EB-2006-0088

**IN THE MATTER OF a Consultation by the Ontario Energy Board on the Appropriate Cost of Capital and Incentive Regulation for Electricity Distribution Companies**

**FINAL WRITTEN RESPONSE OF**
**BLUEWATER POWER DISTRIBUTION CORPORATION ( BLUEWATER ) CHATHAM-KENT HYDRO INC. ( CK HYDRO ), MIDDLESEX POWER DISTRIBUTION CORP. ( MPDC ), NEWMARKET HYDRO LTD. ( NHL ), and WELLAND HYDRO-ELECTRIC SYSTEMS CORPORATION ( WELLAND HYDRO ) ( collectively referred to as the Distributors )**

**OVERVIEW:**

1. The Ontario Energy Board (“Board”) is seeking input from stakeholders regarding the appropriate cost of capital and incentive regulation for local electricity distribution companies (“LDCs”) in Ontario.

2. In order to prompt discussion, Board Staff published a discussion paper dated July 25, 2006, containing a “Staff Proposal” to address these two issues. The Board invited interested parties to provide expert reports and other evidence in response to the Staff Proposal by August 14, 2006.

**Reference:** Ontario Energy Board, “Staff Discussion Paper on Cost of Capital and 2$^{nd}$ Generation Incentive Regulation for Ontario’s Electricity Distributors”, July 25, 2006

3. The Board also made provision for a technical conference to be held on September 18-22, 2006, at which Board Staff and any other participants who had provided reports would be expected to make their experts available for questioning and discussion.

4. The Distributors understood that the purpose of the consultation was to review and consider improvements to the Board's current cost of capital methodology, as set out in the 2006 Rate Handbook, that is used, among other things to determine the capital structure and costs of equity and debt financing to be used to set just and reasonable rates for LDCs.

**Reference:** Ontario Energy Board, "Rate Handbook, 2006"

5. In particular, the Distributors understood that the consultation was intended to ensure that the current cost of capital methodology or proposed changes sufficiently advance, and would not impair, the policy objective of the Ontario Government and the Board in enabling Ontario LDCs, operating in a newly de-regulated market place, to have access to sufficient market capital, at competitive rates, and to finance needed improvements in the electricity infrastructure of Ontario within their respective areas.

6. The Distributors did not anticipate that the proceedings would also raise a second policy issue, relating to the desirability or otherwise of mergers, consolidation and acquisition activities involving smaller LDCs in Ontario. We are not aware of any stated position or direction of the Ontario Government or the Board on that issue. Indeed, in the course of these proceedings, we have noted that a number of statutory impediments to LDC consolidation currently exist. In light of those provisions, we do not believe the Board has any statutory mandate within which it could effectively address that issue, nor do we believe it is an appropriate issue to be addressed by the Board in the absence of any such direction or framework.

7. Moreover, the basis for Board Staffs' belief that varying capital structures create a barrier to merger is open to serious question. Ms. McShane, testifying for Hydro One Networks at the technical conference (Transcript, September 20th at page 57-58 and 115-117) stated that, provided that the capital structure of an LDC properly reflects the risks faced by that LDC, then the commensurate returns on debt and equity capital are necessary to compensate the LDC for the risks it faces.

st to Board Staff to list every way in which varying capital structures created a barrier to merger, they cited only two examples (see page 41 of Board Staff Responses to Questions). On analysis, both examples in reality represent LDC's choosing to merge operationally, without merging legally. We suggest that any prudent manager would seek to reduce risk through harmonizing operations but, unless forced to merge legally, might well choose to enjoy the higher revenues that would normally be associated with higher risk. If these examples reflect the entire concern of Board Staff, then we suggest the preferable solution is to impose rate harmonization as a condition of merger or acquisition at the time of a MADD application, or to require LDCs subsequently to justify rates where it is shown that there may be advantages to two LDCs merging legally. These are matters in the control of the Board. They are completely unrelated to the issue of whether to allow the industry to have varied capital structures, and it seems unreasonable to try to accomplish these goals indirectly, through capital structure regulation, given the many potential unintended consequences discussed by all parties to this process.

9. The Distributors submit that, if and when the relevant statutory impediments are removed, merger and consolidation will tend to occur naturally, without the need for any external prompting and without any unintended biases, if, but only if, this Board continues its path of creating a stable, market-sensitive regulatory environment for the electricity sector in Ontario, including fair and reasonable allowances for LDCs' capital structure and for the costs of equity and debt financing for rate-setting purposes.

