommendations be implemented without allowing those opposite in interest an opportunity to test them in either a utility-specific or generic rates proceeding. For reasons which follow, we are of the view that those who wish to question Mr. Aiken's recommendations, before they are implemented, are entitled to do so at a hearing.

10. We also provide comments on information pertaining to the appropriateness of allowing Government-owned utilities to recover, in utility rates, notional or fictional costs they do not incur, including ROE and related notional income taxes and question whether it is appropriate to continue to treat Government-owned utilities as if they were stand-alone commercial enterprises raising equity in the capital markets.

4 See paras.25, 26 and 39 to 45 of these comments.

II. Nature, Scope and Possible Outcomes of this Proceeding

A. A Consultative and not an Adjudicative Proceeding

11. Prior to and at the outset of the Stakeholder Conference, the Board and its Staff emphasized that this is a "consultative" rather than an "adjudicative" proceeding. In its August 22, 2009 letter to Robert Warren, the Board stated:

> *"As you know, this initiative is a consultative process and not an adjudicative one. As such, concepts such as "evidence", "record" and "cross-examination", among others, in their traditional sense do not apply."* (emphasis added)

This distinction is important because the *Ontario Energy Board Act* requires a hearing before rates are set.[5] Moreover, considerations of fairness require that no decision having an effect on rates be made without there being an opportunity for parties opposite in interest to challenge, in a hearing, assertions of fact and opinion that are in dispute.

12. In his opening remarks on September 21, 2009, Mr. Garner emphasized the same point as follows:

> *"Let me, before we start, also speak a bit about the nature of this conference. It's a stakeholder conference, meaning that it's not a hearing, but a consultation convened by the Chair for the purpose of developing the Board policy issues."* (Transcript Day 1, page 3, line 14) (emphasis added)
>
> *"The focal point of the conference is the means by which the Board shall determine the cost of capital. What we're not doing today in this conference is talking about numbers. We're talking about the means about how we're going to get to numbers. And it's about the application and the derivation of the current equity risk premium methodology the Board uses.* (Transcript Day 1, page 4, line 14 to line 20)

13. In his opening remarks, Board Chair Mr. Wetston emphasized that the purpose of the consultative was to gather information. He stated as follows:

> *"It came to our attention at the Board over this last year or year and a half that it was important for us to embark on this consultation, on this conference, in order to obtain further information in three key areas. We outlined this to you all in previous correspondence, which you have.*
>
> *Let me re-emphasize the three areas: The potential need to adjust the established cost of capital methodology based on the equity risk premium approach to adapt to changes in financial market and economic conditions. I assume there will be a fair bit of discussion about that, and, given the materials that have been filed, that is obviously the case.*
>
> *Secondly is to determine the reasonableness – and I underline the "reasonableness" – of the results based on a formulaic approach for setting the cost of capital. I underline the fact that it's been a formulaic approach.*

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5 *Ontario Energy Board Act 1998,* sections 21(2), 34 and 78.

> *And, thirdly, importantly, to guide the Board's discretion to adjust those results, it appropriate. Discretion is key to the exercise of our judgment with respect to the cost of capital.*
>
> *So the fair return standard, not new to any of you, will be and will receive considerable attention in this consultation. Moreover, in this consultation we will be, as you all know from the outline of the issues, concerned with the means, the methodology, by which the Board shall determine the cost of capital."* (Transcript Day 1, page 5, line 25 to page 6, line 23)

14. Mr. Wetston also indicated that the outcome of the conference will be a "Board policy". He stated:

> *"So the product of the stakeholder conference - Mark alluded to that - will be a Board policy. And to be clear, this consultation is not about whether the return on equity is too high or whether it's too low, or whether or not it's correct or just right, if anybody can tell me what that is. It's about whether it meets the fair return standard. Is it robust enough to guide the Board's discretion at any point in time in dealing, obviously, with the various applications it has before it?*
>
> *So the potential effect, if any, on specific utility revenue requirements as a result of this consultation and the determination of just and reasonable rates will not be addressed in this process, but obviously if addressed will be done in future rate proceedings."* (Transcript Day 1, page 6, line 24 to page 7, line 9)

15. In its August 20, 2009 letter to Mr. Warren, the Board indicated that the results of this process could influence its approach to all of the utilities it regulates. The Board stated:

> *"While the issues list refers to the consultation as one addressing the cost of capital for electricity distributors, that does not necessarily preclude the results of this review, which is on the application and derivation of the equity risk premium approach (ERP), from being applicable to other rate-regulated sectors."*

16. In the context of these remarks, we suggest that, for the purposes of considering the possible outcomes of this process, one needs to first identify each of the elements of the Board's current cost of capital methodology or policy that are applied to all of the utilities it regulates. Next, the extent to which some or all of these elements are based on Board findings with respect to disputed issues of fact and opinion pertaining to such matters as investor behaviour and the state of the capital markets should be considered. We suggest that elements of the Board's current policy that are based on previous Board findings with respect to disputed issues of fact and opinion should not be changed in a consultative process. They should only be changed at the conclusion of an adjudicative proceeding in which parties opposite in interest have been able to test the disputed issues of fact and opinion upon which each of them relies.

17. Facts and opinions expressed during the course of a consultative are untested and should be of no probative value in considering whether prior Board findings with respect to disputed facts and opinions should be changed. With this guiding principle in mind, we turn to a consideration of the elements of and the basis for the methodology the

Board currently applies to determine the cost of capital components of just and reasonable rates for all of the utilities it regulates.

B. Elements of and Basis for the Board's Current Cost of Capital Methodology

18. The elements of the current methodology or "policy" the Board applies to all of the utilities it regulates include the following:

(a) The Board determines a risk-based deemed utility capital structure. The prevailing deemed utility capital structures of the utilities the Board regulates have either been established or confirmed[6] in a rates proceeding. Deemed utility capital structure ratios, established or confirmed in a rates proceeding, can only be changed in a subsequent rates proceeding. For example, Enbridge Gas Distribution Inc. ("EGD") and Union Gas Limited ("Union") obtained equity thickening relief in recent rate hearings before the Board;

(b) The Board uses specified consensus forecasts to determine, annually, the prospective costs of short-term and long-term utility debt when determining a utility's embedded costs of debt;

6 We recognize that most of the electricity distributors the Board regulates applied for approval of a capital structure that conforms to that set out in the December 2006 Report. The capital structure aspects of these applications were not challenged and, as a result, the capital structure set out in the December 2006 Report was confirmed in a rates proceeding for each specific utility.

