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April 16, 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

These comments on the questions the Board poses in its letter of March 16, 2009, to All Interested Stakeholders are submitted on behalf of our client, Canadian Manufacturers & Exporters ("CME").

A. Introduction

The questions the Board poses relate to the "values" for the costs of debt and equity which result from applying the Board's Cost of Capital Guidelines for electricity distributors to data contained in consensus forecasts and Bank of Canada/Statistics Canada information for January 2009.

The Board's March 16, 2009 letter implies that it is considering whether any retroactive changes should be made to the values specified in its February 24, 2009 letter to All Licenced Electricity Distributors. In that letter, the Board fixed the Return on Equity ("ROE") at 8.01%, the Long Term Debt Rate at 7.62%, and the Short Term Debt Rate at 1.33% for implementation in rates effective May 1, 2009.

The Board's letter suggests that it is contemplating retroactive adjustments to rates it has already determined for 23 of the electricity distributors that it regulates. The letter states as follows:

> *"Written comments received will be considered by the Board in its determination as to whether to make adjustment to any of the Cost of Capital parameter values calculated by the Board's formulaic approaches for the 2009 rate year. The Board notes that this determination may impact the rates for the 23 distributors that had their rates rebased this year. If the Board determines to make any*

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adjustments, a mechanism to adjust rates in 2009 will be established. The Board expects to make its determination by early June, 2009."

There are a number of factors and guiding principles which should be considered before formulating responses to the questions the Board poses. These include the following:

(a) Retroactive rate adjustments are an extraordinary form of relief which should only be considered when there is sworn and tested evidence to convincingly demonstrate an immediate and material threat to utility financial integrity;

(b) The established "triggers" for initiating a review of the Board approved ROE Adjustment Mechanism, which has stood the test of time, should not be disregarded in the absence of sworn and tested evidence of the type described above;

(c) The inappropriateness of a consultative process and the need for an adjudicative process, which complies with the review and variance provisions of the Board's governing legislation and rules of procedure, before varying any component of a methodology used to calculate quasi-judicially approved rates; and

(d) The need for sworn and tested evidence with respect to current and prospective capital market conditions before varying any component of a methodology used to calculate quasi-judicially approved rates.

We submit comments on these factors and guiding principles as a precursor to providing responses to the specific questions the Board has posed.

Our comments on the questions the Board poses are made having regard to the fact that no one has adduced any evidence in any regulatory proceedings before the Ontario Energy Board ("OEB") to demonstrate the existence of extraordinary circumstances which threaten the financial viability of any electricity distributors the Board regulates. As far as we are concerned, such evidence does not exist.

In making our comments on the questions the Board poses, we recognize that the National Energy Board ("NEB") in a Decision released on March 19, 2003, changed the method it applies to determine the Cost of Capital of one of the gas transmission utilities it regulates. As well, by letter dated March 23, 2009, the NEB has signalled its plan to review its most recent Generic Cost of Capital Decision. We also recognize that there is currently in progress, before the Alberta Utilities Commission ("AUC"), a generic proceeding instituted in July 2008 to review the Generic Return on Equity ("ROE") for 2009, the Generic ROE Adjustment Mechanism and Capital Structures of Utilities it regulates. We understand that an oral hearing is scheduled to commence sometime in May 2009.

We submit that circumstances pertaining to these NEB and AUC proceedings do not provide a factual foundation for a determination by the OEB, on its merits, of disputed factual matters pertaining to the Cost of Capital related questions it poses in its March 16, 2009 letter.

We also submit that, without evidence establishing a material and immediate threat to the financial integrity of electricity distribution utilities, it is not in the public interest, in the midst of a recession, to increase electricity distribution rates to provide their government owners with more profit. Increasing rates for such a purpose is tantamount to imposing an additional consumption tax on electricity distribution ratepayers. Such action is not in the interests of the Ontario economy which is struggling to cope with large scale job losses, plant shutdowns, and the other effects of the severe recession in which we find ourselves.

