

DBRS Canada Newsletter

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ONTARIO ENERGY BOARD RESETS UTILITY RETURN ON EQUITY LEVELS

The Ontario Energy Board (OEB) recently released a cost of capital decision (the Decision) that will begin to affect Ontario-based regulated utilities in the 2010 rate year. The Decision maintains a formulaic approach to setting return on equity (ROE) levels; however, the existing formula will be reset to address the relatively low current ROE level, and refined to reduce its sensitivity to changes in government bond yields.

The current formula, which would have produced an estimated ROE of approximately 8.39% for use in 2010 Cost of Service Applications, will be reset to the forecast long-term Government of Canada bond yield plus a 5.50% equity risk premium. Using a forecast long-term Government of Canada yield of 4.25%, this would provide an initial ROE of 9.75% to be incorporated in 2010 Cost of Service Applications, for rates effective January 2010. While the initial ROE will be adjusted annually, the adjustment parameters are being refined to reduce the sensitivity to changes in government bond yields. As such, the government bond adjustment factor is being reduced to 0.50 from the current 0.75, and a corporate bond yield variable is being introduced into the formula. Thus, ROE levels will be adjusted annually by 50% of the change in the applicable forecast government bond yield, and 50% of the change in the spread of an A-rated bond index over the 30-year Canada bond yield (see formula below). DBRS notes that the reset ROE level will be incorporated into 2010 Cost of Service Applications; therefore, if a utility does not file in 2010, the reset ROE would not be applicable. Furthermore, actual reset ROE levels will depend upon when a utility's rates come into effect.

To incorporate the utility credit spread measure, a utility bond spread based on the difference between the Bloomberg Fair Value Canada 30-year A-rated Utility Bond index yield and the long Canada bond yield will be used, subject to a 0.50 adjustment factor. While the inclusion of this factor introduces an additional area of potential volatility, the revised adjustment mechanism is viewed as favourable, given: 1) the reduction of the government bond adjustment factor from 0.75 to 0.50 reduces sensitivity to a single factor, and 2) on a long-term basis, the likely magnitude of absolute changes in the value of the utility bond spread factor is considerably less than changes that could occur in the level of government bond yields. These two adjustment factors combined would serve to dampen the negative impact on ROEs of market swings such as occurred earlier this year, when government yields declined while corporate spreads increased materially.

The ROE for a prospective test year (ROE_t) will be calculated by the following adjustment formula:

$$ROE_t = BaseROE + 0.5 \times (LCBF_t - BaseLCBF) + 0.5 \times (UtilBondSpread_t - BaseUtilBondSpread)$$

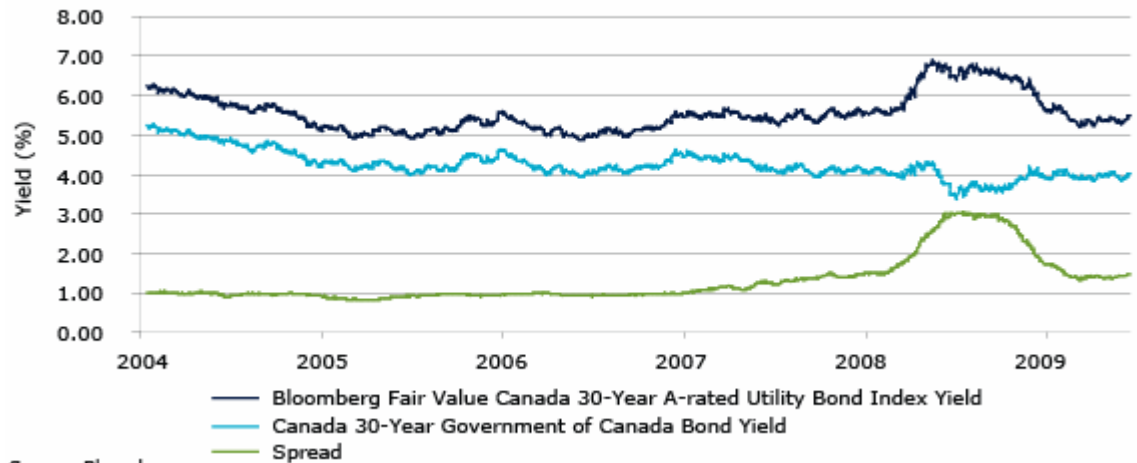
With:

- $LCBF_t$ = the Long Canada Bond Forecast for the test year
- $UtilBondSpread_t$ is the average spread of 30-year A-rated Canadian Utility bond yields over 30-year Government of Canada bond yields over all business days in the month three (3) months in advance of the implementation date for rates
- As noted above, based on September 2009 data, the BaseROE is set at 9.75%, the corresponding BaseLCBF is 4.25%, and the BaseUtilBondSpread is 1.415%.

Thus, the ROE adjustment formula is specified as:

$$ROE_t = 9.75\% + 0.5 \times (LCBF_t - 4.25\%) + 0.5 \times (UtilBondSpread_t - 1.415\%).$$

Canada 30-Year A-rated Utility Bond Index Yield vs. Canada 30-Year Bond Yield



In addition, various changes were made to the way the cost of long-term and short-term debt is to be determined. Notably, the OEB stated its intention to have the method used to determine the long-term cost of debt for electricity distributors evolve over time to converge with the process used for natural gas distributors. Electricity distributors currently use an OEB-deemed long-term cost of debt regardless of a distributors' actual cost of debt, while natural gas distributors utilize a weighted cost of embedded debt.

The Decision deals only with ROE and cost of debt; the OEB stated that its current policies on capital structures continue to be appropriate. The OEB will review the cost of capital methodology every five years or earlier if the methods are viewed to be producing results that do not meet the OEB's Fair Return Standard. DBRS notes that when considering a specific utility's rate application, the OEB can deviate from the parameters as outlined in the Decision when justified by specific circumstances.

DBRS views the Decision as positive for the credit profile of Ontario utilities, in that the reset ROE level is expected to be approximately 135 basis points (bps) higher than under the status quo. It should also reduce volatility caused by fluctuating government yields through both the lower adjustment factor and the inclusion of the bond spread adjustment mechanism. DBRS estimates that for a generic utility, a 100 bps increase in allowed ROE (holding all else equal) would result in EBITDA-to-interest increasing by approximately 0.15x to 0.20x and cash flow-to-debt increasing by approximately 65 bps to 70 bps. While the Decision is viewed as supportive of current ratings, in general, it is not expected to materially reduce any utility's financial risk and, therefore, its implementation is not expected to directly result in any positive rating actions.

For further information, please contact Michael Caranci, mcaranci@dbrs.com.

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