(c) The Board places primary reliance on the ERP approach when determining the initial ROE for the utilities it regulates. The ERP approach consists of adding a risk adjusted ERP and a flexibility adjustment to the risk-free cost of capital consisting of a test period forecast of the Long Term Canada ("LTC") rate. For utilities such as EGD, Union, Hydro One Networks Inc. ("Hydro One") and Ontario Power Generation Inc. ("OPG"), the initial benchmark ROE has been determined on the basis of findings with respect to the costs of capital made in rate hearings held for each utility. For other distributors, the ROE starting point is set out in the Board's December 2006 Report. That starting point, in turn, is based on findings with respect to the cost of capital made in Hydro One's RP-1998-0001 Decision.[7] No weight is ascribed to the higher ROEs allowed to U.S. regulators when applying the ERP approach. The Board made express findings to this effect in its January 16, 2004 Decision in RP-2002-0158 on applications by Union and EGD for a review of the Board's Guidelines for establishing their respective return on equity. In that proceeding, the Board rejected the request of Union and EGD that new benchmark equity returns be established for each of them at higher levels on the grounds that the higher returns of American utilities supported their request for higher equity returns.[8] The Board reiterated its support for this approach in its December 2006 Report.[9]

(d) Accordingly, the benchmark ROE for each OEB regulated utility has been either established or confirmed in rate hearings on the basis of findings with respect to cost of capital made in those proceedings are in prior rates proceedings. The ROE adjustment mechanism is applied in a rates proceeding on the basis of a explicit or implicit determination that the results it produces are reasonable.

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7 See December 2006 Report at page 17 where it is evident that the ROE starting point used for electricity distributors was based on an application of the ERP approach in Hydro One Networks Inc.'s RP-1998-0001 Decision. Findings made in that adjudicative proceeding formed the basis for the initial application of the December 2006 Report to those electricity distributors whose rates have been set in accordance with that report.

8 In rejecting these contentions, the Board stated:

> *"There are many reasons why ROE may differ from one jurisdiction to another in North America. These may include differences in legislation, timing, tax laws, accounting practices, risk considerations arising from different capital structures and from regulatory practices which may or may not shield the utility from business or weather risks, and other regulatory considerations unique to each jurisdiction, including varying reliance on the common tests for determining a fair ROE. There was no evidence that would allow the Board to make a meaningful comparison of these factors, including the relative riskiness of Canadian and American utilities, in other to understand the difference in ROE between American and Canadian utilities. The bare fact that American utilities might earn a higher ROE than Canadian utilities, as suggested by Ms. McShane and argued by the Applicants, is an inadequate basis upon which to determine whether the ROE for the Applicants should be increased to a level similar to the ROE for American utilities."*

As well, in rejecting the contention that the difference in ROE between American and Canadian gas utilities was a factor that could create a disadvantage for Canadian utilities and their shareholders, the Board noted:

> *"There was no evidence before the Board to suggest that the Applicants are experiencing any difficulty in raising equity capital from or through their respective parents."*

9 The Board's December 2006 Report adheres to these findings, noting that the "current approach" results in a return sufficient to enable distributors to attract capital (see page 21 of the December 2006 Report) despite the recognized fact that allowed returns in the United States have typically been higher than those approved in many Canadian jurisdictions (see page 20 of the December 2006 Report).

(e) The Board uses a formulaic adjustment mechanism to determine subsequent changes to ROE, although no one is bound by the "guidelines" that establish the ROE adjustment mechanism. Any party is free to apply, in rate hearings, for approval for costs of capital in rates which differ from the results of applying the ROE adjustment formula. If any specific utility, or if utilities generally, wish to seek Board approval for a ROE which is higher than that produced by applying the adjustment formula, on the grounds that the ERP method should be displaced in favour of other methods, or on grounds that the ROE adjustment formula is defective, then they must do so in either a generic or utility-specific rates proceeding.[10] Union and EGD exercised this right in 2003 when they requested that their "benchmark" ROEs be increased and that the ROE adjustment mechanism be modified to be less sensitive to changes in LTC rates; and

(f) Currently, the Board treats Government-owned and privately owned utilities in the same manner, even though Government-owned utilities do not raise equity in the capital markets.

19. The features of the current methodology that some suggest should be changed include the following:

(a) Item 18~~5~~(a) – Deemed Capital Structure – Some contend that the Deemed Short-Term Debt component of the capital structure for electricity distributors set out in the December 2006 Report of 4% is no longer appropriate;

(b) Item 18~~5~~(b) – Costs of Debt – Some contend that utility bond rates rather than corporate bond rates should be used to calculate the deemed long-term debt rate for electricity distributors and question the appropriateness of applying the deemed long-term debt rate to unfunded debt ;

(c) Item 18~~5~~(c) – Reliance on the ERP method – Some seek to revise the ERP method on the grounds that ascribing weight to the equity returns allowed to U.S. regulated utilities is required to reflect the "comparable investment" element of the FRS;

(d) Item 18~~5~~(c) – Reliance on the ERP method – Some suggest that the ERP method should be changed to operate from a "cost of utility debt" base rather than from the risk-free rate of return represented by a test year forecast of the LTC rate;

(e) Item 18~~5~~(d) – ROE adjustment formula – Some contend that the ROE formula has been defective from the outset and others suggest that its sensitivity to the LTC rate should be reduced.

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10 The December 2006 Report recognizes, at page 8, a distributor's right to seek a capital structure and/or equity risk premium at variance with the parameters specified in that Report. Our understanding is that, in principle, the Board accepts that there can be justifiable deviations from "guidelines" the Board establishes. We understand that it was this principle that prompted the Board's November 20, 2006 Decision in EB-2006-0087 to terminate the code development process then underway to review the cost of capital and to develop a 2nd generation incentive regulation mechanism, and instead, to proceed to implement its cost of capital and 2nd generation incentive regulation policies by means of guidelines, as was communicated to interested parties by Board letter dated November 23, 2006. Our understanding is that the right to seek justifiable deviations from guidelines is available to all parties and not merely to distributors.

20. Each of these challenges to the elements of the Board's current cost of capital methodology are based on facts and opinions which are in dispute and untested. Except for the cost of debt deficiencies that Mr. Aiken identifies, the Consumer Groups do not agree with these challenges. Accordingly, an adjudicative proceeding must be held before any changes are made on the basis of these challenges.

