

DBRS Canada Newsletter

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CREDIT IMPLICATIONS OF RECENT REGULATORY DEVELOPMENTS FOR CANADIAN PIPELINE AND UTILITY COMPANIES

During the fourth quarter of 2009, several provincial and federal regulatory decisions were announced that affect how allowed levels of both return on equity (ROE) and the equity component in the capital structure for Canadian pipeline and utility entities are determined. These two critical factors are used in a regulated entity's cost of service calculation and, therefore, have a direct impact on its financial results and credit metrics.

From the mid-1990s to early 2009, regulated ROE levels were directly linked to government of Canada long bond yields. In recent years as long-term interest rates dropped significantly, allowed ROEs followed suit, resulting in weakening credit ratios and lower returns on equity capital compared with other investment alternatives. Additionally, with the increase in corporate credit spreads, which peaked in early 2009, the long-term cost of debt for regulated entities was fast approaching approved ROE levels, implying that the ROE levels were too low to justify incremental equity investment in the entity. Although this pressure has recently subsided somewhat, it was another signal that the adjustment mechanisms for determining allowed ROE needed to be reviewed within the context of an evolving financial market.

In terms of magnitude of change, the six decisions handed down in Q4 2009 can generally be divided into three groups, with DBRS viewing the decisions by the National Energy Board (NEB) and the British Columbia Utilities Commission (BCUC) as the most material, followed by the Alberta Utilities Commission (AUC) and Ontario Energy Board (OEB) rulings. The decisions by Québec's Régie de l'énergie (Régie) and Newfoundland and Labrador's Board of Commissioners of Public Utilities (PUB) deviate the least from the status quo.

The NEB discontinued its March 1995 Multi-Pipeline Cost of Capital Decision (RH-2-94) in October 2009, indicating that "there have been considerable changes in financial and economic circumstances." DBRS believes that the NEB's decision to abandon RH-2-94 without replacing it with another generic formula could lead to increased rate case activity (at least in the short term) until a new playing field is established, noting, however, that multi-year negotiated agreements have largely been the preferred route in the past. DBRS expects that the NEB will take into account each pipeline's specific business risk profile when deriving allowed ROEs and equity components, and that the end results will likely be dispersed over a range that exceeds the baseline created by RH-2-94.

The five provincial regulatory decisions all resulted in higher approved ROEs than their respective formulas would otherwise have produced, with two also increasing the equity component in the capital structure. Common themes in the provincial decisions were the acknowledgement that the formulas were either not providing a fair return or had not kept up with changing financial conditions and the acknowledgement of the impact of increased credit spreads on the relative attractiveness of incremental equity investment in regulated entities. The five provincial decisions rendered in Q4 2009 produced a range of outcomes, from an elimination of the ROE adjustment formula (e.g., BCUC) to more modest one-time ROE adjustments with the adjustment formula being retained (e.g., PUB), as well as differing adjustments to capital structures.

These recent decisions are viewed as a positive for the credit metrics of the affected pipeline and utility entities, although transparency has in certain instances been diminished. An improvement in a regulated entity's ROE and/or equity thickness would be viewed positively in the context of its financial risk profile. On the other hand, deteriorating ROE levels have not had a direct negative effect on DBRS ratings of pure pipeline and utility companies. Therefore, recent increases in approved ROE levels or equity thickness should not, in themselves, result in positive rating actions unless the improvement is significant enough to be viewed as a material reduction in financial risk. None of the decisions rendered in Q4 2009 are viewed (by themselves) as materially changing any one entity's financial risk profile; rather, the improvements are viewed as supportive of current ratings and would improve flexibility within the rating category.

For more details, please see the DBRS industry study *Recent Regulatory Developments for Canadian Pipeline and Utility Companies*, available at www.dbrs.com.

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