B. Retroactive Rate-Making

We submit that retroactively adjusting the 2009 rates of 23 distributors, which have already been determined in quasi-judicial rates proceedings, constitutes an extraordinary form of relief which should only be considered where fully tested evidence establishes exceptional circumstances which pose an immediate and material threat to the financial viability of an affected electricity distribution utility.

It would be inappropriate to retroactively adjust any rates which the Board has already quasi-judicially determined before utility-specific evidence of this nature has been presented in accordance with the legislation and rules of procedure governing quasi-judicial rates proceedings before the Board.

C. ROE Adjustment Mechanism

The Board's letter inviting comments on the questions it poses implies that it is currently questioning the continued appropriateness of the ROE adjustment mechanism established in its Report of the Board on Costs of Capital and 2nd Generation Incentive Regulation for Ontario Electricity Distributors dated December 20, 2006 (the "2GIRM Report"). Yet, this is the very adjustment mechanism that the Board expressly approved in its recent EB-2007-0905 Decision with Reasons dated November 3, 2008, in the Payment Amounts Application brought by Ontario Power Generation Inc. ("OPG"). In that Decision, at page 162, the Board stated:

> *"The Board agrees that adoption of a formula approach to setting the ROE is appropriate in the circumstances. The Board will adopt the existing ROE adjustment formula outlined in its report on cost of capital and 2nd generation incentive regulation for purposes of determining OPG's return on equity."*

As of November 2008, the current recessionary circumstances were well known.

As well, Board support for the adjustment mechanism as stated in the November 3, 2008 EB-2007-0905 Decision with Reasons was made in the context of utility and intervenor support for the mechanism, including the evidence from OPG's witness, Kathleen McShane, who stated as follows:

> *"… I recommend that the formula should be reviewed if forecast long Canada bond yields <u>fall below 3.0%</u> or exceed 8.0%. Long Canada yields outside of the range of 3.0%-8.0% may indicate a materially*

> *altered relationship between long Canada bond yields and the utility cost of equity. The specification of 3.0% as the bottom end of the range recognizes there has been no experience with long-term Canada yields near this level since the early 1950s. With respect to the upper end of the range, if long Canada yields were to reach 8.0%, the real cost of capital or inflation would be materially higher than that which is currently anticipated. Both circumstances would warrant a review of the validity of the formula."* (emphasis added) [1]

The long term Canada rate the Board determined in Appendix A of its letter of February 24, 2009, is 3.714%, more than 71 basis points above the floor of the range which Ms McShane applies before there is any need to review the adjustment mechanism. In the context of the Board's express approval of the adjustment mechanism some five months ago and the prevailing long term Canada rate which is still well above 3%, there is no need to review the values produced by the adjustment mechanism, particularly when there is no evidence whatsoever from any Ontario regulated electricity distributors suggesting that the application of the adjustment mechanism for determining rates effective May 1, 2009, is causing any immediate or material threat to utility financial integrity.

The fact that the values produced by the current adjustment mechanism continue to be appropriate is corroborated by testimony from Hydro One witnesses in the recently completed oral hearing with respect to Hydro One's 2010 and 2011 Transmission Rates Application. There, Hydro One witnesses confirmed that it will adjust its transmission rates, effective July 1, 2009, to reflect consensus forecasts and Bank of Canada/Statistics Canada data as of March 2009.[2] This evidence confirms that the current values produced by the adjustment mechanism remain appropriate for rates effective May 1, 2009.

D. Current and Prospective Capital Market Conditions

Comments on the questions posed cannot be provided without considering evidence with respect to the current state of the capital markets. In that connection, on April 8, 2009, Dr. Laurence Booth provided some intervenor representatives, including CME, with a one hour synopsis of the current and prospective capital market conditions which pertain to the Board's questions. We rely on the information Dr. Booth provided.