C. <u>ROE Adjustment Mechanism</u>

21. The ROE adjustment mechanism is a feature of the ERP approach and methodology the Board currently applies to establish just and reasonable rates. The Board has repeatedly determined, both implicitly and explicitly, in contested rates proceedings, that the ROE adjustment mechanism produces just and reasonable rates. An explicit determination to this effect was made in the Union/EGD proceeding decided by the Board on January 16, 2004.[11]

22. As recently as November 2008, the Board confirmed, in a rates proceeding, the appropriateness of its existing ROE adjustment formula. In its Decision with Reasons dated November 3, 2008, in OPG's Payment Amounts Application for Prescribed Facilities, the Board agreed with OPG that its existing formula approach to setting ROE continues to be appropriate.[12]

23. Moreover, every utility that has applied to the Board for a determination of the cost of capital components in its rates, based on an application of the ROE adjustment formula, explicitly and implicitly acknowledges that the formula produces just and reasonable rates at the time of each application . Similarly, the Board's determination of rates based on an application of the adjustment formula constitutes an explicit adjudicative determination, at the time of the decision, that the formula continues to produce just and reasonable rates. In these circumstances, we suggest that considerations of *res judicata* waiver and estoppel preclude utilities, whose rates are based on an application of the ROE adjustment formula, from now asserting that the adjustment formula was defective <u>from the outset</u>. To find otherwise would mean that utilities have intentionally asked the Board to apply an adjustment formula that would not produce just and reasonable rates. For these reasons and others, the Consumer Groups dispute the contention that the ROE adjustment mechanism has been defective from the outset.

D. <u>Determining the Possible Outcomes of this Consultative Review</u>

24. Based on the foregoing, the Consumer Groups submit that the possible outcomes of this review are limited to a Board report on whether the information it has received prompts it to question the continued appropriateness of any elements in the cost of capital methodology the Board currently applies. If so, then the questions should be scheduled for determination in either a utility-specific or generic rates proceeding.

25. When considering whether a *prima facie* case for change of any element of the methodology exists, we urge the Board to focus primarily upon objective and unchallenged facts. Examples of such facts include the following:

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11 RP-2002-0158 Decision with Reasons, January 16, 2004, at paras.141 to 143.

12 EB-2007-0905 Decision with Reasons, November 3, 2008, at pages 161 and 162.

(a) The ready access of Canadian utilities and their owners to debt and equity capital on favourable terms, despite financial market turmoil and regulatory allowed equity returns that are lower than their U.S. counterparts. Canadian utilities are clearly succeeding in the competition for capital available from global sources;

(b) Recent declines in the cost of Canadian utility debt;

(c) Significant premiums paid to acquire Canadian utilities; and

(d) Transparent differences between Canadian and U.S. capital markets.

These objective facts are the key to evaluating the information provided during the course of this consultation.

26. The objective information presented in the consultation indicates clearly that investors are satisfied with the debt and equity returns of OEB regulated entities. There is no objective information regarding investor behaviour to demonstrate that the Board's formula does not meet the FRS. Expert opinion can be valuable in interpreting the meaning of such market observations. But where the opinions of experts are incompatible with objective facts pertaining to investor behaviour, they are insufficient to provide the basis for a process to allow the exploration of theoretical constructs in an adjudicative setting. It is perhaps trite to note that such opinion referenced in the consultative setting falls well short of an evidentiary record required to directly change a Board policy of such importance and longstanding application.

27. The Consumer Groups set out, in these final comments, their views as to why the arguments of those who are proposing changes to the formula are wrong. In considering its next steps, we urge the Board to place considerable weight on the fact that no proponent for change was able to objectively establish that investor behaviour necessitates that change. Before establishing an adjudicative process to consider possible changes, there needs to be some clear and objective information that investors in OEB regulated utilities are not satisfied with the debt and equity returns they currently receive. All of the objective information presented in the consultative leads to the conclusion that investors are satisfied with the debt and equity returns of OEB regulated entities.

III. Evaluation of Information re: Robustness of ERP Approach

28. At the outset, we emphasize that the ERP approach is used to set an initial benchmark utility ROE. Thereafter, the ROE adjustment mechanism is applied to make annual changes to the allowed ROE. In the event that the ROE adjustment mechanism is not producing a reasonable return, then the ERP approach can be used to "re-set' the initial benchmark ROE[13]. For the purposes of evaluating the compatibility of the ERP approach with the "comparable investment" feature of the FRS, we include the ROE adjustment mechanism as a feature of the ERP approach.

29. While the success of the ERP approach in generating fair rates of return is in dispute among the participants in this consultation, there does appear to be a consensus on the mechanics of applying the existing ERP approach to determine the benchmark ROE of an OEB regulated utility, namely:

 (a) determining the risk-free rate represented by the LTC rate;

 (b) determining the ERP for the market as a whole;

 (c) adjusting the ERP of the market as a whole to reflect the reduced risk of utilities; and

 (d) adding flexibility costs.

30. Under the existing ROE adjustment mechanism, the benchmark ROE is adjusted annually to reflect 75% of the annual change in the 30 year LTC's rate.

31. Similarly, there appears to be a consensus that the return component of regulated rates must satisfy the elements of the FRS[14] for determining ROE which are:

 (a) financial integrity standard;

 (b) capital attraction standard; and

 (c) comparable investment standard.

32. Under the ERP approach, the Board considers information with respect to financial integrity, capital attraction and comparable investment and places considerable weight on investor behaviour to provide a reasonable barometer of the formula's success in meeting the FRS.

33. Those calling for changes to the ERP approach, including the ROE adjustment formula, do not appear to be questioning the mechanics of the ERP approach. Rather, they appear to be asserting that the application of these mechanics is generating results that do not comply with the "comparable investment" feature of the FRS. Those calling for

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13 After rejecting the requests of EGD and Union for an increase in their respective benchmark equity return, the Board, in its January 16, 2004 Decision in RP-2002-0158, proceeded to consider the benchmark return that would result from a fresh application of its ERP approach and concluded at para.141 that:

> *"If we had to set a new benchmark rate of return based on the ERP evidence in this proceeding, this rate would not be materially different from that produced by applying the current formula."*

14 These elements of the FRS are described in the Board's July 30, 2009 letter to Stakeholders.

change readily acknowledge that the financial integrity and capital attraction features of the FRS are being satisfied.

34. There were a number of reasons presented for a change in the ROE formula approach. The primary ones are:

(a) the behaviour of financial markets in the course of the recent crisis shows a necessity to make adjustments to the current formula. In particular, the narrow spread between the utility ROE and the rate required for corporate bonds calls for action;

(b) the opinion of individuals employed in relevant positions in financial markets is that the allowed ROE is too low; and

(c) there are significant low risk investment opportunities for Canadian and American capital available from American regulated utilities whose allowed equity returns are higher than those of OEB regulated utilities.