10. It is also significant that Board Staff appear to have ignored the important role that Incentive Regulation might play in removing barriers to amalgamation. One of the greatest barriers to amalgamation is the lack, or at least the uncertainty, of financial incentives for shareholders. During the 2006 EDR process, the Board considered comments from stakeholders that in a PBR regime, amalgamations are encouraged through the ability of distributors to pass savings to shareholders and that those objective are furthered by permitting applications to be based on historic test years. The Board apparently accepted those submissions for the 2006 EDR and we suggest that Board Staff should consider that

on process. LDCs attempting to evaluate merger opportunities may assume that filing on the basis of historical test year is the most reliable and reasonable approach, but certainty on that issue would be of tremendous assistance. The importance of this point is now emphasized with the recent lifting of the transfer tax by the Province.

**The Issues and the Position of the Distributors**

11. The Distributors are otherwise vitally interested in all aspects of the "cost of capital" debate. On September 5, 2006, in response to clarifications sought by the Coalition of Large Distributors and others, the Board provided participants with a "Guide for Presentations", which listed specific questions on which the Board was seeking input from participants in their presentations. The Distributors have, therefore, participated in the consultation to address a number of the issues raised.

12. In particular, in this Final Written Response, the Distributors provide the Board with additional factual material and submissions on the following issues raised by the Staff Proposal and the Board's Guide for Presentations, that are of primary importance to them, as follows:

(a) **Regulatory Instability, Fairness, and Regulatory Risk –** Board Staff has approached its cost of capital proposals by "starting with a blank slate", and offering new proposals, with implications for rate-making, without regard to past and current methodologies approved by this Board, or their results. The Distributors disagree with this approach. Any change in existing regulatory structures represents a risk to LDCs and their debt and equity investors. A material change in current methods and techniques for determining appropriate capital structures for LDCs, in principle or in the result, or in the financial consequences of deviating from those structures, or a change in what constitutes a fair return on LDCs' debt and equity capital, risks unfairness. We have assembled academic and market literature, as well as Canadian and US regulatory decisions, that support the position that regulatory instability and unfairness create real risks for LDCs, that translate into real additional costs of raising capital in debt and equity markets. This issue is addressed in Section A of this Submission, below.

**Use of Imputed of Deemed Capital Structures: –** The Distributors also take issue with the analysis in Board Staff's Proposal, to the extent that it may assume that increasing debt, and reducing the equity component in LCDs capital structures, is always beneficial to electricity customers. We provide further expert analysis, including academic and empirical research, which supports the position that, if an LDC is to be "deemed" for rate-making purposes to have a higher debt component than it actually has in its capital structure, then a corresponding increase in the cost of its "deemed" equity capital must also be recognized and allowed. This is because adding debt to a company, adds the related interest and other expenses to its fixed cost base. This, in turn, "magnifies" the impact on the LDC's remaining equity capital of any variability or risk factors affecting its revenue streams, both because the amount of this equity component in its capital structure is reduced by the amount of additional debt, and because the fixed debt costs then make up a larger proportion of its total costs. This increase in variability and risk to the equity investors is also a real risk, for which they will require compensation in the form of a higher rate of return on the equity. The Distributors believe that Board Staff's analysis, and that of its experts, overlooks or downplays this inevitable market effect. We fear the result, if implemented, may be a reduced incentive for the existing equity shareholders to "reinvest" dividends in LDCs if their return on equity is inadequate. It may also result in a reduced ability, or increased costs, to all LDCs to access alternative debt and equity capital sources in the markets. This issue is addressed in Section B of this Submission, below.

(c) **Application of the CAPM Methodology –** In principle, NHL has not contested Board Staff's proposal to use the Capital Asset Pricing Model ("CAPM") methodology to determine the optimum capital structure and associated return on equity for LDCs. This does not mean that we endorse sole reliance on CAPM. However, the evidence called by NHL has focused on identifying errors in the way the CAPM methodology is applied in the Staff Proposal. These errors result in the Staff Proposal recommending an unduly low return on equity, and an unduly restrictive range of allowable capital structures, at least as they apply to smaller LDCs. Testimony of NHL's witnesses corrects these errors, and presents revised recommendations based on a proper application of CAPM. This issue is addressed in Section C of this Submission, below.

(d) **The Recognition of a Small Utility Premium –** In response to the critique, presented for the first time at the technical conference held September 18-22, the Distributors present with this submission additional evidence and analysis to provide an empirical, economic and policy rationale for the Board to continue to recognize and allow smaller LDCs a "premium" through their re options, and related rates of return. The Distributors are concerned that the Staff Proposal to eliminate this in future cost of capital methodologies ignores the available evidence (including that of Board Staff's own experts) and the principled arguments that have supported this approach by the Board in the past, and that continue to support the approach in other jurisdictions. This issue is addressed in Section D of this Submission, below.

