CAPITAL STRUCTURE AND RETURN ON EQUITY

1.0 PURPOSE

This evidence describes the methodology that OPG has used to determine its capital structure and return on equity (“ROE”) for the test period. It also summarizes the capitalization and cost of capital for 2010 – 2013.

2.0 OVERVIEW

OPG is seeking approval of the test period cost of capital as presented in Ex. C1-1-1, Tables 1 and 2. In determining the cost of capital, OPG has applied the capital structure of 47 per cent equity and 53 per cent debt approved by the OEB in EB-2007-0905 and EB-2010-0008.

OPG’s application incorporates an ROE of 8.98 per cent for 2014 and 2015 as this is the latest rate published by the OEB pursuant to the ROE formula set out in Report of the Board on the Cost of Capital for Ontario’s Regulated Utilities, December 2009, EB-2009-0084 (“Cost of Capital Report”). OPG proposes to use the methodology approved by the OEB in EB-2010-0008 to establish the ROE for 2014 and 2015 that would be used in the payment amounts order resulting from this application.

The debt components of OPG’s cost of capital are determined using the methodologies approved by the OEB in EB-2007-0905 and EB-2010-0008. These are described in Ex. C1-1-2 and Ex. C1-1-3 for long and short term debt, respectively.

3.0 CAPITAL STRUCTURE

For the test period, OPG has applied the deemed capital structure of 47 per cent equity and 53 per cent debt approved by the OEB in EB-2007-0905 and EB-2010-0008.

OPG is not proposing any changes to its capital structure as there have been no significant changes in the risks faced by OPG’s regulated asset portfolio that are not otherwise addressed by proposals to establish new variance and/or deferral accounts as described in Ex. H1-3-1. The debt component of OPG’s capital structure is determined using the...
methodologies approved by the OEB in EB-2007-0905 and EB-2010-0008. These are described in Ex. C1-1-2 and Ex. C1-1-3 for long-term and short-term debt, respectively.

OPG has applied this capitalization to the rate base described in Exhibit B, as adjusted to reflect the application of the "lesser of Asset Retirement Costs and Unfunded Nuclear Liabilities" provision applied by the OEB in EB-2007-0905 and in EB-2010-0008. The rate base for the 2014 - 2015 test period includes the hydroelectric facilities that will be subject to rate regulation by the OEB. The capitalization and cost of capital for the 2010 to 2015 period is summarized in Ex. C1-1-1, Tables 1 - 6.

4.0 RETURN ON COMMON EQUITY

OPG’s current payment amounts incorporate a return on equity of 9.43 per cent for 2011 and 9.55 per cent for 2012 as provided in the EB-2010-0008 Payment Amounts Order, Appendix A, Tables 4b and 5b.

4.1 Forecast Return on Equity for the Test Period

OPG’s application incorporates an ROE of 8.98 per cent for 2014 and 2015 as this is the latest rate published by the OEB pursuant to the ROE formula as set out in the Cost of Capital Report. OPG proposes to use the same methodology approved by the OEB in EB-2010-0008 (Decision with Reasons, pp. 121-123) to establish the ROE for 2014 and 2015, as described below:

- Separate ROEs are established for each year of the test period;
- For the first year of the test period (2014), the ROE will be set using data available for the three months prior to the effective date of the payment amounts order, in accordance with the OEB’s Cost of Capital Report; and,
- For the second year of that test period (2015), the ROE will be set at the same time as the first year but using data from Global Insight instead of the Consensus Forecasts used by the OEB because the Consensus Forecasts data is only projected for 12 months.
4.2 Return on Equity for Historical and Bridge Periods

The EB-2010-0008 Decision with Reasons (p. 151) established a requirement for OPG to file “an analysis of the actual annual regulatory return, after tax on rate base, both dollars and percentages, for the regulated business and a comparison with the regulatory return included in the payment amounts by June 30th of each year.” OPG filed this information for 2010 to 2012.

The chart below presents the regulatory earnings before tax (i.e., pre-tax return on equity), regulatory income taxes, and after-tax return on equity for each of 2010 - 2012.

