Ontario Energy Association ("OEA")
2024 Cost of Capital and Other Matters

Information Requests for Dr. Sean Cleary
Exhibit M4

M4-0-OEA-1

Reference:

Exhibit M4
Pages 1-4

Preamble:

I provided expert evidence sponsored by the Industrial Gas Users Association (IGUA) in the 2023 EGI rebasing proceedings (EB-2022-0200). I have served as an expert witness on behalf of the Office of the Utilities Consumer Advocate of Alberta on several occasions including generic cost of capital proceedings in 2013-2014 (Proceeding ID 2191), 2015-2016 (Proceeding ID 20622), 2018 (Proceeding ID 22570), 2019-20 (Proceeding ID 24110), 2022-23 (Proceeding ID 27084), as well as the generic regulated rate option proceeding (Proceeding ID 2941) in 2014 and the EPCOR Energy Alberta 2018-2021 Energy Price Setting Plan4 proceeding (Proceeding ID 2357) in 2017. I also prepared evidence on behalf of the Newfoundland Consumer Advocate in cost of capital hearings in 2015-2016, and in 2018.

Question(s):

a. For each proceeding where Dr. Cleary developed recommendations for ROE and /or capital structure referenced above, please provide a table with Dr. Cleary's recommendations and the ultimate decision by the regulator.

M4-7-OEA-2

Reference:

Exhibit M4
Page 18, lines 1-5

Preamble:

With respect to 1a), OEB's current practice of using actual debt rates in most cases considers the impacts of different funding sources, as noted by LEI. However, the deemed long-term debt rate (DLTDR) can be used as an estimate or a ceiling (if the actual rate is higher than DLTDR). This approach satisfies the FRS, is intuitive, and is easy to apply, and I agree with LEI that there is **no need to make changes** to this practice.

Question(s):

a. Assuming the OEB were to adopt Dr. Cleary's recommended DLTDR as an estimate or ceiling, and this DLTDR is a current debt rate (as recommended by Dr. Cleary in response to Issue #7), how would utility debt costs from historical issues (e.g., over the past 30 years) be considered in relation to a current debt rate as a cap?

M4-1-OEA-3

Reference:

Exhibit M4
Page 18, lines 23-24

Preamble:

Allowing some utilities to earn a higher return despite engaging in business activities of similar risk **would violate the comparable return standard**.

Question(s):

a. Does Dr. Cleary believe the opposite also holds true, i.e., allowing some utilities to earn a lower return despite engaging in business activities of similar risk would violate the comparable return standard? Please explain.

M4-2-OEA-44

Reference:

Exhibit M4
Page 20, lines 14-17

Preamble:

[In response to Issue #2] My recommendations (which align with LEI) are: Maintain the OEB's current policy of reviewing business and financial risk factors if there is a perceived significant change from the status quo and adjusting the allowed equity ratio as appropriate to address material changes in the utility risk profile.

Question(s):

a. Does Dr. Cleary believe it is possible to determine an appropriate equity ratio for Ontario's utilities that satisfies the fair return standard without comparing the business and financial risks of Ontario's utilities to those elsewhere in North America? Please explain.

M4-3-OEA-5

Reference:

Exhibit M4
Page 21, lines 4-13

Preamble:

I concur with LEI that regulatory mechanisms can play a valuable role in stabilizing utilities' cash flows and thereby affecting their business and financial risks. In fact, these regulatory mechanisms are one of several factors that are considered by debt rating agencies in their business risk assessment of utilities. As noted by LEI on page 74 of its evidence: "With respect to the major OEB regulatory mechanisms introduced since 2006, LEI believes that they have generally reduced the risks for electricity distributors." This conclusion is supported by the ranking of regulatory support provided by S&P as of November 2023 (as included in Figure 47 on page 129 of LEI's evidence), which shows the OEB ranked as one of just 10 jurisdictions (out of 60) that was ranked in the top category of "Most credit supportive (strong)," recognizing that of course other considerations play an important role in such a ranking.

Question(s):

a. Is Dr. Cleary aware of the authorized ROEs and capital structures for the utilities in the other nine jurisdictions in S&P Global's "Most Credit Supportive" category? Please provide a table that lists the authorized ROEs and capital structures for the large electric and gas utilities in each of these other nine jurisdictions.
b. Is it Dr. Cleary's view that the ROEs and capital structures for Ontario's utilities should be comparable to the other nine jurisdictions in this category?
c. Please provide a detailed explanation for why or why not.