(e) **Other Issues –** In addition, the Distributors offer the following analysis and positions on other issues raised by the Board, and by other participants.

(i) The Distributors support **Retaining the Status Quo for Cost of Capital Regulation** in preference to any proposals for change put forward by Board Staff or other participants.

(ii) The Distributors agree there is **No Evidence of a Liquidity Crisis in Capital Markets** per se, but suggest this issue is a "straw man": the real issue is whether, within those capital markets, the newly de-regulated LDCs in Ontario will continue to have rates of return on their debt and equity capital that are competitive with other enterprises of similar risk, such that they will be able to access capital markets on reasonable terms.

(iii) On the issues related to **Short Term Debt**, the Distributors support the position advanced by the EDA.

(iv) The Distributors see **No Significant Impact in Delaying Capital Cost Changes to 2008**.

(v) **Use of a Panel of Experts** to determine essential elements of LDCs' capital structure or cost of capital, or indeed other elements that are essential to the determination of "just and reasonable rates" for LDCs, should not be accepted, except perhaps in relation to market data collection and analysis.

(vi) Finally, the Distributors themselves have suggested that existing statutory **Restrictions on Municipal Debt** should be lifted, at least as they may apply to additional investment by municipal owners of LDCs in new debt and equity capital of electricity LDCs in Ontario.

These issues are briefly addressed in Section E of this Submission, below.

## ility, Fairness, and Regulatory Risk

13. All of the Distributors' submissions are grounded in the principle that LDCs are entitled to recover through the rates charged to their customers all costs of providing service, including a fair return on capital.

14. In *Northwestern Utilities vs. City of Edmonton* [1929], 2 D.L.R., p. 8 the Supreme Court of Canada stated, and the Distributors accept, that rate levels established by a regulator such as the Board should be "just and reasonable" to the consumer as well as to the utility, and that what is "just and reasonable" to an LDCs is the rates charged should yield a fair rate of return on money invested. In the U.S., the landmark decisions in *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 391 (1944) recognize that the benchmark or criterion for measuring that "fair return" should be the returns available in the markets on alternate investments of comparable risk, and this principle has been recognized in Canadian regulatory decisions.

15. These cases, and the principles they set down, have been widely applied. We have included in Schedule "A" to this Submission a summary of the most relevant court and regulatory decisions relating to this and other issues covered in this Submission.

16. The Distributors submit that based on these cases, and a consistent body of expert analysis accepted by the courts and boards that decided them, it is well established and not controversial that

- the required "fair return" on investment is determined by the nominal risk-free rate from time to time, plus a "risk premium" for the risks associated with the enterprise; and
- the risk premium is affected not only by business, financial, capital budget, and liquidity risks - all of which increase operating and financial leverage, thus increasing the required rate of return for all businesses – but also, in the case of regulated utilities, "**regulatory**" risks, derived from the market's perception of the stability or instability, and fairness or unfairness, of past and future regulatory decisions affecting the industry

and submit herewith additional expert analysis from Dr. Morin, prepared with the assistance of Energy and Environmental Economics Inc. ("E3"), which elaborates on these risk in the context of the present consultation process, and proposed regulatory approach (Schedule "A", Part One). They have assembled academic and market literature, with reference as well to Canadian and US regulatory decisions, that support the position that regulatory instability and unfairness create real risks for LDCs, that translate into real additional costs of raising capital in debt and equity markets.

18. In summary, this analysis suggests that regulatory risk is a prime determinant of total investment risk, because it can have a direct impact on LDCs' costs, earnings and rates of return on capital. Broadly speaking, these risks are of two kinds: the risk of surprise or unfairness, resulting from a specific regulatory decision that represents a material departure from past principles or assumed outcomes on which utilities have relied; and the risk of frequent or periodic changes resulting in a market perception of regulatory instability. Regulators should certainly consider such risks, both with a view to minimizing them when making changes to the regulatory system, and otherwise in their assessment of total investment risks to be considered and compensated in the rate-making processes.

19. In formulating its Proposal, Board Staff has indicated it is "starting with a blank slate", and offered new proposals for rate-making without regard to past and current methodologies approved by this Board, or their results. The Distributors disagree with this approach. Any change in existing regulatory structures represents a risk to LDCs and their debt and equity investors. A material change in current methods and techniques for determining appropriate capital structures for LDCs, in principle or in the result, or in the financial consequences of deviating from those structures, or a change in what constitutes a fair return on LDCs' debt and equity capital, risks unfairness.

