Cost of Capital
Business Considerations

Coalition of Large Distributors

Comments on Board Staff's Current Process

• Cost of Capital constitutes a significant portion of LDCs' revenue requirement, as noted by Board Staff (Board Staff draft report, June 19, 2006, p.6). Accordingly, it is inappropriate to determine ROE without fully testing the evidence via a hearing process.

• Capital market participants have pointed out serious shortcomings with Board Staff's intention to use only the CAPM methodology. (BMO Capital Markets, "Pipelines and Utilities", June 27, 2006, pp. 9 – 13). It is imperative that all industry participants engaged in this discussion heed the warning flags raised in this report.

• CLD believes that limiting the determination of ROE to a single methodology is inappropriate. As has been shown in previous cost of capital hearings, and as discussed in some of the current expert submissions, reliance on a single methodology fails to recognize the strengths and weaknesses inherent in all estimation methodologies.

Comments on Board Staff's Current Process

• CLD urges Board Staff and the Board to reconsider its current process, and recommends that this matter be dealt with in a generic hearing. CLD submits that this is the only appropriate way to review an issue as complex and significant as this, and notes that such a review will assuage investor concerns.

• CLD believes that an appropriate approach until a full hearing is concluded is to (properly) apply the Cannon methodology for 2007 cost of capital, as this methodology is widely accepted as being reasonable.

Current Business Environment Facing LDCs

• Many LDCs (notably Toronto Hydro, Hydro Ottawa and Hydro One) face significant refurbishment of their distribution plant over the next ten years.

• Significant capital spending is not limited to the distribution sector. While media attention has been focused on the enormity of the incremental generation expenditures facing Ontario, infrastructure costs as a whole (including roads, sewers, water-mains, transmission lines, generation, and distribution plant) are estimated to increase, in parallel, by billions of dollars over the next ten-to-twenty years.

• Most of this capital will likely be sourced from debt capital markets. Therefore, it is incumbent on the OEB to "get the ROE right", since this metric constitutes a key decision criterion for institutional investors and is a critical relative comparator used by credit rating agencies.

CAPM Shortcomings from a Business Perspective

• As pointed out by expert submissions, a properly determined cost of capital reflects business, financial, regulatory and political risk. CLD submits that these risks are as high or higher than they were in 2000. The "proxy *Betas*" used by Board Staff in implementing the CAPM do not properly capture these risks since the sample of companies likely face different risks than those faced by LDCs.

•Ontario's LDCs have experienced a disproportionately high share of political and regulatory risk over the past 6 years, and these risk categories are enduring (e.g., lack of clarity around the regulatory treatment of Smart Meters and with respect to on-going CDM).

• It is precisely this regulatory uncertainty and lack of confidence that has led capital market participants to repeatedly note that the return component for LDCs' shareholders is too low in comparison to similar companies in other jurisdictions. Board Staff's current proposal has served only to add to this concern.

Return on Equity and Capital Structure

- CLD supports Board Staff's proposal to deem a capital structure for all LDCs at a 60% debt: 40% equity level, and to allow sufficient flexibility within the equity layer to accommodate the issuance of preferred shares.

- For LDCs that may experience financial difficulty with moving to a lower equity/high debt structure, a phased approach may be appropriate. This underscores the need for an adequate ROE.

- Board Staff's proposal to allow an extra return on equity for new infrastructure investment is arbitrary and ad hoc, would be cumbersome to implement, and is not in the best interest of ratepayers. From investors' perspective, the premium return will likely create a new class of equity, which would be costly and impractical. Equally important, new bond holders would also benefit from the higher equity returns since "coverage ratios" would be higher for debt issued to finance new investment, thereby potentially leading to covenant challenges for debt that, for the most part, would be issued on a *pari passu* basis.

- CLD questions whether Board Staff has correctly applied the Cannon methodology for calculating ROE. It appears that the 8.37% ROE proposed by Board Staff is based on an incorrect application of Cannon's methodology using bond market data from 2005.