Based on the information Dr. Booth transmitted to those in attendance during the one hour Information Session held on April 8, 2009, we understand that the current capital market information establishes the following points:

(a) Utilities generally, including Ontario electricity distribution utilities, are not having any difficulty accessing debt capital.

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[1] Evidence of Kathleen McShane, EB-2007-0905, Exhibit C2, Tab 1, Schedule 1, page 110

[2] Hydro One Transmission Rates Case, EB-2008-0272, Exhibit I, Tab 1, Schedules 3, 4 and 5 and Transcript Volume 3, pages 62 and 63

(b) Since most, if not all, Ontario electricity distributors are owned by municipal or provincial governments, they do not acquire equity in the capital markets. Accordingly, such utilities are not having any difficulty attracting equity capital.

(c) Other utilities, such as the Board regulated gas utilities and NEB regulated gas transmission utilities, are not experiencing any problem attracting debt or equity capital. If they consider the long term debt rate to be too high, they have the option of borrowing under the auspices of shorter terms which are available at debt costs lower than prevailing long term bond rates.

(d) Evidence corroborating the fact that Canadian utilities generally are not experiencing any problem attracting capital includes recent issues by TransCanada PipeLines Limited ("TCPL") and Union Gas Limited ("Union"). The evidence filed by Union with its April 2, 2009 Application with respect to 2008 Earnings Sharing and Incentive Regulation Review shows that, for the period 2009 and 2010, Union assumes it will be able to maintain short term borrowings of $500M at an interest rate of 3.50% and issue long term debt in 2010 at a rate of 6.0%.[3]

In an Information Session held on April 8, 2009, Union representatives confirmed that these cost of debt forecasts remain valid.

(e) Long Canada rate forecasts as of January 2009 hovered around the 4% range down from what they were previously as a result of the flight to treasuries caused by the combined effect of the credit crunch, the liquidity crisis, and the severe recession. Long Canada rates are expected to remain above the 3% floor below which they should fall before a review of the Board approved ROE adjustment formula is triggered.

(f) Long term BBB rated debt bonds have spiked up, as they did in past recessionary times, primarily due to business viability concerns which arise in a severe recession.

(g) Long term A rated corporate bonds have also spiked up to levels which reflect spreads over Long Canadas which are wider than they have been historically in times of a recession. According to Dr. Booth, this situation is likely caused by the credit crunch, the flight to treasuries, and liquidity constraints currently affecting bond trading. According to Dr. Booth, the wide spread between A rated bonds and Long Canadas now appears to be narrowing somewhat.

(h) There is no increase in the perceived risk of utilities. The decline in utility share prices has been about 50% of the decline in the value of the market as a whole which merely corroborates that the evidence upon which the Board has traditionally relied to establish the equity risk premium for utilities over and above the risk free long term Canada rate.

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[3] See EB-2009-0101 evidence of Union, Exhibit A, Appendix C, Schedule 1, page 1 filed April 2, 2009.

E. Spreads Between ROE and the Current Cost of Long Term Debt in Times of Economic Turmoil

The Board's March 16, 2009 letter notes that applying the approved adjustment formula to January 2009 data produces a spread between Board approved ROE and current long term debt costs of 39 basis points, which is considerably narrower than the spread that existed before the situation of economic turmoil emerged in the last quarter of 2008.

This is not the first time the Board has had to fix rates in the midst of a situation of economic turmoil. Such a situation occurred in the late 70s and early 80s. At that time, the problem was 'runaway' inflation and astronomically high short and long term debt costs. In its Reasons for Decision in E.B.R.O. 382 dated April 8, 1982, being an Application by Union Gas Limited ("Union") for rates for the test period ending March 31, 1983, the Board described the situation that then prevailed as follows:

> *"This application is being processed during a time and within an economic environment that may be euphemistically described as unusual. Inflation is high and persistent, interest rates are high and erratic and financial markets are reacting in a manner that makes long term comparisons difficult.*
>
> *Mr. Kierans has reported that long-term bond markets are closed to Union. …*
>
> *For all these reasons the economic and regulatory environment is perceived to be rather unusual. It is, however, the ambiance within which this Board must derive, in the final analysis, just and reasonable rates that will enable the applicant to maintain itself in what is commonly regarded as a state of financial integrity."* [4]

The Board's rate setting response in that period of economic turmoil is informative in that it demonstrates that, in situations of economic turmoil, the spreads between the prevailing corporate long term debt costs and the Board approved ROE can be very narrow and, in fact, be significantly negative in a particular test year.