20. The Distributors submit that at least three features of the Board Staff Proposal, reviewed in more detail in the following Sections of this Submission, individually, constitute unfairness to Ontario LDCs in this sense. In particular, they are:

f "deemed" capital structure options for smaller LDCs from the current 4-tier system, to a "one-size-fits-all" deemed capital structure of 60:40 debt to equity (see Section B, below);

- the proposed significant reduction of returns on equity capital for LDCs actually using the 60:40 capital structure, from the current rates of approximately 9% to the rate proposed by Board Staff and its experts in their Proposal, which is 8.37%; and
- the resulting elimination of any additional "risk premium" for smaller LDCs in Ontario.

21. Moreover, it is the Distributors' position that, collectively, these impacts, together with the unusual procedures adopted by the Board in this consultation and the related License Amendment Proceeding (EB-2006-0087), have raised or threaten to raise a market perception of regulatory instability in the emerging electricity sector in Ontario. Direct evidence of this developing perception is found in a publication by BMO Capital Markets, in its "Wires, Pipes & Btus" edition dated October 13, 2006, at pp. 6-10, which was filed by the Coalition of Large Distributors in EB-2006-0087 on October 20, 2006. This perception, if realized, will result in a further increase in the cost of both debt and equity capital to all LDCs, which again is a real cost for which LDCs will be entitled to seek compensation in rates.

22. These considerations reinforce the October 20 Preliminary Submissions by the Distributors in EB-2006-0087, which call for a change in the process to allow for a proper hearing on these issues.

## *Section B: Financial Risk and Deemed Capital Structures*

23. The case law summarized in Schedule "A" and expert opinion on which it is based, as well as the supplementary analysis of Dr. Morin and E3 in that Schedule, Part Two, also support the following analysis.

- The Weighted Average Cost of Capital ("WACC") or "Asset Return" for regulated utilities can best be determined by reference to a proxy group of companies of comparable risk.

panies is comparable in risk to a utility then the utility should have the same WACC as the proxy companies. However, comparable companies must experience comparable risks across all risk dimensions – business, financial, capital budget, liquidity, and regulatory – in order to provide an appropriate comparison group.

- Once an appropriate WACC is determined on this basis, the respective costs of the debt component and of the equity component will vary depending on the capital structure (or debt:equity ratio) adopted by a given utility.

24. In its Proposal, Board Staff has proposed several proxy groups as electricity LDC comparables, to determine their capital structure and equity returns. The appropriate pool of comparable companies ought ideally to face identical risks to those experienced by Ontario LDCs. However, Board Staff's Proposal acknowledges that no such identical comparator group exists.

25. The Distributors are concerned that selection of the wrong comparator group may result in Ontario LDCs not receiving returns commensurate with their actual risks, which would be in violation of fair return principles. The Distributors agree with Board Staff and their experts that more work is necessary to assemble the available data, and analyse its comparability. They agree that this work, at least, may be suitable for assignment to a "panel of experts" as proposed.

26. In the meantime, for purposes of this consultation only, the Distributors have accepted the advice of E3 that the closest comparator group presented in the Board Staff Proposal appears to be that identified as the "60-Month All Rate-Regulated" group. They have used the data from this group to test Board Staff's Proposal and present their own expert calculations.

27. Using that data, E3's Expert Testimony dated August 14, 2006 confirmed that Board Staff's calculation of LDCs' WACC would be correct at 6.47%, and that this would be constant over the relevant capital structure regardless of the actual debt:equity ratio selected.

28. Having once determined such a WACC, regulators next sometimes assign hypothetical (ie. "deemed" or "imputed") capital structures to regulated utilities for rate-setting purposes. This is based both upon empirical observation, and mathematical

ologies, that there is an "optimum" debt:equity ratio (or, more usually, a range of such ratios), within which the advantages of the generally lower costs of debt capital are maximized, without increasing the resulting return on equity required by investors beyond reasonable and available market levels.

29. However, where the actual capital structure of an LDC has less debt than the "deemed" or "imputed" level, the expert evidence provided by the Distributors' experts emphasizes that applying the "imputed" debt level for rate-making purposes is appropriate <u>only</u> if the cost of the remaining equity is revised to take this into account. In these circumstances, the "imputed" rate of return on the remaining equity portion must be higher than that required in the capital structure actually used by the LDC, to reflect the resulting changes in investor expectations regarding the rate of return on the resulting, more highly-levered equity portion. In each case, where this model is applied, the overall WACC received on the total capital of the LDC should remain the same. This is because the purpose of the model is not to lower the WACC overall (this being a constant, derived from analysis of the comparator group), but rather to avoid allowing the LDC to pass on to ratepayers the additional costs of capital that may arise from its adoption of a non-optimal capital structure.

