ATTACHMENT 2

NOTE: ATTACHMENT 2 IS PART OF THE FILING GUIDELINES: DETERMINATION OF TOTAL REVENUE REQUIREMENTS AND LOAD FORECASTS FOR TRANSMITTERS, PHASE ONE OF APPLICATION FOR UNIFORM TRANSMISSION RATES

ONTARIO ENERGY BOARD
DRAFT GUIDELINES ON A FORMULA-BASED RETURN ON COMMON EQUITY FOR REGULATED UTILITIES

March, 1997

DRAFT GUIDELINES ON A FORMULA-BASED RETURN ON COMMON EQUITY FOR REGULATED UTILITIES

PURPOSE

The Ontario Energy Board ("the Board") intends to move to a formula-based approach using the Equity Risk Premium method for determining the fair rate of return on common equity ("ROE") for Ontario natural gas utilities. The following guidelines have been developed to facilitate the implementation of a formulaic ROE mechanism. The guidelines have two phases: an initial setup and an ongoing adjustment mechanism.

THE INITIAL SETUP

The initial setup will establish a just and reasonable return on equity for each of the Ontario LDCs, given a test year long Canada forecast, which will be the base against which subsequent adjustments to the formula-based ROE can be made.

Step 1: *Establish the forecast of the long Government of Canada yield for the test year*

> The forecast yield for long-term Government of Canada bonds will be established for the test year by taking the average of the 3 and 12 months forward 10-year Government of Canada bond yield forecasts, as stated in the most recent issue of <u>Consensus Forecasts</u>, and adding the average of the actual observed spreads between 10 and 30-year Government of Canada bond yields, as reported in the <u>Financial Post</u>, for each business day in the month corresponding to the most recent <u>Consensus Forecast</u> issue.

Step 2: *Establish implied risk premium*

> A utility's test year ROE will consist of the projected yield for 30-year long Canada bonds plus an appropriate premium to account for the utility's risk relative to long Canada bonds. The primary methodological approach to be used in evaluating the appropriate risk premium should be the equity risk premium test.

THE ADJUSTMENT MECHANISM

Once the initial ROE has been set for each of the utilities, as per the above-mentioned steps in the initial setup phase, a procedure must be put in place to automatically adjust the allowed ROE for each utility to account for changes in long Canada yield expectations. The timing of the adjustment mechanism process for each utility will be consistent with its fiscal year-end.

Step 1: *Establish the forecast long Canada rate*

The formula-based equity risk premium approach annually adjusts a utility's allowed ROE based on changes in forecast long-term Government of Canada bond yields. Each year the process outlined in Step 1 of the initial setup phase will be repeated and an updated, consensus-based forecast of 30-year long-Canada bond yields will be obtained. The current test year rate forecast will then be compared to the previous test year forecast.

Step 2: *Apply adjustment factor*

The Board suggests that the difference between the forecast long Canada rate calculated in Step 1 and the corresponding rate for the immediately preceding year should be multiplied by a factor of 0.75 to determine the adjustment to allowed ROE. This adjustment factor will then be added to the utility's previous test year ROE and the sum should be rounded to two decimal points. An illustration of the adjustment formula is shown below.

Allowed ROE for test year 1		12.25%
Test year 2 long-Canada forecast (30-year)	8.30%	
Test year 1 long-Canada forecast (30-year)	9.25%	
Change in interest rates	-0.95%	
Adjustment factor (0.75 to 1)		-0.7125%
ROE for test year 2		11.5375%
Approved ROE for test year 2 (rounded to nearest 2 decimal points)		11.54%

TERM OF THE RATE OF RETURN FORMULA

The rate of return formula should be reviewed as conditions arise that may call into question its validity. Parties to a proceeding may ask the Board to review the formula when they feel it is appropriate or the Board may do so on its own initiative. In either case it will be the Board's decision as to the time for a review.

The Board may request the presentation of other tests or require some weighting for other tests in the formula should the Board want to assure itself that the ERP formula approach does not lead to perverse results and is directionally in line with other market indicators.

An adjustment to the utility-specific risk premiums should be done only when there is a clear indication that relative risks have changed. The Board believes that the capital structures should be reviewed only when there is a significant change in financial, business or corporate fundamentals.