M4-4-OEA-6

Reference:

Exhibit M4
Page 23, lines 26-30

Preamble:

LEI recommends estimating the base CORRA based on the average of 3-month CORRA futures rates over the next 12 months. Since the CORRA is linked directly to the Bank of Canada's rate decisions, I am fine with this suggestion; although, I would also be fine with using the existing CORRA rate as of September 30th of each year as the base CORRA rate.

Question(s):

a. Please explain Dr. Cleary's rationale for recommending a spot bond yield rather than a monthly average, as the OEB currently uses in the ROE formula?
b. Has Dr. Cleary examined the intra-month volatility of the CORRA rate in order to recommend a rate for a single day (September 30)?
c. If so, please provide that analysis.

M4-6-OEA-7

Reference:

Exhibit M4
Page 24, lines 25-29

Preamble:

LEI recommends that the DLTDR be set as a cap for all utilities (including gas distributors and OPG) and not just electric T&Ds as is current practice. I agree with this suggestion. As LEI states on page 93 of its evidence: "All OEB-regulated entities reviewed have a similar senior debt credit rating, and there is no reason to only subject electricity distributors and transmitters to a cap."

Question(s):

a. Has Dr. Cleary examined the senior debt ratings of all OEB-regulated utilities to corroborate this statement by LEI?
b. If so, please provide a table listing the senior debt ratings for each OEB-regulated utility.
c. Is Dr. Cleary aware of any other North American regulator that "caps" the cost of long -term debt?
d. If so, please provide the decisions implementing these caps.

M4-10-OEA-8

Reference:

Exhibit M4
Page 29, lines 25-27

Preamble:

While LEI relies entirely on its CAPM estimates, I believe it is informative to discuss some of the other approaches they use in estimating Ke, even though LEI correctly disregards these estimates.

Question(s):

a. If Dr. Cleary's recommended base ROE for Ontario's utilities is based on an equal weighting of the results of his CAPM, DCF, and Risk Premium models, as stated on page 43 of his report, please explain why Dr. Cleary believes it is appropriate for LEI to base its ROE recommendation solely on the results of LEI's CAPM analysis.

M4-10-OEA-9

Reference:

Exhibit M4
Page 30, lines 2-10

Preamble:

On page 113 of its evidence, LEI estimates Ke = 8.65% using what it refers to as an equity risk premium (ERP) approach, which adds an estimate of ERP to the base LCBF. LEI's estimate is determined using 3.15% as the LCBF, which is based on March 2024 forecast long-term Canada yields. As discussed in detail in Section 3.7 above, and in Appendix A, I disagree with the use of forecast yields versus using actual prevailing yields. This applies to any approach taken to estimating Ke, as well as to estimating LCBF for the OEB ROE formula. I do note that 3.15% is very close to the actual 30-year government yield of 3.30% as of June 5, 2024 (which I use in my CAPM estimates), so the difference in this particular situation is very minimal (although this will not always be the case).

Question(s):

a. Does Dr. Cleary believe that a long-term utility investor would use a spot bond yield for a single day to estimate the required rate of return on assets with lives of 30 years or longer?
b. Is Dr. Cleary aware of any North American regulator that relies on the spot bond yield for a single day to estimate the required cost of equity? If so, please provide the specific decision reference.

M4-10-OEA-10

Reference:

Exhibit M4
Page 30, lines 11-13 and 26-27

Preamble:

LEI estimates an ERP of 5.5%, which is the mid-point of the average of the 2001-24 actual returns on the S&P/TSX Index (of 6.77%), and the average returns on the BMO equal weight utilities index (of 10.98%).

As such, I agree with LEI's decision to not consider this Ke estimate in their final ROE estimate.

Question(s):

a. What is the basis for Dr. Cleary's conclusion that LEI has not used this Ke estimate? (please refer to LEI's Figure 41 in responding)

M4-10-OEA-11

Reference:

Exhibit M4
Page 31, lines 17-18

Preamble:

LEI's DCF analysis is flawed by its heavy reliance on data for U.S. utilities rather than Canadian utilities.