30. Thus, if it is assumed that it is proper to impute a capital structure consisting of substantially more debt, the higher common equity cost rate related to a changed debt:equity ratio must be reflected in the approach. The greater the debt ratio, the greater is the return required by equity investors. Both the cost of incremental debt and the cost of equity must be adjusted to reflect the additional risk associated with the hypothetical capital structure. The arguments work in reverse if a hypothetical capital structure consisting of less debt than the actual were to be imputed. This has at least two implications for the debate during the technical conference between participants in this consultation:

- First, it is logically inconsistent to combine an "imputed" or "deemed" debt capital structure with an "actual" return on equity that excludes the effects of the proposed capital structure. By omitting the repercussions on equity costs and debt costs, a serious conceptual error would be committed in determining the cost of equity capital. With a deemed (fictitious) capital structure, the cost of and taxes all must be artificially adjusted so as to be consistent with the fictitious capital structure adopted.

- In addition, to the extent that the regulatory process passes the savings resulting from the tax advantage of increased debt to ratepayers, rather than to shareholders, the cost of equity required to compensate shareholders for the risks they bear will be increased. This is shown in Schedule "A".

31. However, Board Staff in its Proposal has not carried through the logic of this analysis. Basic finance theory requires that return on equity <u>increase</u> as debt is added to the capital structure, in order to maintain WACC at a level equal to that of the proxy companies with similar risks. Board Staff's approach provides <u>lower</u> returns, on <u>less</u> equity, and will severely impair the ability of small LDCs to contribute to the required renewal of Ontario's electricity infrastructure.

32. This is because adding debt to a company, adds the related interest and other expenses to its fixed cost base. This, in turn, "magnifies" the impact on the LDC's remaining equity capital of any variability or risk factors affecting its revenue streams, both because the amount of this equity component in its capital structure is reduced by the amount of additional debt, and because the fixed debt costs then make up a larger proportion of its total costs. This increase in variability and risk to the equity investors is also a real risk, for which they will require compensation in the form of a higher rate of return on the equity. The Distributors believe that Board Staff's analysis, and that of its experts, overlooks or downplays this inevitable market effect.

33. Accordingly, E3 reviewed the Board Staff proposal to move to a single capital structure for all Ontario LDCs, of 60/40 debt to equity capital, in place of the four-tiered capital structure options provided to Ontario LDCs under the Board's current methodology. While E3's analysis acknowledged Board Staff's position that the current four-tiered structure is overly complex and not fully supported by market data, it did find that there remains sufficient support in market data for a tiered approach. Given the Board's objective of simplifying the regulatory process, E3 recommended in its written testimony that the Board adopt a 2-tiered model, accepting Board Staff's 60/40 structure for Ontario LDCs with

ving those with less than $100 million rate base the option of a 50/50 structure. In support of this recommendation, E3 found as follows.

- The recommended 50/50 structure option is reflective of the amplified business risk arising from the smaller market area and customer base served by many small Ontario LDCs, such that removing this option from them could imperil their financial health and/or their ability to earn a fair rate of return commensurate with those risks.
- The recommendation is also consistent with the existing capital structure actually employed by many smaller LDCs in Ontario and elsewhere.

34. We note that the Staff Proposal on this issue is not even consistent with the findings of Board Staff's own experts, in their initial report, which indicated that empirical evidence does appear to provide continued support a tiered system, to accommodate smaller LDCs. While some efforts were made by Board staff to qualify this evidence at the technical conference, by saying the expert recommendation was transitional, we note the word transitional does not appear anywhere in the original written report and, in any event, we submit the report provides support for our recommendations herein. In particular, we suggest Board Staff has offered no evidentiary basis for its proposed departure from the *status quo* on this issue.

**Reference:** Transcript, September 20, pp. 119-124 and 128ff.

35. E3's findings and recommendations are also consistent with the Distributors' own experience in the market. They reinforce our concern that the Staff Proposal, if accepted, would actually hinder the ability of all LDCs to attract new equity and debt financing at competitive market rates, and so impair all of the important policy objectives underlying this consultation.

36. In addition, while the current four-tiered structure recognizes and compensates LDCs for size-related risks, as demonstrated in Section D below, Board Staff's Proposal not only removes this flexibility, it also does not adequately compensate LDCs on a WACC basis or on a return on equity basis.

n violation of the fundamental legal requirement for an adequate return on equity capital, consistent with the market returns available to alternative investments of comparable risk.