35. The case for change, based on the recent financial crisis and the related narrowing of spreads, is no longer relevant because the evidence establishes that markets have recovered, and that, apart from a possible window of time late in 2008, Ontario utilities regulated by the Board's formula have had no trouble accessing capital on reasonable terms. Further, the narrow spreads which were formerly trumpeted as evidence of inadequate regulatory treatment have largely reverted to pre-crisis levels. In particular, as Dr. Booth's presentation notes, the A spreads are close to normal cyclical levels.[15] Dr. Booth summarized the current financial market for Canadian utilities coming out of the economic crisis as follows on Day 3 p.16:

> *"There have been no utility downgrades. The utilities have raised a significant amount of capital. Absolute financing costs are extremely low. Most utilities are lowering their embedded cost of debt by refinancing at the current point in time. So it is extremely difficult to say that the cost of debt is not fair and reasonable."*

We reiterate that in this consultative process, opinions of experts, including Dr. Booth, are of no probative value when considering whether prior findings with respect to <u>disputed</u> facts and opinions should be changed. This portion of Dr. Booth's presentation pertains to objective facts that cannot reasonably be challenged.

36. The case for change based on the untested opinions of individuals employed in financial markets is tenuous. While it may be conceded that the jobs of those engaged in raising capital for formula regulated utilities would be made easier by altering the Board's approach to the ROE in a manner favourable to such utilities. that is hardly the requisite test. First, it seems difficult to contemplate substantive reform in this important area on the basis of the opinions relied upon by the proponents of change that have not been tested. This is so particularly when the objective information pertaining to investor behaviour clearly establishes that the financial integrity and capital attraction standards are being satisfied. The utilities regulated by the ERP approach, including the ROE adjustment formula, continue to access capital on reasonable terms. The information

15 We adopt and support Mr. Aiken's careful and thorough analysis of the "Current State of the Financial Markets" at pages 2 to 6 of his comments on behalf of LPMA and BOMA.

reveals that investors do not consider such utilities as riskier and requiring a higher return than that produced by the formula.

37. With respect to the assertion that the higher ROE's allowed for U.S. regulated utilities represent a better opportunity for investors, it must be noted that the financial integrity and capital attraction standards are not met only in the event that investments in the regulated utility are preferred to every other investment in the market. Bonbright notes that the capital attraction criteria are designed to permit well-managed, soundly-financed utilities to attract needed capital.[16] The desire of some investors to prefer other arrangements for investment that may involve government participation and higher rates of return does not mean that utilities regulated by the formula have been shut out from obtaining needed capital. As well, the willingness of investors to consider such investments can hardly be ascribed simply to the unattractiveness of formula regulated utilities. As Dr. Booth noted in his comments during his appearance at the consultative conference on Day 3, page 48:

> *"I am very bullish on Canada. I think we will see a surplus in Canada for the foreseeable future. Some of that capital will get exported. I don't see that as a bad thing. In fact, I see it as a good thing. It is a sign that we, as Canadians, are wealthier and we've got the capital to invest not just in our infrastructure and assets, but we have money to buy the American assets, because they're not saving enough."*

Again, we regard Dr. Booth's description of the current situation in Canada to be supported by objective facts which cannot reasonably be challenged.

38. Moreover, it needs to be remembered that the Board has repeatedly rejected the notion that the higher ROE allowed to U.S. utilities, in and of itself, calls for higher allowed returns in Canada.[17] As Dr. Booth notes in his September 2009 comments at page 24, the Province of Ontario rejects the notion that higher allowed returns for U.S. utilities call for increases in the equity returns the Board allows to the utilities it regulates. At page 24 of his comments, Dr. Booth notes the submissions to this effect made by the Province of Ontario in the National Energy Board's ("NEB") recent TQM hearing to that effect.

39. Finally, the hard information derived from the purchase and sale transactions involving formula regulated utilities and utility assets belies the proposition that such utilities are underperforming reasonable investor expectations. Dr. Booth has noted in his comments the 45% premium offered by AltaGas income trust for the assets of AltaGas Utility Group. (This premium has apparently increased from the filing of his comments). The 70% premium paid by Fortis for BC Gas assets, while perhaps not an empirical assessment of the generosity of allowed returns subject to ROE formula regulation, is

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16 Parcell, David *The Cost of Capital, A Practitioner's Guide,* Society of Utility and Regulatory Financial Analysts, 1999.

17 The contention that higher allowed ROEs in the U.S. requires higher ROEs in Canada was rejected explicitly in the RP-2002-0158 Decision and Order dated January 16, 2004 as already noted, and in the December 2006 Report. The contention was implicitly rejected in both the EB-2006-0501 Decision with Reasons dated August 16, 2007, pertaining to Hydro One Networks Inc. and the EB-2007-0905 Decision with Reasons dated November 3, 2008, pertaining to OPG's Payments Application. In both these cases, evidence of higher U.S. allowed returns was tendered to support the requests for higher equity returns than those currently allowed by the Board. In each case, the Board rejected the utility requests to move equity returns closer to those allowed by U.S. regulators.

certainly not consistent with a theory that the market believes that the "formula is broken" or that such utilities must feature higher ROE's to guarantee investor confidence in their financial integrity. In addition, Dr. Booth has noted at Day 3 p. 14:

> *"So the record is, over the last year, six utility holding companies in Canada have simply demonstrated what we all know. They're defensive stocks. They have not varied with the market. They're low risk, and you will not expect them to come up when the market comes up, just as you didn't expect them to go down when the market went down."*

40. The objective facts pertaining to the premiums realized on the sale of formula regulated Canadian utilities was one of the reasons for the Board's January 16, 2004 rejection of the request by Union and EGD for higher benchmark ROEs. In its RP-2002-0158 Decision, the Board stated:

> *"In fact, the evidence reveals that utility ownership transfers in recent history have taken place at above book value. While there may be many reasons that a company may be willing to pay more than book value for utility assets, there was no evidence to suggest that investors are deterred from investing in Canadian utilities because of inadequate prospective returns."*

This situation remains unchanged.

41. Under the financial integrity and capital attraction legs of the FRS, the case against change is so overwhelming that the proponents of higher ROE's have seemingly concentrated entirely on the third leg, namely the comparable investment standard. Yet, the information pertaining to the ability of OEB regulated utilities to obtain all the capital they need is highly relevant to a consideration of whether investors are satisfied that the returns they earn from OEB regulated utilities are reasonable.