For example, for the 12 month test period ending September 30, 1981, the Board fixed rates for the Consumers Gas Company, the predecessor of Enbridge Gas Distribution Inc. ("EGD") on the basis of the following Costs of Capital:

(i)	Short Term Debt	12.66%
(ii)	Long Term Debt	13.73%
(iii)	ROE	14.25%

The spread between the then current corporate Long Term Debt rate of 13.73% and the Board determined ROE of 14.25% was 52 basis points.[5]

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4 Reasons for Decision E.B.R.O. 382 dated April 8, 1982, at pages 51 to 53

5 Reasons for Decision E.B.R.O. 376-I and II dated January 30, 1981, at pages 70 to 83

In the following year, in Reasons for Decision in E.B.R.O. 381 dated January 27, 1982, the Board determined Costs of Capital for EGD's predecessor for the test period ending September 30, 1982, were as follows:

(i)	Short Term Debt	18.25%
(ii)	Long Term Debt	18.5%
(iii)	ROE	16.25%

The negative spread between the then prevailing Long Term Debt Rate of 18.5% and the Board determined ROE of 16.25% was negative 225 basis points.[6]

A year later, for the test period ending September 30, 1983, the Board determined Costs of Capital for EGD's predecessor were as follows:

(i)	Short Term Debt	13.5%
(ii)	Long Term Debt	15.5%
(iii)	ROE	15.75%

The spread between ROE of 15.75% and corporate Long Term Debt costs of about 15.5% was 25 basis points.

For Union's test period ending March 31, 1982, the spread between the prevailing Long Term Debt rate for Union of about 15.25% and the Board approved ROE of about 15% was negative 25 basis points.[7] For Union's test period ending March 31, 1983, in which the evidence indicated that the Long Term Debt markets were closed to Union, the spread between the Long Term Debt rate of 18.5%, which the Board determined for EGD's predecessor in the E.B.R.O. 381 Decision dated January 27, 1982, and the Board approved ROE for Union of 16.75% was negative 175 basis points.[8]

In the unusual economic conditions that prevailed between October 1, 1980, and September 30, 1983, the spreads between the then current corporate Long Term Debt rate and the Board approved ROE ranged between a negative spread of 225 basis points and a positive spread of 52 basis points.

The point is that the narrow 39 basis points spread between ROE and the Long Term Debt rate to which the Board refers in its March 16, 2009 letter is not unprecedented. Narrower spreads and, in fact, negative spreads between ROE and the current Long Term Debt rate have occurred in prior years without posing any threat to the financial integrity of the affected utilities. The fact that the spread between the ROE and the Long Term Debt rate has declined to a spread of 39 basis points in 2009 is not a cause for alarm.

6 Reasons for Decision E.B.R.O. 381 dated January 27, 1982, at pages 63 to 96
7 Reasons for Decision E.B.R.O. 380 dated September 14, 1981, at pages 63 to 68
8 Reasons for Decision E.B.R.O. 382 dated April 8, 1982, at pages 61 to 70

F. Process

We note that in its Decision on Cost Eligibility dated April 14, 2009, indicates,

> *"… that in the event that the Board determines that there is merit in considering adjustment to any of the Cost of Capital parameter values calculated by the Board's formulaic approaches for the 2009 rate year, the Board will initiate an appropriate process to consider those adjustments."*

The comments which follow are provided to support the proposition that a Generic Hearing is the appropriate process in which to consider possible adjustments. While a consultative process can be used to establish the procedure to be followed to consider evidence pertaining to the need for and the appropriateness of adjustments to the values which the Board approved adjustment mechanism currently produces, a consultative process cannot be utilized to determine the nature of any changes ultimately established by sworn and tested evidence to be needed and appropriate.