Question(s):

a. Please indicate which Canadian utilities Dr. Cleary recommends as proxies for Ontario's utilities for purposes of estimating the cost of capital and why.
b. Please indicate which Canadian gas utilities Dr. Cleary recommends as proxies for Ontario's gas utilities for purposes of estimating the cost of capital and why.
c. Please provide a table showing the percentage of revenues and income for the most recent year the companies recommended by Dr. Cleary (in response to (a)) derive from Canadian regulated utility operations, U.S. regulated utility operations, and other.

M4-10-OEA-12

Reference:

Exhibit M4
Page 41, lines 10-13 and Page 100, Table 10

Preamble:

It is also based on sustainable growth rate estimates ranging from 1.46% to 2.17%, and averaging 1.80%, which seems reasonable for mature low risk, regulated utilities that should be expected to grow slower (but steadier) than average firms and overall GDP growth in the 3.3-4.3% range, as discussed previously.

Question(s):

a. Please confirm that, as shown in Attachment J, Dr. Cleary has used dividend payout ratios of 100% for several companies in calculating his "sustainable" growth rates for the Canadian sample from 2017-2023.
b. Does Dr. Cleary believe it is reasonable that a utility company in his Canadian sample would be expected to payout 100% or more of its net income as dividends over the long-term? If so, please explain why this assumption is reasonable. If not, please explain why this assumption was used in Dr. Cleary's calculation of the "sustainable" growth rate.
c. Please confirm that in the U.S., the Federal Energy Regulatory Commission has specifically rejected the use of sustainable growth rates in the DCF model.

M4-10-OEA-13

Reference:

Exhibit M4
Page 42 and 105

Preamble:

As mentioned, the usual range is 2-5%, with 3.5% being commonly used for average risk companies, and lower values for less risky companies.

The BYPRP approach adds a risk premium (generally in the 2-5% range) to the yield on a firm's outstanding publicly-traded long-term bonds.

Question(s):

a. Please provide the source for the contention that an appropriate risk premium is in the range of 2-5% and that 3.5% is commonly used for average risk companies.
b. Please explain what constitutes an "average" risk company and how that assessment would be made.

M4-10-OEA-14

Reference:

Exhibit M4
Page 43, lines 17-19

Preamble:

Based on an equal weighting of the three approaches, I determine the following best estimate for allowed Ontario utility ROEs:

$$Ke = (1/3)(6.05) + (1/3)(7.4) + (1/3)(7.7) = \mathbf{7.05\%}$$

Question(s):

a. How does Dr. Cleary's base ROE recommendation of 7.05% for Ontario's utilities compare to the average authorized ROE for other Canadian electric and gas utilities in 2024?
b. Please confirm that Dr. Cleary's base ROE recommendation of 7.05% for Ontario's utilities is 145 basis points lower than the lowest authorized ROE for any other investor-owned electric or gas utility in Canada (i.e., Newfoundland Power has an authorized ROE of 8.50% on a common equity ratio of 45.0% and currently has a General Rate Application pending before its regulator in which Newfoundland Power is requesting an increase in its authorized ROE to 9.85%).
c. Please explain why Dr. Cleary recommends an equal weighting of the results of the CAPM, DCF and Risk Premium models if his research indicates that the CAPM is more heavily relied upon and the DCF model is not widely used.
d. Has Dr. Cleary performed any analysis of how the credit outlooks, metrics and ratings of Ontario's utilities would be impacted if the OEB were to adopt his recommended base ROE of 7.05% and his proposed reductions in the equity ratio for Hydro One Inc. and Enbridge Gas? If so, please provide that analysis. If not, what is the basis for Dr. Cleary's conclusion that his cost of capital recommendations would satisfy the Fair Return Standard?
e. What is Dr. Cleary's understanding of the concept of gradualism?
f. Please explain how Ontario's utilities can compete for capital with other comparable-risk investments if the authorized ROE and deemed equity ratios for Ontario's utilities are well below the average for their North American peers in Canada and the U.S.

M4-10-OEA-15

Reference:

Exhibit M4
Page 46, lines 15-17

Preamble:

As the AUC stated in Alberta 2018 GCOC Decision 16 22570-D01-2018, para. 393 (emphases added): "In the Commission's view, although observable, the **ROEs approved for the U.S. utilities are not strictly market data."**

Question(s):

a. Please confirm that in October 2023 the AUC set the base ROE for all electric and gas utilities in Alberta at 9.0% (Decision 27084-D02-2023).
b. Further, please confirm that the authorized ROE in 2024 for Alberta's electric and gas utilities is 9.28% through the operation of the AUC's newly adopted formula.