42. We reiterate that information pertaining to investor behaviour is key to determining whether the "comparable investment" feature of the FRS is being satisfied. The comparable investment standard calls for regulators to allow a utility the return it would receive if it were investing in other securities possessing an attractiveness, stability and certainty to that of the company's enterprise.

43. The actual behaviour of investors in the market contradicts the thesis of those who say that the higher allowed returns in the U.S. demonstrate a systemic unfairness in the returns allowed in Canada. Investors clearly do not regard this "gap" as unfair. This "gap" has existed for years and investors have nevertheless continued to readily invest in Canadian utilities. Despite this reality, the higher ROE proponents continue to elaborate a "Made in America" analysis and solution for a non-existent problem. This means the direct transposition of American utility results into the Canadian context, despite the lack of a practical market basis for the theory.

44. If investors are prepared to invest in both Utility A and Utility B, despite the fact that Utility A has an allowed return that is lower that Utility B, such investors are satisfied that they are receiving the return they should receive from each utility, having regard to the relative attractiveness, stability and certainty of the securities of each utility. In the absence of real market evidence that investors regard the return of Utility A as too low by shying away from or refraining from investing in it, one would ordinarily not try to build

a case that investors have it wrong and that Utility A actually needs a higher return provided by the regulator.

45. Put in other way, in the example above, both utilities meet the comparable investment standard in that investors do not require an adjustment to the return of Utility A to make it comparable to Utility B for the purpose of investment.

46. This simple fact is occluded by the efforts of the proponents for change to suggest a variety of reasons why the market is behaving in a way that is contrary to the way they believe it should behave and that the returns of Canadian utilities should line up in numerical conformity with their American counterparts. Concentric suggests that a utility can go along meeting the financial integrity and capital attraction of the fairness standard before calamity strikes.[18] Dr. Vanderwiede suggests that bond ratings have no relevance to the equity market.[19] Mr. Dalton suggests that some impairment to Ontario utility financial health is taking place that is unseen because of the lack of publicly traded utilities.[20]

47. Whatever the theory, American utilities, as Ms McShane notes in her comments provide the "alternative universe"[21] for the purpose of staking out the proposition that the formula does not meet the comparable investment standard. The problem for the proponents is that this alternative universe possesses different business and regulatory conditions and operates in a national economic environment that has significantly different characteristics than its Canadian counterpart.

48. Dr. Booth's written comments and oral remarks at the conference delineate the key macroeconomic factors that would make direct comparability of Canada and US utilities an incorrect assumption. On Day 3, Tr. p.27, Dr Booth noted:

> *"It makes no sense for us to take a rate of return from a US capital market and apply it to Canada without making adjustments. In fact, not only does it make no sense. I taught international finance at U of T for 15 years and one of the first things we teach is a principle called interest rate parity.*
>
> *You cannot take rates of return or interest rates from another country and apply them to a different currency without making adjustments. You have to take into account, at the very minimum, the depreciation or appreciation of the currency.*
>
> *So I reject the Concentric report. I don't think it reflects the value of what we have done in Canada and the suffering we have gone through over the last 20 years, and the fact that, by and large, Canada has got it right in terms of macroeconomic policy, tax policy. We have got it right in terms of regulation of our utilities, and I see no reason why we would want to follow American practice."*

18 Tr. Day 2, pp.87, 88.
19 Tr. Day 1, p.185.
20 Power Advisory Comments, p.14.
21 Responses to OEB Questions, EDA, Kathleen McShane, p.12.

49. The objective facts reveal that there are differences between Canadian and U.S. capital markets and between Canadian and U.S. regulated utilities.22 We may not agree on the extent of these differences, but no one can reasonably say there are no differences. In fact, the Rating Methodology for Regulated Electric and Gas Utilities that Moody's applies specifically recognizes the superior business and regulatory climate in Canada. The Rating Methodology contained in Moody's Global Infrastructure Finance dated August 2009, at page 27, states as follows:

> *"In Canada, regulation of electric and gas utilities is overseen by independent, quasi-judicial provincial or territorial regulatory bodies. Accordingly, the transparency and stability of regulation and the timeliness of regulatory decisions can vary by jurisdiction. However, generally the regulatory frameworks in each jurisdiction are well established and there is a high expectation of timely recovery of cost and investments. Furthermore, Moody's considers the overall business environment in Canada to be relatively more supportive and less litigious than that of the U.S. Moody's views the supportiveness of the Canadian business and regulatory environments to be positive for regulated utility credit quality and believes that these factors, to some degree, offset, the relatively lower ROE's and higher deemed debt components typically allowed by Canadian regulatory bodies for rate-making purposes. As a result of the relatively low ROE's and higher deemed debt levels that are generally characteristic of Canadian utilities, for a given rating category, these entities often have weaker credit metrics than their international peers."* (emphasis added)

The Concentric Report is incompatible with the objective facts pertaining to investor behaviour and with Moody's Rating Methodology which recognizes the more supportive business and regulatory environment in Canada.

50. There is also little to commend a direct comparison of Canadian and US utilities based on observable regulatory, business and "event risk". The differences are well recognized outside the theoretical world of the proponents of the Made in America solution. The Merrill Lynch report from the February 2009 NARUC conference shows directionally a weakening of credit standards in US utilities together with higher ROE's, more common equity and lower bond ratings. At best, some US utilities attain similar ratings to their Canadian counterparts, despite the presumably advantageous features of higher ROE and common equity ratios.

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22 At pages 15 to 19 of his final comments on behalf of LPMA and BOMA, Mr. Aiken provides a detailed summary of the differences between the Canadian and U.S. economies, Canadian and U.S. financial markets, and Canadian and U.S. regulated utilities. We adopt Mr. Aiken's summary of the objective information that overwhelmingly demonstrates these differences.

51. The point is that while the sources of capital may be global, the geographic areas or capital markets in which capital is invested are national. That the Canadian and U.S. capital markets are different cannot reasonably be questioned. The objective information overwhelmingly demonstrates that the markets are different. Similarly, it cannot reasonably be suggested that Canadian and U.S. utilities do not differ.[23] It is investor behaviour that determines the extent to which different utilities are comparable. Investors, wherever they may be, continue to treat Canadian utilities, with lower allowed equity returns, as comparable to their U.S. counterparts. Investors, by their behaviour, clearly accept, as reasonable, the "gap" between the allowed equity returns of Canadian and U.S. utilities.

