EB-2024-0063

ONTARIO ENERGY BOARD

IN THE MATTER OF the Ontario Energy Board Act, 1998, S.O. 1998, c. 15, Sch. B;

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

INTERROGATORIES OF CANADIAN MANUFACTURERS & EXPORTERS ("CME") TO ELECTRICITY DISTRIBUTORS ASSOCIATION ("EDA")

Interrogatory M3-2-CME-1

Ref: Exhibit M3, p. 25

At page 25, Nexus provides its opinion that strategic risk should also be included in an analysis of risks reviewed for utilities.

(a) Please elaborate on Nexus' definition of "strategic risks". To the extent that strategic risks include risks to volume, regulation, and policy, or financing please describe why "strategic risks" are not simply rehashing business or financial risks through another avenue.

Interrogatory M3-2-CME-2

Ref: Exhibit M3, p. 26

At page 26, Nexus states "The electric power industry is undergoing a significant transition which is exposing the distributors to not only the normal risk associated with utility operations, but uncertainty regarding the future of the electric distribution business model." It also states that the adoption of mainly fixed charges is an impediment to revenue growth for distributors.

(a) Please confirm that Ontario distributors' move to mainly fixed charges mitigates the uncertainty about the future of the electric distribution business model.

(b) To the extent that a) is not confirmed, please explain why not.

(c) If there Board were, in the future, to move electricity distributors back to more volumetric charges, thereby increasing revenue growth, please describe the impact of such a decision on Nexus' conclusions regarding business risk and cost of capital.

Interrogatory M3-3-CME-3

Ref: Exhibit M3, p. 30

At page 30, Nexus states “Nexus Economics does not agree with LEI that the regulatory environment offered in Ontario is significantly safer than its peers and, therefore, should be provided with a lower ROE.” Nexus provides several reasons why distributors still are subject to high risk.

(a) How many of the peers in Nexus’ peer group operate in jurisdictions where adjustments can be made to the deemed return once rebasing is established.

(b) Nexus states that 2 peers in the peer group have K-Bar mechanisms. How many of the peers in Nexus’ peer group have an ICM mechanism or comparable mechanism? How many of the peers in Nexus’ peer group have a “C” Factor or related capital true up mechanism. How many of the peers in Nexus’ peer group do not have access to any incremental capital mechanism of any kind?

(c) How does Nexus view the availability of custom IR mechanisms, whereby utilities can craft their own mechanisms such as the custom capital factor used by Hydro One in terms of Ontario’s utilities level of risk?

Interrogatory M3-3-CME-4

Ref: Exhibit M3, p. 31

At page 31, Nexus states that 54 distributors did not earn their ROE during the period 2015-2022. Nexus goes on to state that “the expected outcome for a distributor operating prudently should produce an outcome where that distributor earns its deemed ROE.”

(a) Please provide any analysis conducted by Nexus that would demonstrate that these utilities were operating prudently.

Interrogatory M3-10-CME-5

Ref: Exhibit M3, pp. 3-4.

At page 3, Nexus sets out the three components of the fair return standard, the comparable investment standard, the financial integrity standard, and the capital attraction standard. At page 4 Nexus states that the current ROE set by the Board and LEI’s proposed ROE “are likely, now and over time, to result in a situation where Ontario utilities are unable to attract capital on reasonable terms.”

(a) Please confirm whether the quoted statement relates to the financial integrity standard and/or the capital attraction standard.

(b) What does Nexus view to be “reasonable terms” pursuant to the capital attraction standard? Is there specific terms which would be reasonable or unreasonable? Is the reasonableness of the terms related to a comparative analysis of the terms received by other businesses? If reasonableness is determined through a comparative analysis, please describe nexus’ understanding of the different roles of the capital attraction standard and the comparable investment standard.

(c) What evidence is Nexus relying on to support the statement that current ROEs granted to Ontario utilities are unable to attract capital on reasonable terms? Please make reference to specific terms faced by specific Ontario utilities that are unreasonable.

(d) Please confirm that to the extent the answer to a) does not include the financial integrity standard, whether or not Nexus has determined whether LEI’s proposed ROE would fail the financial integrity standard. If the answer is yes, please outline all evidence Nexus relies on to determine that Ontario utilities currently, or will in the future have financial integrity issues.