## *Section C Application of the CAPM Methodology*

**NHL s Retainer of E3**

38. On review the Staff Proposal, NHL was satisfied that it supported the use of the CAPM methodology to determine cost of capital matters. Our experience supports the position, urged by Board Staff, that CAPM is not only an appropriate methodology, but is indeed the best available methodology and the one <u>most widely used in practice by investors</u> in North American capital markets, for determining their expectations as to cost of capital matters for businesses, including electricity LDCs. Although regulators in the majority of jurisdictions continue to consider other methodologies, in addition to CAPM, for cost of capital regulation, the predominant usage of CAPM in the investment community must be recognized.

39. Surprisingly, however, as noted above, the application of that methodology in the Staff Proposal appeared to suggested that returns on equity for Ontario LDCs be significantly lowered, from 9% to 8.37%, and that the imputed capital structure options be severely reduced for smaller LDCs, compared to the current methodology. These results, if accepted without challenge, would not promote the policy of ensuring the availability of capital, particularly for smaller LDCs. To the contrary, the availability of adequate capital to <u>all</u> LDCs will actually be jeopardized by lowering their rates of return, and reducing their currently available options for capital structure.

40. Accordingly, NHL initially retained E3 as its experts to review and comment on this aspect of the Staff Proposal. Indeed, Ron Warrington and Michelle Smart of E3 were engaged, in preference to experts with a more academic or hearings-related practice, because

pplying the CAPM methodology to real-life project and enterprise financings in North American energy markets, on which real investors regularly invest large sums.

41. E3 performed a review of the methodology and calculations applied by the experts retained on behalf of Board Staff. In their written report of August 14, 2006, E3 confirmed that CAPM was an appropriate method for use by the Board in determining cost of capital matters for Ontario LDCs, but found errors in the application of that methodology by Board Staff's experts, that led to incorrect results and recommendations in the Staff Proposal.

**Reference:** E3, "Expert Testimony", August 14, 2006

42. In order to focus the Board and other participants on the most important differences between their own analysis and results, and those of Board Staff's experts, E3's written report adopted and applied as many as possible of Board Staff's assumptions and inputs to the CAPM as possible. In particular, they used the 60-Month, All-Rate-Regulated comparator group data provided by Board Staff, itself, for the reasons referred to above. In summary, using that approach, E3 found as follows.

- The return on equity values in Appendix "A" of the Staff Proposal had been underestimated at 8.37%, which is even lower than the rate of 9% allowed by the Board's current methodology.
- This was due in part to the use of inappropriately high imputed debt interest rates. Those rates were, in all cases in Appendix "A", higher than the corresponding equity rates, which is inconsistent with the normal market expectation of a higher rate of return on equity, commensurate with its higher risk, as compared to debt.
- Applying the corrected methodology and calculations, and using Board Staff's own values for the 60-month, rate-regulated scenario (which E3 considered to be the closest comparator group for Ontario LDCs in the Staff Proposal), E3 derived a return on investment of 10.3 – 10.9%%, using debt interest of 6.01%.
- This calculation does not adjust for size premium or flotation costs.
- E3 considered these results to be consistent with the rates of return currently being earned by electricity utilities in the United States, and with the current market rates for corporate debt interest in Canada.

**Conference**

43. The results of the technical conference have reinforced these concerns with the Staff Proposal, in two ways. First, E3's presentation of oral testimony at the conference elaborated and strengthened its findings and recommendations. The challenges posed by other participants, including Board Staff and its experts, were effectively answered both at and following the conference. Second, and as important, the Board heard evidence from other parties that corroborates E3's analysis and results in important respects.

44. Following the Technical Conference, on September 22, 2006 E3 provided Board Staff with a Document answering all the questions posed at the hearing, and setting out clearly and in detail where they believed the analysis of Board Staff's experts had erred, and how their corrected calculations were made. E3 offered to meet with Board Staff or their experts to resolve this technical issue directly with them on numerous occasions. However, despite such offers, by October 7 Board Staff and their expert had still not found time to meet with E3. Accordingly, NHL filed a copy of E3's analysis with the Board and all participants as required at that time.

45. It was only on October 13, that Board Staff contacted E3 by e-mail to address the difference in their respective approaches. E3 immediately responded, again explaining in detail why the Board Staff approach was wrong in principle, and why E3 had made the adjustments it did. Attached as Schedule "B" to this Submission is a complete copy of this e-mail exchange between E3 and Board Staff from September 22 to October 13, 2006. We note that Board Staff did not respond to that analysis, nor did they ask NHL any follow-up questions about it prior to or at the reconvened technical conference on October 17, 2006.

