Comments on the Cost of Capital Determination for LDCs

EB-2006-0088

Donald Carmichael
September 13, 2006

Cost of Capital
EB-2006-0088

Conclusions:

- The proposed process to determine an appropriate ROE for the LDCs is seriously flawed and will not be supported by the capital markets;
- The proposed CAPM methodology is less transparent and subject to more arbitrary decisions that the methodology currently in use;
- The proposed range of ROEs is inadequate to attract capital on reasonable terms and conditions;
- If accepted, the proposed regulatory process will exert downward pressure on the LDCs credit ratings and their ability to access the long term debt market; and
- The capital markets would support a generic hearing on ROEs and an annual adjustment formula.

Cost of Capital
EB-2006-0088

Process Flawed:

- In the view of capital markets, the proposed process to determine LDCs' cost of capital and ROE is seriously flawed;
- The process relies on only one model, the CAPM, to determine the ROE as opposed to other jurisdictions such as Alberta, British Columbia and the NEB where the comparable earnings test and DCF are also considered;
- Investors and lenders expect that the regulatory process will review all relevant risks and ROE evidence prior to coming to a decision. The proposed process would not accomplish these objectives to their satisfaction; and
- The proposed process appears to be less transparent and subject to arbitrary decisions made by Board Staff regarding "comparable companies", the appropriate periods of time from which to determine the expected market return and the utility Beta factor, the equity risk premium and the longer term risk free rate than the process being replaced.

Cost of Capital
EB-2006-0088

CAPM Methodology Plagued with Difficulties:

- Board Staffs application of the CAPM raises the following issues:
- the use of a 15 year risk free rate does not reflect the long-term nature of utility investment and has certain technical difficulties associated with it;
- the determination of the market return including the time period used and the use of a forward rate versus the achieved rate;
- the selection of so called “comparable companies” results in the significant underestimation of Beta in the CAPM;
- if adopted, the proposal would result in different ROE methodologies and less robust financial performance in Ontario (electric versus gas distribution) and electric utilities in Ontario versus those in other jurisdictions (Alberta, British Columbia);

Cost of Capital
EB-2006-0088

CAPM Methodology Plagued with Difficulties:

- it is impossible to determine if the CAPM methodology as proposed, will result in relatively stable and predictable ROEs or will increase their volatility thereby increasing utility risk;

- with consolidations and foreign takeovers of large cap Canadian companies, the TSX is becoming a market dominated by the oil and gas and financial sectors. It is not a truly "diversified market portfolio" now or is it likely to be in the future. This being the case, reliance solely on the CAPM is not appropriate; and

- many untested assumptions and deviations from the advice of their own experts have been accepted by Board Staff to reach their proposal. These assumptions and deviations should be tested much more rigorously before such a significant change in the determination of the ROE is accepted by the Board.

Cost of Capital
EB-2006-0088

Is the Proposed ROE Range Adequate?

- In my view, the range of ROEs proposed between 7.50% and 8.37% is inadequate to attract long term investment capital on reasonable terms and conditions and would fail to preserve the financial integrity of the LDC utilities.

- A leading utility equity market analyst (Karen Taylor, BMO Capital Markets) has described the proposed range of ROEs as “confiscatory” and “likely violating the fair return standard”.

Cost of Capital
EB-2006-0088

Constructive Capital Structure Proposals:

- The capital markets support the proposal to allow a total equity component financing rate base to be up to 40% with up to 4% in the form of preferred share capital, at the option of the utility;

- The total equity ratio is justified by the increase in business and financial risks faced by the LDCs since Dr. Cannon's original proposals;

- The 40% total equity ratio does not reduce the requirement for the utility to exhibit robust cash flow and earnings coverage of interest; and

- From a capital markets perspective, differing regulated equity bases do not restrict consolidations or mergers between utilities.

Cost of Capital
EB-2006-0088

Debt Financing likely to be More Difficult:

- Long term fixed interest rate debt is the optimal form of external capital to finance additions to rate base. The policy framework and regulatory environment must remain stable to allow the LDCs to maintain or enhance their credit profile and credit ratings to ensure access to the long term market on reasonable terms and conditions.

- Larger LDCs have successfully issued long term debt in the past to refinance shareholder loans or consolidate existing liabilities. Such issues have generally not financed new capital expenditures.

- Commercial banks are very liquid but unlikely to lend beyond 10 years;

- Long term fixed rate debt is sourced from insurance companies (20 to 30 major purchasers) which rely on credit ratings and their own credit analysis;

Cost of Capital
EB-2006-0088

Debt Financing likely to be More Difficult:

- Rating agencies and investors consider policy and regulatory changes to be the greatest risk for a regulated utility;

- Large LDCs have credit ratings ranging from BBB(high) to A. Although at higher levels when the electricity market opened, ratings were reduced reflecting greater uncertainty with respect to the policy framework and the LDCs ability to earn an appropriate return;

- Rating agencies believe ROEs in Canada are too low resulting in interest and cash flow coverage that are inadequate given their risk profile. The proposed ROE range reinforces this view and risks additional downward pressure on existing ratings;

- LDCs will face greater difficulty raising long term debt capital on reasonable terms and conditions in the future as there will be extensive demands from the generation, transmission and distribution sectors in Ontario. The generation and transmission borrowers would likely be viewed as stronger credits than the LDCs if the proposal is accepted.

Cost of Capital
EB-2006-0088

Why Change?

- There is no compelling argument as to why the current approach to rate setting or adjustment should be abandoned. Proposals by both Board Staff and their experts rely on input from outside experts or arbitrary decisions. The current approach is similar to those used in other jurisdictions and investors and lenders are familiar with it.

- Other jurisdictions rely on multiple approaches including CAPM, comparable earnings and DCF. Each methodology has well known strengths and weaknesses; however, each one also provides important incremental information to determine an appropriate ROE;

- The OEB should reconcile the differences between methodologies after considering the data and the unique strengths and weaknesses of each model;

- Having established an appropriate base ROE via a generic hearing, the capital markets have accepted annual formulaic adjustments to reflect changes in capital market conditions;

Cost of Capital
EB-2006-0088

Why Change?

- If the ROE is estimated appropriately, incentives for new investment should not be required;

- Arbitrary restrictions imposed by the Board on dividends and other management decisions would raise the cost of capital and ROEs. The capital markets believe the Board's role is to set rates, not manage the utility.