52. Moreover, the "Made in America" solution must also overcome the reluctance of Canadian regulatory authorities to embrace a direct comparison to US utilities. One example of such a ruling is found in Decision 2004-052 of the Alberta Energy Utilities Board in the Generic Cost of Capital Decision dated July 2, 2004, at pages 25 and 26, the Board stated as follows:

> *"<u>Return Awards for U.S. Utilities</u>*
>
> *The Applicants generally took the view that it is appropriate to consider utility ROEs awarded by U.S. regulators, due to the similarity between Canadian and U.S. utilities and due to the high degree of integration of the capital markets of the two countries.*
>
> *The Board notes the evidence of various Applicants that low risk gas distribution utilities in the U.S. have allowed returns in the 11% range on a 45% common equity component, and that prior to incentives, the base return for interstate electric transmission companies allowed by FERC is in excess of 12% on a 50% equity component.*
>
> *The Board also notes the submissions of various interveners that there are several differences between Canadian and U.S. regulation. The Board, in particular, notes CAPP's submission that U.S. pipelines operate under a regulatory regime that has exposed them to severe realized and potential risks. In this regard, the Board notes the evidence of CAPP indicating low actual returns of a number of U.S. interstate pipelines.*
>
> *In the Board's view, the Applicants did not demonstrate that the regulatory regimes in the two countries are sufficiently comparable that the Board should place significant weight on the return awards for U.S. utilities. For example, the Board notes differences in legislation, public*

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[23] This is apparent from another excerpt from the Rating Methodology Moody's applies to Regulated Electric and Gas Utilities at page 6 that states as follows:

> *"Moody's views the regulatory risk of U.S. utilities as being higher in most cases than that of utilities located in some other developed countries, including ... Canada. The difference in risk reflects our view that individual state regulation is less predictable than national regulation; a highly fragmented market in the U.S. results in stronger competition in wholesale power markets; U.S. fuel and power markets are more volatile; there is a low likelihood of extraordinary political action to support a failing company in the U.S.; holding company structures limit regulatory oversight; and overlapping or unclear regulatory jurisdictions characterize the U.S. market. As a result, no U.S. utilities, except for transmission companies subject to federal regulation, score higher than a single A in this factor"*

and regulatory policies, the higher prevalence of longer-term settlement arrangements, the federal/state jurisdictional divisions, the development of RTOs and other differences in the structure of regulated industrial sectors, and differences in national fiscal, tax and monetary policies. The Board notes AltaLink acknowledged that there are some differences in the Canadian and U.S. electric industry structures that may impact some of the higher return and equity component awards in the U.S.

Furthermore, the Board notes the recent acquisitions, at premiums to book value, by U.S. companies of an interest in TransAlta Corporation's former distribution and transmission businesses. The Board considers these acquisitions, which are discussed further below, may be an indication that the regulated returns available in Alberta are not too low for U.S. firms, relative to investment opportunities in their home country given all relevant circumstances.

Directionally, the evidence on the awards available to U.S. utilities would support a 2004 ROE above the Board's CAPM estimate. However, the Board concludes that limited weight should be placed on this evidence due to the differences in the regulatory, fiscal, monetary, and tax regimes in the two countries."

53. The dominoes upon which the change proponents have built their case rapidly tumble when the principal criticisms of the current formula are vetted against the evidence in the market, the regulatory environment and the macroeconomic reality in each country. For example, how can one give credence to the proposition that changes in LTC's have failed to reflect changes in utility capital costs, and still acknowledge the profound differences in the economic environment of both countries that favours Canadian utilities?

54. As Concentric's written and oral comments illustrate, you must rigorously apply US data to come up with the conclusion that LTC's have not tracked utility capital costs such that the comparable investment standard has been breached. The ephemeral nature of this model is demonstrated by Concentric's discarding of pre 1997 Ontario data in Table 4 of its comments in coming up with a new coefficient, in opposition to the technique used in its 2007 Report that verified the relevance of the .75 coefficient to the historical data.

55. Similarly, as Dr. Booth described in his oral comments, there is no reason to believe that adjustments pursuant to a corporate or utility bond index will generate more accurate picture of the utility cost of capital. Firstly, the reasons that the LTC's are used were elaborated on Day 3 Tr. 29:

> *"It is the benchmark bonds that we're worried about. They're the ones that have the greatest liquidity. They're the ones we look at to look at the yield curve. They're the ones that we look at in terms of reference points for investor expectations."*

56. Secondly, the increased volatility associated with making adjustments pursuant to a bond index is flagged by Dr. Booth in his presentation where he stated as follows:

> *"And as I show in my evidence, there is a huge difference between the spreads and the time trend in the long Canada bond yield. The long Canada bond yield has gone down because inflation has gone down, because we have got our deficits under control. The spreads of the A or*

> *the BBB over the long Canada bond fluctuate with the business cycle, but they basically -- they're going to average out basically to zero. I mean, the difference is going to average out to zero.*
>
> *So all you are doing when you key things off the A bond yield or the utility bond yield is generating business cycle uncertainty through to the ROE. But over the whole of the business cycle, you're not going to gain anything compared to basically using an average market risk premium and an average beta. All you're going to do is generates a lot of uncertainty in the ROE, to nobody's obvious benefit."*

We suggest that an ERP approach which does not operate from a "risk-free" base is fraught with pitfalls and is an approach that has never yet been considered and tested in an OEB rates proceeding. Utility bonds are clearly not "risk free" like LTCs. All of the implications of the "utility bond as a base" concept will need to be thoroughly tested in a rates proceeding before such a concept could be considered for implementation. Accordingly, we urge the Board to refrain from heading down this path.

IV. Evaluation of Information as to whether the Results of Applying the ROE Formula Adjustment Mechanism continues to be reasonable

57. As outlined in the preceding section of these final comments, the information the Board has received during this consultative clearly indicates that investors are satisfied with the returns the ERP approach, and its ROE adjustment formula, produce because they continue to readily invest in Canadian utilities with lower allowed ROE's than their U.S. counterparts. In these circumstances, it is clear that investors regard Canadian utilities with regulated ROE's lower than U.S. utilities to be "comparable investments". Having regard to this uncontradicted and objective evidence of investor behaviour, the "comparable investment" feature of the FRS is clearly being satisfied.

58. Having regard to the information presented at the consultation, it is questionable whether applying the ERP "re-set" button in October 2009 is likely to produce a ROE which materially differs from the ROE that the adjustment formula produces.