M4-10-OEA-16

Reference:

Exhibit M4
Page 47, lines 23-26

Preamble:

Based on this evidence, I recommend an adjustment factor of 0.75 for both factors, which maintains the relationship, is more responsive to changing market conditions, and will still reduce year-to-year fluctuations in allowed ROEs relative to a weighting of 1.0.

Question(s):

a. Please explain how Dr. Cleary determined that the adjustment factors in the OEB's ROE formula should be changed to 0.75 from 0.50. Please provide any empirical analysis performed by Dr. Cleary supporting his recommendation.
b. Dr. Cleary contends on page 46 of his report (Exhibit M4) that LEI's regression equation is flawed by design and should not be used to set the adjustment factors in the Ontario formula. Does Dr. Cleary also believe that the analysis that the OEB relied on the December 2009 Order (EB-2009-0084) as the basis for reducing the adjustment factor for the LCBF from 0.75 to 0.50 is flawed? Please explain.

M4-10-OEA-17

Reference:

Exhibit M4
Page 60, lines 9-10

Preamble:

The 30-year Government of Canada bond yield as of June 5, 2024 was 3.30%, while the 10-year yield was 3.39%.

Question(s):

a. Dr. Cleary uses the spot yield on the 30-year Government of Canada bond as of June 5, 2024, as the risk-free rate in his CAPM analysis. Please confirm that the 90-day average yield on the 30-year GOC as of June 28, 2024 was 3.44% within a range from 3.19% to 3.74%.
b. Please discuss the tradeoffs between using a spot bond yield or a longer-term average bond yield calculated over 30 or 90 days.
c. The OEB formula currently uses a bond yield forecast. In Dr. Cleary's opinion, why should the OEB deviate from its past practice and use his recommended spot bond yield?

M4-10-OEA-18

Reference:

Exhibit M4
Page 76, lines 12-15

Preamble:

It may also be useful for the Board to compare the allowed ROEs using its existing formula those determined in another Canadian jurisdiction that determined allowed ROEs during regular proceedings and which did not use an automatic adjustment ROE formula over this time period.

Question(s):

a. Dr. Cleary compares the Ontario formula return to the authorized ROE in Alberta, which until recently was among the lowest in Canada, at 8.50%. Please explain why Dr. Cleary chose Alberta and did not also compare the Ontario formula return to the authorized ROE for electric and gas utilities in other Canadian and U.S. jurisdictions.

M4-10-OEA-19

Reference:

Exhibit M4
Page 91, lines 28 through Page 92, line 6 and Page 93, Table 8

Preamble:

The December 31, 2023 weekly beta estimate average is 0.668, while the average for monthly betas is 0.582, both of which are well above the long-term average beta estimate of 0.35 discussed above, and also the 0.45 beta estimate I have used during previous proceedings. The seven-year average weekly betas for the Canadian sample is 0.658, while the seven-year average monthly beta estimate is 0.513 – with both estimates lying well above the historical average of 0.35. The average of all four beta estimates provided for this sample is 0.60, well above the long-term average beta estimate of 0.35, and my usual beta estimate of 0.45, which lies slightly above the mid-point of these two figures.

Question(s):

a. Please add the betas for Enbridge Inc. to Table 8 of Dr. Cleary's report (Exhibit M4) and recalculate the averages.
b. Please explain why Dr. Cleary did not use the current average beta for the Canadian sample (e.g., the weekly beta of 0.668) as of December 31, 2023, or the long-term average beta (e.g., the weekly beta of 0.658) from 2017-2023 in his CAPM analysis rather than his own personal beta estimate of 0.45.
c. If Dr. Cleary believes it is reasonable to use a spot estimate of the long Canada bond yield as the risk-free rate as of June 5, 2024 in his CAPM analysis, please explain why Dr. Cleary does not believe it is also reasonable to use the most current available calculations for beta in his CAPM analysis?
d. Does Dr. Cleary agree with LEI's use of daily betas, as shown in Figure 39 of LEI's report (Exhibit M1)? If not, why not?
e. Please explain Dr. Cleary's rationale for excluding U.S. companies from his proxy group if those U.S. companies have betas that are similar to the companies in his Canadian sample.