Interrogatory M3-10-CME-6

Ref: Exhibit M3, p. 4, figure 1.

At page 4 Nexus provides a figure showing the ROEs of what it has determined to be businesses of “like risk”.

(a) With respect to the comparable investment standard, is it Nexus’ view that in order for a company to have an ROE that satisfies the comparable investment standard, it should have an ROE at or very close to the median or mean of the sample group of “like risk” companies?

(b) If the answer to a) is yes, please provide Nexus’ view on the possibility of an upward spiral of ROEs. In other words, every sample of companies will, definitionally, have entities which have ROEs below average and above average or above the median and below the median. If every single entity in a group of “like risk” companies is required to have at least the average/median ROE in order to satisfy the comparable return standard, wouldn’t this, over time, continually increase the average ROEs as each entity with below average ROE has their ROEs increased at least to the previous average, thereby necessitating an increase to each other entities’ ROE consistently upwards?

Interrogatory M3-10-CME-7

Ref: Exhibit M3, p. 8, 19

At page 8, Nexus states electrification and risks associated with the energy transition “can result in a required return on equity greater than those of its would-be peers.” However, at page 19, Nexus states that it chose its peer group from jurisdictions that are “adopting strong electrification policies”. Therefore, Nexus’ peer group should also face any risks associated from the energy transition and electrification.

(a) Please confirm that because both Ontario utilities and Nexus' peer group will face any risks that occur as a result of electrification/the energy transition, that the existence of an energy transition/electrification does not suggest that Ontario utilities require a greater return on equity than the peers selected by Nexus.

(b) If a) is not confirmed, please set out, in detail any analyses conducted by Nexus in this regard and provide what differences in electrification or the energy transition between Ontario and other jurisdictions Nexus is relying on to conclude that Ontario utilities should be entitled to a greater ROE than Nexus' peer group.

Interrogatory M3-10-CME-8

Ref: Exhibit M3, p. 10

(a) With respect to the energy transition, does Nexus believe that the increase in load and customers for electric utilities will have any effect decreasing the risk to those electricity distributors? Why or why not?

Interrogatory M3-10-CME-9

Ref: Exhibit M3, p. 8, 19

At page 11, Nexus states "Evidence contradicting LEI's claim that Ontario's regulatory mechanisms reduce risk is its own Figure 19, which illustrates that, on average, a group of Ontario distributors are not earning their deemed return. The systematic underearning does not support the claim that the regulatory environment in Ontario is as safe as LEI claims."

(a) Does the opposite hold true in Nexus' view? In other words, does the fact that many utilities not only regularly earn their ROE, but regularly over-earn their ROE mean that Ontario's regulatory environment is safe for those utilities? Why or why not?

Interrogatory M3-10-CME-10

Ref: Exhibit M3, p. 16.

At page 16, Nexus states that "In 2009, the Board agreed that no single test is, by itself, sufficient to ensure that all three requirements of the fair return standard are met."

(a) Please confirm Nexus' understanding whether it is permissible to accept the ROE outcome from a single test as being the appropriate ROE for a utility or utilities, as long as other tests were considered prior to the Board's determination, as long as the ROE outcome meets the three requirements of the fair return standard.

Interrogatory M3-10-CME-11

Ref: Exhibit M3, p. 18

At page 18, Nexus provides its analysis on enterprises of like risk.

(a) Is it Nexus' view that utility ROEs should only be calculated with reference to a sample of other utilities? Would it ever be appropriate to compare utility ROEs to unregulated businesses?

(b) If the answer to a) is yes, please describe under what circumstances it would be appropriate. If the answer to a) is no, please explain why not.

(c) Do Ontario utilities have "like risk" to any unregulated businesses? If yes, please provide why they aren't in the peer group. If no, please elaborate on why not.

Interrogatory M3-10-CME-12

Ref: Exhibit M3, p. 18

At page 18, Nexus states that its opinion is that peers operating in Canada and the United States are entities of like risk, while entities operating in the UK and Australia are not. Nexus states "Firms operating in other financial markets, including the UK and Australia, operate under different legal, institutional, and macroeconomic circumstances which could influence utility ROEs".