59. The presentation of Dr. Booth provides some comfort as to the reasonableness of the current approach. First, as he notes on page 17 of his comments, the Board's ROE approach uses a model that has been found by a study in 2001 in the Journal of Financial Economics to be overwhelmingly used by CFO's to estimate opportunity costs. Secondly, he cites the 2008 study of 884 finance professors that found the median market risk premium estimate to be 5.1% in Canada and 6% in the United States (p.39). Finally, as Dr. Booth notes there is the considerable market evidence that shows, even in the teeth of the recent economic crisis, the utilities remained on a solid financial footing. For example, EGD was able to complete an issue of 5 year debt in November 2008 at 5.57%.[24] It issued 30 year debt in August 2009 at 5.75%.[25] In his comments, Mr. Aiken notes that the deemed long-term debt rate has fallen from the 7.62%, set out in the Board's February 24, 2009 letter, to 5.82% as of September 2009.[26] In its Interrogatory Response to Energy Probe No. 29 recently filed as Exhibit H-3-29 in the EB-2009-0095 proceeding, Hydro One indicates that on July 16, 2009, it issued 31 year debt at an effective cost rate of 5.53% and that it anticipates issuing 10 year debt in November 2009 at an effective cost rate of 4.83%. The costs of debt for the utilities the Board regulates are rapidly declining.

60. While no formula can accurately produce a utility cost of capital at every point of the business cycle, the record shows that, even after some unprecedented events in financial markets, the results obtained when the ROE is reset using current financial parameters are reasonable.

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24 Dr. Booth's September 2009 Written Comments at page 32.
25 Mr. Aiken's final comments on behalf of LPMA and BOMA at page 5.
26 Mr. Aiken's final comments on behalf of LPMA and BOMA at page 3.

61. While there is considerable divergence of views on the Market Risk Premium, betas, and the coefficient for adjustment purposes, there are limits to the range of possible outcomes. Currently, the formulaic adjustment result of 8.39%[27] is very near the mid-point of the ROE range of 7.75% to 9.13%[28] that results from applying the ERP method.[29] The ROE so derived is congruent with the standard of reasonableness of result. The Consumer Groups suggests that in these circumstances, there is little reason to provoke a revision of the current formula based on results that may have prevailed in January 2009.

62. In all of these circumstances, the Consumer Groups suggest that the information the Board has received during this consultative falls far short of justifying the need for an adjudicative proceeding to consider possible changes to the ROE adjustment formula.

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[27] Mr. Aiken's final comments on behalf of LPMA and BOMA at page 3.

[28] This is the range that results where the risk premium for the market as a whole is 500 basis points at the low end, and 775 basis points at the high end. We do not accept that the risk premium for the market as a whole is any more than 600 basis points for the reasons discussed by Dr. Booth. Nevertheless, we have used 775 basis points in our calculation because we understand some consultative participants are asserting that the equity risk premium for the market, as a whole, is as much as that amount. Our calculation is based on an LTC rate of 4.75%, a beta of 0.5 and an allowance for all other items of 75 basis points.

[29] Mr. Aiken performs a similar analysis to demonstrate that the ROE adjustment mechanism continues to produce reasonable results. His analysis reflects a risk premium, for the market as a whole, having an upper limit of 600 basis points. See the final comments on behalf of LPMA and BOMA at page 7.

V. Evaluation of Information to Guide the Board's Discretion to Adjust the Results of Applying the ROE Adjustment Mechanism

63. For reasons already outlined, the Consumer Groups submit that, outside the ambit of either a utility-specific or generic adjudicative rates proceeding, the Board has no discretion to change the elements of the cost of capital methodology or policy that are based on findings or conclusions with respect to matters of fact and opinion which are in dispute.

64. When considering possible changes to the ROE adjustment mechanism in an adjudicative process, the primary information that should guide an exercise by the Board of its discretion to modify the methodology should be objective information pertaining to investor behaviour. Where investors continue to readily invest in OEB utilities with allowed ROE's lower than their U.S. counterparts, then there is no justification for changing the methodology in order to increase the equity returns allowed to OEB regulated utilities.

VI. Evaluation of Information to guide the Board's Discretion to adjust the Costs of Debt Capital

65. Similarly, we suggest that the Board's discretion to change elements of the methodology it currently applies related to the debt component of capital structure and its costs should be exercised at the conclusion of an adjudicative rates proceeding[30] in which parties opposite in interest can test the facts and opinions upon which their different positions are based. The information that should guide the Board in exercising its discretion at the conclusion of such proceeding is that described in Mr. Aiken's comments which we adopt and support.

[30] To the extent that any of Mr. Aiken's proposals are relevant to Hydro One's Cost of Debt, then they can be properly tested at the hearing of Hydro One's current application for distribution rates for 2010 and 2011. All of Mr. Aiken's recommendations are relevant to the other 2010 Cost of Service Re-Basing Applications that are now either before the Board or will be before the Board shortly. The recommendations can be tested by those who question them in one of those proceedings involving a large electricity distributor. A generic proceeding is not necessary to permit Mr. Aiken's recommendations to be properly and fairly tested. Mr. Aiken can elicit the information he needs to support the utility specific implementation of his recommendations during the evidentiary phase of all of the 2010 Cost of Service re-basing applications. The evidentiary phase of some of these cases may conclude before the Board issues its Report with respect to this Consultative. If the Board is of the view that Mr. Aiken's recommendations appear to have merit,, then procedural directions should issue in each of those re-basing cases to allow matters pertaining to Mr. Aiken's recommendations to be tested, if indeed there is anyone that wishes to challenge them. In this way, matters pertaining to Mr. Aiken's recommendations can be tested in these cases, if necessary, before any final utility specific rates for 2010 are fixed and approved.

VII. Appropriateness of Allowing Government-owned Utilities to recover ROE and related notional income taxes in utility rates

66. Question Three (3) in the "Issues for Discussion at Stakeholder Conference", in part, reads as follows:

> *"Should the approach to setting cost of capital parameter values differ depending on whether a distributor finances its business through the capital markets ...:*

67. The factual issue this question raises is whether Government-owned utilities that do not raise equity in the capital markets should continue to be treated, for rate-making purposes, as if they did.

68. For the reasons we have already outlined, the ERP methodology, for determining an initial benchmark equity return, and the subsequent application of the ROE adjustment mechanism, to produce equity returns in subsequent test periods, continues to produce reasonable results for utilities that actually raise equity in the capital markets.