Making adjustments to values effectively changes the Board approved methodology. The process for considering changes to the Board approved methodology for determining the rates for electricity gas distributors should be the type of generic hearing process the Board followed in the RP-2002-0158 Applications by Union and EGD when it considered the need for changes to the methodology used to determine the Costs of Capital for those gas distributors. That process was analogous to a Generic Hearing process.

As well, rates which the Board has already approved for 23 of the electricity distributors it regulates are the result of quasi-judicial proceedings, some of which are based on binding Settlement Agreements between the affected utility and its ratepayers. These rates cannot be reviewed or changed without first complying with the review and variance provisions of the statutes and rules which govern proceedings before the Board. These provisions call for a quasi-judicial hearing.

G. Responses to Board's Questions

In the context of all of these factors, our comments on the five questions the Board has posed are set out below:

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

   The flight to treasuries has tended to reduce the yield on long term Canada. At about a forecast rate of 4%, the rate is still above the 3.0% floor below which it should fall before a review of the adjustment mechanism is triggered.

   Bank of Canada actions to stimulate the economy are pushing short term rates down.

Concerns about enterprise viability, the credit crunch, the lack of liquidity in bond trading, and the flight to treasuries, separately and in combination, are putting upward pressure on corporate bond yields for both BBB rated and A rated bonds.

The spread between the Board determined ROE and the Board determined long term debt rate is currently narrow, but not as narrow as it has been in prior periods of economic turmoil. Current indications are that the spread between A rated bonds and long term Canada's is narrowing with the result that the spread between the ROE and the Board determined Long Term Debt Rate will tend to widen during the remainder of 2009.

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

The values produced by the methodology are reasonable.

A number of electricity distribution utilities the Board regulates have recently agreed to have the Cost of Capital values in their rates determined by an application of the adjustment formula the Board itself approved for OPG in its November 3, 2008 Decision.

There is no evidence that the values are causing any immediate and material threat to the financial integrity of any electricity distribution utilities that the Board regulates.

There is no evidence to indicate that any electricity utilities the Board regulates are having any difficulty accessing capital and

The capital markets do not perceive utilities to be any riskier than they were when the Board's adjustment formula was established.

The 39 basis points spread between the ROE and the current Long Term Debt Rate is not a cause for alarm. It sits at the upper end of the spreads between ROE and current Long Term Debt Rates that prevailed in the 1980 to 1983 situation of economic turmoil when the spreads range between a negative amount of 200 basis and a positive amount of 52 basis points.

2.1 If the values are not reasonable, what are the implications, if any, to a distributor?

Not applicable.

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

No adjustments are either necessary or appropriate.

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

Under the Board's approved adjustment formula, there will always be some ebb and flow in the annually determined ROE in tandem with the ebb and flow in interest rates on Long Canada bonds.

Traditionally, the Board has always attempted to determine prospective test year costs of capital on the basis of the most current information. Hydro One, for example, agrees to use March 2009 information to determine the Cost of Capital components of its transmission rates effective July 1, 2009.[9] We can see no good reason for modifying this principle. November data could be used to determine rates effective January 1 of the following year, but not used to determine rates effective May 1 of the following year.

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

The other key issues to be considered relate to process and the need for any changes to values produced by the Board approved adjustment formula to be based on sworn and tested evidence. This evidence must satisfy the process requirements of the Board's governing legislation and rules of procedure pertaining to the review and variance of prior quasi-judicial Decisions.

As well, the general prohibition against retroactive rate-making should be respected so that any approved changes are implemented prospectively and not retroactively.

Please contact me if you have any questions about these comments.

Yours very truly,

Peter C.P. Thompson, Q.C.

PCT\slc
c. Paul Clipsham (CME)

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9 See footnote 2