(a) Please confirm that entities operating in Canada operate under different legal circumstances than firms operating in the United States. If this is not confirmed, explain why fully.

(b) Please confirm that entities operating in Canada operate under different institutional circumstances than firms operating in the United States. If this is not confirmed, explain why fully.

(c) With respect to "macroeconomic circumstances", is Nexus referring to its opinion that Canada operate in an integrated capital market?

(d) Please provide any other macroeconomic circumstances that Nexus believes are the same or comparable as between Canada and the US but differ in relation to Canada / the UK or Australia.

(e) On Page 17, Nexus states that enterprises of like risk do not need to be identical, but must merely share similarities and empirical analysis must be performed to determine if they are like. Is it Nexus' view that enterprises in the UK and Australia do not share any similarities whatsoever?

(f) If the answer to e) is that they do not share any similarities, please explain why.

(g) If the answer to e) is that they do share some similarities. Please provide all empirical analysis performed by Nexus to demonstrate whether these entities are “like” or not.

Interrogatory M3-10-CME-13

Ref: Exhibit M3, p. 38

At page 38, Nexus states “Our goal in this Chapter is to identify and quantify the opportunity cost of equity capital that can be applied to a risky asset, namely a distribution electric utility in Ontario.”

(a) Please confirm whether Nexus’ view is that a distribution electric utility in Ontario is a risky asset in comparison to other equity investments, such as private market businesses.

(b) If the answer to (a) is yes, please reconcile this opinion with the belief that utility stocks are less volatile and are recession resistant, as outlined in numerous articles (including one found here: https://www.investopedia.com/ask/answers/122314/what-kind-investors-buy-utility-stocks.asp

Interrogatory M3-10-CME-14

Ref: Exhibit M3, p. 53

At page 53, Nexus critiques LEI’s DCF analysis. In the paragraphs outlining why Nexus believes the DCF is a worthwhile tool, it states that the FRS is forward looking and therefore uncertainty is a necessary part of both the DCF and analyzing whether ROEs meet the FRS.

(a) There is evidence that not only are DCF subjective assessment of future earnings growth estimates are regularly wrong, but they are systemically biased and overly optimistic. In other words, they are not simply wrong, but consistently wrong in a specific direction. Please provide Nexus’ view of whether or not a systemic bias in the DCF calculation would mean that other methodologies are to be preferred over the DCF, or if an adjustment should be made to the DCF in order to correct or account for the bias.

Interrogatory M3-10-CME-15

Ref: Exhibit M3, p. 54

At page 54, Nexus states “It is true, as LEI notes, that beating the autopilot of index investing is 8 very difficult. It is for this reason why the survivors in the stock-picking industry may be 9 useful to listen to.”

(a) Please confirm that Nexus is using the term “survivors” to refer to the investment analysts and portfolio managers who continue in that profession.

(b) Please provide any analysis conducted by Nexus to suggest that investment analyst and portfolio manager “survivors” have any greater accuracy or success rate.

(c) Please indicate how Nexus has tailored its DCF analysis to take more account of “survivors” rather than any and all analysts or managers, whether a “survivor” or not.

(d) Please provide any analysis conducted by Nexus to suggest that government and bank professionals forecasts in respect of future interest rates for the CAPM calculation have the same or similar systemic bias or lack of accuracy as do investment analysts and portfolio managers in their EPS growth forecasts.

(e) Please provide Nexus’ view on whether or not “having skin in the game” may lead to optimism biases. For instance, it has been widely studied that people’s expectation of their own performance is, was, and will be an overestimate of reality.[1] Given that the forecasts of stakeholders with “skin in the game” are a reflection of their own expected performance, does Nexus view it as possible that the fact that they have “skin in the game” in fact increases optimism biases in forecasting?

[1] For instance, see Metcalfe J. Cognitive optimism: self-deception or memory-based processing heuristics? Pers Soc Psychol Rev. 1998;2(2):100-10. https://pubmed.ncbi.nlm.nih.gov/15647138/