M4-10-OEA-20

Reference:

Exhibit M4
Page 92, lines 9-12

Preamble:

This illustrates that beta "estimates" for companies can change dramatically through time, and therefore why it is appropriate to reference long-term averages and use judgment since beta estimates at any given point in time based on historical data may not represent the best estimates of "future" betas.

Question(s):

a. To what does Dr. Cleary attribute the "dramatic" change in betas for the utilities in his Canadian sample?
b. On page 30 of his report (Exhibit M4), Dr. Cleary states that utilities perform better during periods of uncertainty due to their low-risk nature. Please reconcile this statement with Table 8 of Dr. Cleary's evidence that shows that raw betas for utilities in Canada and the U.S. were higher in 2023 and during the period from 2017-2023 compared to the long-term historical levels reported by Dr. Cleary.

M4-12-OEA-21

Reference:

Exhibit M4
Page 114, lines 4-15

Preamble:

Recent debt rating reports identify excellent business risk and very low industry risk (S&P); as well as reasonable regulatory support (DBRS Morningstar (DBRS)) as strengths for HOI. This is consistent with HOI's regulated operations conducted in a well-defined and economically strong region with strong regulatory support, and where it can reasonably pass on legitimate costs to its customers.

Currently, HOI maintains the following long-term debt ratings: DBRS – A(high) – Stable; S&P – A(Stable)73; and, Moody's – A3. The DBRS rating has been the same for over 10 years, while the S&P rating of A- has been maintained since 2019 while the qualifier was upgraded to "positive" in August of 2023 and then the rating was upgraded to A in June 2024. Moody's rating of A3 has been maintained since 2019, and was confirmed in May of 2023. These high ratings are indicative of sound credit quality, and contribute to HOI's ability to issue debt at attractive rates (as will be discussed in Section 6.2.2).

Question(s):

a. Has Dr. Cleary considered Hydro One's rating analysis from S&P, including business risk and industry risk, compared to other North American utilities? If so, how was this information considered by Dr. Cleary? If not, why not?
b. Has Dr. Cleary considered the impact of his recommendation to lower the deemed equity ratio for Hydro One to 36% on the rating agencies' assessment of the business risk and industry risk of Hydro One, as well as the relative impact of Dr. Cleary's recommendation on Hydro One's ability to attract capital compared to other North American utilities? If so, how was this considered? If not, why not?
c. Has Dr. Cleary considered comments in credit reports from other rating agencies such as Moody's, which notes that Hydro One has a low equity thickness, in arriving at his recommendation to reduce the deemed equity ratio for Hydro One to 36%?
d. How does Dr. Cleary view ratings from DBRS relative to other rating agencies such as S&P and Moody's in terms of Hydro One's ability to attract capital in North America, including the U.S., in terms of investors' reliance on them?
e. Assuming integrated North American capital markets, should more emphasis be placed on the views of other rating agencies, such as S&P and Moody's, rather than on DBRS?
f. With regard to his reliance on DBRS ratings, has Dr. Cleary considered that to be included in the Bloomberg US Corporate Index, a security must be rated by Moody's, S&P or Fitch – a DBRS rating is not acceptable as per: US-Corporate-Index.pdf. Please explain.
g. With regard to reliance on DBRS ratings, is Dr. Cleary aware of the U.S. Securities and Exchange Commission's Staff Report on Nationally Recognized Statistical Rating Organizations (NRSROs), dated February 2024, which notes that DBRS represents 2.9% of the total outstanding credit ratings of all NRSROs, while S&P represents 50.0% and Moody's 31.6%?

M4-12-OEA-22

Reference:

Exhibit M4
Page 116, lines 10-12

Preamble:

We continue to assess **HOL's business risk profile as excellent**. Our assessment reflects the company's **low-risk regulated utility operations** that provide essential services in Ontario.

Question(s):

a. Has Dr. Cleary considered the business risk profile of Hydro One's North American peers with similar credit ratings, with whom Hydro One is competing for capital? If so, please explain how Dr. Cleary took this information into account in arriving at his recommendation to lower Hydro One's deemed equity ratio from 40% to 36%.