**Conclusion on the CAPM Methodology**

46. Based on this record, NHL is satisfied, and submits, that the approach of E3 is demonstrably correct. As final confirmation, however, the Distributors have commissioned a second analysis on this issue, which is consistent E3's essential finding, using the same

f a range of returns on equity for LDCs of between 10.3% and 10.9%. A copy of this analysis is included in Schedule "A", Part 3.

47. Based upon these calculations, Board Staff's 8.37% return on equity proposal is thus over 2% lower than that required to maintain a WACC commensurate with similar investments in the comparable companies.

48. Based on this analysis, and confirmation, the Distributors submit that Board Staff has failed to substantiate that its alternative approach, or resulting rate of return at 8.37%, are appropriate, despite ample opportunities to do so, and that the Board should not rely on this aspect of the Board Staff Proposal.

## *Section D: The Small Utility Premium*

49. The same case law summarized in Schedule "A" also supports the position that:

- Small companies face additional risks and must therefore receive additional return.

50. Staff has proposed the elimination of Ontario's tiered capital structure which is determined based upon utility size. While the current four-tiered structure recognizes and compensates LDCs for some size-related risks, by at least allowing a range of "deemed" or "imputed" capital structures that are more in line with their observed and "optimal" structures, the Staff proposal would eliminate this.

51. The Distributors strongly contest this proposal, because it is neither based upon sound economic theory or evidence as outlined above and in the Schedules, nor is it even recommended by the Board Staff's own expert advisors. Their testimony referred to above, appears to confirm that small LDCs do indeed face business risks and capital attraction challenges that would not be adequately recognized or compensated, but rather would be exacerbated by moving to a uniform 60:40 capital structure. The conversations surrounding the attempts to qualify this evidence led us to believe that the real concern of Board Staff was

at least to remove possible obstacles. As noted, we believe this is not appropriate.

52. Rather, we provide evidence which shows that Canada has existing precedence for the tiered capital structure in Alberta and currently in Ontario. Further evidence in the US shows select jurisdictions have followed a similar approach – either providing a small company adder to the ROE or and equity structure cushion. In summary, the analysis in Schedule "A", Part Four, suggests as follows:

- Investment risk increases as company size diminishes, all else remaining constant. Overall, for the period 1926-2004, Ibbotson Associates (*2005 Yearbook, Valuation Edition*) found that the smaller companies have experienced returns that are not fully explainable by their higher betas, and that the excess return of that predicted by the CAPM increases as size decreases. This suggests that the cost of equity for small stocks is considerably larger than for large capitalization stocks.
- Smaller companies are less able to deal with significant events that affect revenues and cash flows than large companies. For example, the loss of sales from a few large customers would exert a far greater effect on a small company that on a larger, more diverse company with a large customer base. Size is a significant factor that increases both business risk and financial risk and, therefore, the cost of capital.
- Canada and the US adjust returns and capital structure to account for higher risk among small utilities as noted in regulatory decisions and orders for the Province of Alberta and the States of Florida, California and Maine.

53. This is consistent with the case law summarized in Schedule "A", which has consistently recognized that small utilities, both in Canada and the U.S., should receive additional compensation for their increased risk, through increased equity in their capital structure, increased ROE, or both.

54. A recent example is the decision of this Board dated September 20, 2006 in the case of Natural Resource Gas, EB-2005-0544, which substantially accepted the evidence of Ms. McShane, who also appeared in this proceeding as a witness for Hydro One Networks. We attach as Schedule "C" to this Submission a copy of Ms. McShane's Opinion, delivered to the Board and relied on in that case, which succinctly summarized the empirical and

cognized a "small utility premium" in the gas sector. In summary, Ms. McShane's opinion supports the position that:

(a) A utility that is geographically small, with a highly concentrated economic base, or with significant exposure to customers in a single industry, cannot diversify its risks to the same extent as larger utilities. (p. 10-12).

(b) Negative events are likely to have greater impact on the earnings or viability of smaller, less diversified utilities (p. 10).

(c) This is frequently exhibited in lower debt ratings, and a higher cost of debt capital, than their larger peers (p. 10, 14-17 and Table 3).

(d) It can also be reflected in an inability to be rated or to access public debt markets at all (p. 7).

(e) Analysis of historic returns and betas for small companies has observed that they tend to exhibit higher bets, and to require higher returns (p. 17).

(f) Given these higher business risks and smaller size, incremental compensation to the equity investor is required (p. 13, 17ff.).

55. The Distributors submit that Board Staff's proposal of one capital structure and equity return for all LDCs does not recognize these higher risks faced by small utilities adequately, or at all, and will result in small utilities receiving returns that are not commensurate with their actual risks, and which to that extent are not, fair, just or reasonable.