69. The point that the Consumer Groups are very concerned about is that electricity ratepayers are currently required to pay costs of equity capital that Government-owned utilities do not incur because Government-owned utilities finance their equity investments in their distributors other than through access to the equity capital markets. The Consumer Groups question whether electricity ratepayers should be required to pay costs of equity that Government-owned utilities do not incur. This concern is an extension of the concern raised by Mr. Aiken about the interest costs of debt capital being recovered from ratepayers served by provincially or municipally owned electricity utilities that greatly exceed the debt costs many of those Government-owned utilities actually incur.

70. Provincially and municipally owned electricity distributors do not raise equity in the capital markets. Rather, they collect taxes and taxes collected are ultimately the source of funds for the equity investments by these governments in their utilities. Traditionally, the Board has treated deferred taxes, being Government tax related funds forming part of the equity of privately owned gas utilities, as zero cost capital.

71. However, the Board's current approach is to treat provincially and municipally owned electricity distributors, using taxes as the source of funds for their equity capital, as if they were "stand-alone" commercial enterprises that raise equity in the capital markets. These hypothetical equity investments attract ROE and related notional income taxes. The Board's current approach in allowing Government-owned utilities to recover equity costs and related income taxes which they do not incur was recently affirmed in the Board's November 2008 EB-2007-0905 Decision with Reasons in OPG's Payment Amounts Application. In that proceeding, certain intervenors argued that the ROE awarded to OPG should be limited to 5.85%, being the cost of the stranded debt obligations that the Government assumed when Ontario Hydro was re-structured. The Board rejected these submissions and treated OPG as if it were a "stand-alone" commercial enterprise raising equity in the capital markets.[31]

[31] EB-2007-0905 Decision with Reasons, November 3, 2009, at pages 151 to 153.

72. As a result of the massive cost burden that the *Green Energy and Economy Act* (the "*GEA*") and other Government initiatives will be imposing on electricity consumers, the Consumer Groups question whether Government-owned utilities should continue to be permitted to recover fictional costs from electricity ratepayers. Forty percent (40%) of every dollar of *GEA*-related capital expenditures will be deemed to have been raised in the equity capital markets and will require ratepayers to pay ever increasing equity costs and related income taxes that are not actually being incurred. Why should electricity consumers pay costs for services provided by Government-owned utilities when such costs are not being incurred? In pith and substance, is the collection of such costs in distribution rates disguised taxation?

73. *GEA* costs will be a topic of considerable interest in the pending hearing of the Application by Hydro One for 2010 and 2011 distribution rates. Such costs will also form part of pending applications by other electricity distributors. The Consumer Groups suggest that the rationale for the current approach should be reviewed in either a utility-specific proceeding where *GEA* costs are at issue or, in the alternative, a generic proceeding established to determine whether the current approach of collecting from ratepayers equity costs and related income taxes, that are not being incurred, continues to be appropriate and in the public interest.

74. Since matters pertaining to *GEA* costs are at issue in Hydro One's Application for 2010 and 2011 Distribution Rates, along with the appropriateness of the equity return Hydro One asks the Board to approve, the topic of concern to the Consumer Groups falls within the parameters of issues listed for determination in Hydro One's Application.[32]

75. The Consumer Groups stress that the response to the question about whether Government-owned utilities should be able to recover equity costs and related income taxes they do not actually incur has no relevance to the continued application of the ERP approach, including the ROE adjustment mechanism, to commercial enterprises that actually raise equity in the capital markets. Stated another way, a response to this question cannot possibly justify a conclusion that the equity return formula intended for application to commercial enterprises that actually raise equity in the capital markets is broken in any way. The response to the question cannot be relied upon to justify any tinkering with the ERP approach or the ROE adjustment mechanism applicable to enterprises that actually raise equity in the capital markets.

[32] The Board agreed with Hydro One that matters pertaining to *GEA* costs should not be segregated from its application and scrutinized in a generic proceeding. A generic proceeding is not essential to enable the issue of concern to Consumer Groups to be properly tested in a rates proceeding.

VIII. Conclusion

76. The overwhelming information showing investor satisfaction with existing and new investments in OEB regulated utilities convincingly establishes that the "comparable investment" feature of the FRS is being satisfied by the ERP approach, including its ROE adjustment mechanism. Accordingly, the information the Board has received in this consultative falls well short of justifying an adjudicative proceeding to consider either possible adjustments to the ERP approach, or possible changes to the ROE adjustment formula on the grounds that both the ERP approach and the ROE adjustment mechanism fail to satisfy the comparable investment feature of the FRS.

77. The standard of reasonableness also extends to the fashioning of the ultimate rates that must be paid by energy users across the province based in part upon the allowed rate of return of the regulated utilities. In ratemaking, the regulated industry is essentially allowed to recapture its cost of providing service, including the cost of attracting and rewarding capital. Fairness to the ratepayer lies in limiting the rates to that amount that is sufficient, but no more than clearly sufficient, to cover the total cost actually and prudently incurred.[33]

78. The historical standard for rate reasonableness has particular resonance in an Ontario economy where households and businesses are slowly recovering from a recession without the insulation of guaranteed returns on investment. Manufacturers, as an example, continue to struggle. Recent statistics reveal that manufacturing shipments were down 20% in July 2009 and the re-emergence of the high Canadian dollar exacerbates the situation for Ontario manufacturers. The Consumer Groups submit that the clamour for more contribution from ratepayers to the shareholders of Ontario's utilities must be subject to a particularly high level of scrutiny to ensure fairness.

79. In the submission of the Consumer Groups, an objective view of the state of financial markets shows an economy recovering from a US – provoked global credit crisis in which the Ontario regulated utilities were able to maintain financial integrity and their access to capital. Any unusually adverse results for such utilities associated with the crisis have now abated. There is no evidence that financial markets have undergone a change that requires intervention in the form of a change to the formula; in fact, the resilience of the current Board approach is exemplified by the results that now can be generated.

80. The Consumer Groups submit that the basis of the review that is associated with this consultation exercise should not be transformed beyond the original intention of the Board to inquire into the necessity for adjustments based upon the current state of the markets. This consultation should not be the forum for agitation and back door litigation by long time opponents of the formula approach that, as Chairman Wetston has suggested at the commencement of this exercise, has served Ontario well.

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33 *Puerto Rico Maritime Shipping Authority v. Federal Maritime Commission*, 220 U.S. App. D.C. 13; 678.

IX. Costs

81. The members of the Consumer Groups request that they be awarded their reasonably incurred costs of participating in this consultation.

ALL OF WHICH is respectfully submitted this 30th day of October, 2009.

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