Chart 1: Summary of Regulatory Return

<table>
<thead>
<tr>
<th>Year/Actg Basis</th>
<th>Regulatory Earnings Before Tax</th>
<th>Less: Income Tax Ex. F4-2-1 Table 4, line 29</th>
<th>Less: Income Tax Variances in Deferral and Variance Acts</th>
<th>ROE ($) Ex. C1-1-1 Tables 4-6, line 5</th>
<th>ROE (%) Ex. C1-1-1 Tables 4-6, line 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010 CGAAP</td>
<td>$169.6M</td>
<td>$29.9M</td>
<td>$3.0M</td>
<td>$136.7M</td>
<td>4.71%</td>
</tr>
<tr>
<td>2011 USGAAP</td>
<td>$168.0M</td>
<td>$8.1M</td>
<td>$30.8M</td>
<td>$129.1M</td>
<td>4.47%</td>
</tr>
<tr>
<td>2012 USGAAP</td>
<td>$195.2M</td>
<td>$41.7M</td>
<td>$19.6M</td>
<td>$133.9M</td>
<td>4.73%</td>
</tr>
</tbody>
</table>

The actual ROE presented above is determined using the reconciliation approach as described in EB-2007-0905, Ex. C1-2-1 and applied in EB-2010-0008, Ex. C1-1-1.
The reconciliation approach starts with the financial results for OPG’s prescribed assets calculated in accordance with Generally Accepted Accounting Principles (“GAAP”). The accounting earnings for the prescribed assets for 2010, 2011 and 2012 are adjusted to reflect differences between accounting earnings for the prescribed assets and regulatory earnings. To the extent that OPG’s accounting treatment and regulatory treatment differ, the accounting numbers are removed, and the regulatory amounts are included. This provides a consistent basis for comparing historic and forecast regulatory earnings. The regulatory earnings for the prescribed assets in 2010 through 2012 are used as the basis for determining the stand-alone income tax amounts for these years as provided in Ex. F4-2-1 Table 4.

OPG previously reported 2011 return information on a Canadian GAAP basis, the same basis upon which payment amounts were established in EB-2010-0008. OPG provides this information on a USGAAP basis in this application, as this is the basis upon which all historical information for 2011 is presented. Earnings before tax under USGAAP and Canadian GAAP are reconciled in Ex. F4-2-1 Table 4, note 2.

For the 2013 bridge year, OPG has calculated a forecast ROE based on the 2013 budget information. The 2013 forecast ROE is $94.4M or 2.82% per cent shown in Ex. I1-1-1, Table 5. The forecast 2013 regulatory earnings before tax in Ex. I1-1-1, Table 5, line 20 is used as the basis for determining the forecast income tax expense for the year, as shown in Ex. F4-2-1, Table 5.

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1 The financial results for 2010 and 2011 were reported, in accordance with Canadian GAAP, in the audited consolidated financial statements for OPG’s prescribed assets filed in EB-2012-0002 Ex. A3-1-1, Attachment 2). The audit of the results for 2012 (in accordance with USGAAP) was not complete at the time of filing this Application. OPG will file the 2012 audited financial statements for the prescribed facilities after the audit is complete. The calculation of historical financial results for the prescribed facilities is discussed in Ex. A2-1-1.

2 The payment amounts in effect during 2010 and 2011 were determined on the basis of Canadian GAAP in EB-2007-0905 and EB-2010-0008, respectively. The OEB approved the use of USGAAP for regulatory accounting, reporting and ratemaking purposes for OPG effective January 1, 2012, as per the EB-2012-0002 Payment Amounts Order issued on April 18, 2013. Therefore, historical ROE information for 2010 and 2011 was reported under Canadian GAAP. The Impact for USGAAP Deferral Account established by the OEB recorded, up to December 31, 2012, the financial impacts of OPG’s transition to and implementation of USGAAP from January 1, 2012. The balance of the deferral account as at December 31, 2012 was considered and the financial impacts accepted for recovery in EB-2012-0002; therefore, reconciliation between CGAAP and USGAAP is not required.

3 Ex I1-1-1, Table 5: Regulatory EBT of $88.4M plus income tax recovery of $24.6M minus income tax variances recorded in deferral and variances accounts in 2013 of $18.6M