CAPITAL STRUCTURE AND RETURN ON EQUITY METHODOLOGY

1.0 PURPOSE
The purpose of this evidence is to provide an overview of OPG’s proposals on capital structure and return on capital. This evidence describes the methodology OPG has used to determine its capital structure and return on common equity for the fiscal years from 2005 - 2009 inclusive.

2.0 CAPITAL STRUCTURE
For the 2005 - 2007 fiscal years OPG has applied the capital structure (45 percent equity and 55 percent debt) that was reflected in information provided by OPG to the Province for use in setting the interim period payment amounts.

For the 2008 and 2009 fiscal years OPG proposes to adopt the capital structure and cost of capital recommendations of Foster Associates, Inc. (“Fosters”). Fosters are capitalization and cost of capital experts that OPG engaged to determine the appropriate capital structure and cost of equity for OPG’s regulated operations. The study prepared by Fosters is filed in Ex. C2-T1-S1.

Fosters’ recommended methodology is consistent with the approach applied by most of Canada’s energy industry regulators. The key principles underlying this methodology are that:

1. OPG’s regulated operations should be treated for regulatory purposes as if they were operating on a “stand-alone” basis.
2. OPG’s deemed capital structure should be applied to the financing of assets that are devoted to the provision of regulated service, i.e., its rate base.
3. OPG’s deemed capital structure should only reflect the business risks of the regulated operations.

OPG is seeking a capital structure comprised of 57.5 percent common equity and 42.5 percent debt; the mid-point of the range of 55 percent to 60 percent common equity
recommended by Fosters. The common equity component was established by Fosters assuming a return on common equity of 10.5 percent, which is the return determined by Fosters for a “benchmark utility”\(^1\). This common equity component recommendation reflects OPG’s higher comparative business risks relative to that of a “benchmark utility”.

Fosters’ analysis of the significant business risks associated with OPG’s regulated operations is provided in Ex. C2-T1-S1. This assessment of the business risks associated with the regulated operations is accepted by OPG as a fair and reasonable assessment of these risks. OPG is seeking a regulated capital structure and return on common equity that reflects the business risks associated with its regulated operations.

3.0 RETURN ON COMMON EQUITY

OPG’s return on equity for 2005, 2006 and 2007 is based on the segmented financial information provided in its 2006 and 2007 audited financial statements, adjusted to reflect the impact of regulation. OPG does not determine a stand-alone return on equity for its regulated operations for the purpose of operating its business, financial accounting or tax filing purposes. It is determined as an aid to assessing the adequacy of OPG’s interim payment amounts.

To determine a return on equity for 2005, 2006 and 2007 that is consistent with the return on equity proposed for its test period, OPG used the accounting earnings before interest and income taxes amounts reflected in its 2006 and 2007 audited financial statements for the regulated hydroelectric business segment and the regulated nuclear business segment as the starting point. The difference between accounting earnings before interest and income taxes and OPG’s return on equity for its regulated operations is attributable to three sources: interest, income taxes, and differences between accounting and regulatory earnings. These

\(^1\) The “benchmark utility” is not a specific utility and hence reflects no specific business or financial risk characteristics, but rather the composite of the business and financial risks faced by the proxy utilities used to establish the fair return. The benchmark utility is, however, a relatively low risk A rated utility.
adjustments and the impact on OPG’s return on equity in each of 2005, 2006 and 2007 are described in Ex. C1-T2-S1.

As discussed in section 2, Fosters has recommended a 10.5 percent return on common equity in the context of a 57.5 percent common equity ratio. OPG has accepted that recommendation for 2008 and 2009. OPG’s proposed capital structure of 42.5 percent debt and 57.5 percent common equity and OPG’s proposed rate of return on equity of 10.5 percent are sufficient to enable OPG to maintain its financial integrity and attract capital on reasonable terms.

OPG also sees merit in the recommendation of Fosters to adopt an automatic adjustment mechanism to adjust the rate of return on common equity in future periods. The OEB’s EB-2006-0064 report established the regulatory methodology for setting payment amounts for OPG’s prescribed generation assets. The OEB stated that OPG will be subject to a series of limited issues cost of service proceedings intended to set the cost base upon which to develop an incentive regulation approach in the future. While OPG’s return on equity is an issue in the current hearing, it may not be an issue in these future limited issues hearings. An automatic adjustment mechanism will allow the return on equity to be adjusted to reflect changing market conditions without the requirement to include it as an issue in subsequent limited issues proceedings.

Fosters endorsed the use of the return on equity adjustment mechanism approved by the OEB to establish the cost of capital to be used in adjusting the annual revenue requirement for Ontario’s electric distribution facilities for 2007 and beyond. The Report of the Board on

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2 An update was not prepared by Fosters. Fosters reviewed the consensus forecast of 10-year Canada bond yields and the recent spread with 30-year long Canada Bonds and concluded that no change to the ROE or capital structure recommendation was warranted at this time.
Cost of Capital\(^3\) (OEB’s Cost of Capital Report) states that an adjustment of 75 basis points in return on equity is required for every one percentage point change in forecast 30-year Canada bond yields. Fosters stated that the OEB’s formula is a reasonable reflection of the relationship between the cost of equity and interest rates. OPG supports the application of the OEB’s methodology for adjusting its rate of return on equity in future proceedings and asks that the OEB approve an adjustment formula for use in these proceedings.

Fosters also recommended that the formula be reviewed if forecast long Canada bond yields fall below three percent or exceed eight percent, as those extremes could signal a material change in the capital market environment. OPG agrees that the automatic adjustment mechanism should be reviewed in the event capital market conditions experience significant change, and therefore recommends that the OEB review the formula in the event that forecast long Canada bond yields fall below three percent or exceed eight percent.

In addition, Fosters recommended that OPG have the ability to seek a review of the automatic adjustment formula if its ability to attract capital on reasonable terms is at risk. In the alternative, OPG should be able to seek a review of its deemed capital structure should the business risks of its regulated operations change materially or if its access to capital is threatened. While OPG is of the view that the events described above are unlikely, it believes that the automatic adjustment mechanism needs to be flexible enough to deal with these unusual circumstances. Therefore any automatic adjustment mechanism adopted for OPG should preserve OPG’s right to seek a review of the formula (and/or the common equity component of the deemed capital structure) should its business risks change dramatically or its access to capital become threatened.

\(^3\) Report of the Board on Cost of Capital and 2\(^{nd}\) Generation Incentive Regulation for Ontario’s Electricity Distributors, Issued December 20, 2006 pursuant to EB-2006-0088 (Cost of Capital), EB-2006-0089 (2\(^{nd}\) Generation Incentive Regulation Mechanism), and EB 2006-0087 Licence Amendment proceeding (Appendix B).