## *Section E: Other Issues*

56. The Distributors' position in response to other Board questions in the Guide for Presentations is as follows:

**Retaining the Status Quo for Cost of Capital Regulation** in preference to any proposals for change put forward by Board Staff or other participants.

(b) The Distributors agree there is **No Evidence of a Liquidity Crisis in Capital Markets** per se, but suggest this issue is a "straw man": the real issue is whether, within those capital markets, the newly de-regulated LDCs in Ontario will continue to have rates of return on their debt and equity capital that are competitive with other enterprises of similar risk, such that they will be able to access capital markets on reasonable terms.

(c) The Distributors see **No Significant Impact in Delaying Capital Cost Changes to 2008**.

57. On the issues related to **Short Term Debt**, the Distributors support the position advanced by the EDA.

58. **Use of a Panel of Experts in Capital Cost Regulation**: The Distributors do not support Board Staff's proposal to use a "panel of experts" approach to determine essential elements of the capital structure and cost of capital issues. The record of this consultation amply demonstrates the wide variety of expert approaches and views on these issues, and the potential for selection of panel members to influence the results of the regulatory process. More important, the Distributors believe these are essential components in setting "just and reasonable rates" for Ontario LDCs, such that the Board cannot abdicate or delegate decision-making in these crucial areas to another body.

59. By way of exception, the Distributors would accept that the task of assembling and analysing "comparable" market data on companies with similar risk profiles to Ontario LDCs, for use in applying CAPM or other methodologies, could appropriately be assigned to such a "panel of experts". As long as the affected parties remain at liberty to call their own evidence before the Board as to how that data applies and the results it suggests for a given LDC or rate case, the Distributors would not see any concern.

**t Investment in LDCs**: Given the tradition of municipal ownership of LDCs in Ontario, the Distributors have made the point that continuing restrictions on municipalities' ability to invest are, in themselves, an obvious impediment to municipally-owned LDCs' ability to raise both new equity and debt support from their owners. Whatever their policy basis in the municipal area, given current policy and regulatory directions for the electricity sector, the Distributors submit that there is no rationale for retaining these restrictions in Ontario, at least in relation to municipal investment in that sector. The Distributors urge the Board to consider advising the Government of Ontario of the desirability of legislative reform on this point.

## *Conclusions*

61. This consultation has provided an opportunity for an unusually frank discussion of the competing policy interests concerning capital structure and return on capital issues, particularly for smaller LDCs. However it has not, in the respectful submission of the Distributors, laid the necessary evidentiary foundation or provided the required procedural protection to parties, that would be required to implement any significant reform of the current cost of capital methodologies and techniques used for determining just and reasonable rates for LDCs in Ontario.

### The Process Going Forward

62. Certain information requests made by the School Energy Coalition at the conference, and the proceedings in EB-2006-0087, have also prompted a useful discussion of the options for the Board's process going forward. The Distributors have addressed that issue in their submissions dated October 20, 2006 in EB-2006-0087, and simply adopt and repeat those submissions by reference here.

### Summary of Recommendations

d for the opportunity to participate in this consultation, and thanks Board Staff and other participants for their contributions to the process. Based on all of the proceedings we make the following recommendations.

(a) The Board should not move off its current cost of capital methodology for determining capital structure, return on equity and debt rates. In particular, the record of this consultation does not support adoption of the Board Staff Proposals.

(b) At least three features of the Board Staff Proposal – involving the proposed reduction of “deemed” capital structure options, the proposed significant reduction of returns on equity, and the resulting elimination of any “size premium” – constitute unfairness to smaller LDCs, and the process by which it is proposed to implement such changes risk a perception of regulatory instability, thereby raising the market costs of capital for all Ontario LDCs.

(c) The proposed transition to a single capital structure for all LDCs, regardless of size, may reduce current incentives for the shareholders of small LDCs to “re-invest” dividends, and in a reduced ability, or increased costs, to all Ontario LDCs to access alternative debt and equity capital sources.

(d) Board Staff’s application of the CAPM methodology contains errors that result in an unduly low return on equity, and an unduly restrictive range of allowable capital structure, particularly for smaller LDCs.

(e) These proposals ignore the empirical evidence and other theoretical support for maintaining a “size premium” to recognize the higher risks faced by smaller, less diversified LDCs.

(f) In all these respects, the Board Staff’s proposals represent a marked departure from the principles of a “fair return” on capital, as a component of “just and reasonable” rate-setting, and are contrary to the settled principles applied by courts and regulators, including recent decisions of this Board.

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