Q. Further to the response to PUB-NP-045, is, in Newfoundland Power's opinion, the Ontario Energy Board's automatic adjustment formula appropriate to apply to determine Newfoundland Power's return on equity (ROE) between general rate applications? If it were used what would be the ROE for Newfoundland Power for 2021?

A. The financial crisis that occurred during the 2008-2009 period resulted in most Canadian regulators abandoning a formulaic basis to determine a rate of return on equity for utilities.[1] The Ontario Energy Board ("OEB") reviewed its cost of capital methodology in 2009 and found that the formulaic approach for determining cost of capital remained necessary to enable regulatory oversight of over 70 utilities in Ontario.[2]

The Automatic Adjustment Formula suspended by the Board in 2013 relied on changes in long-term government bond yields to estimate annual changes in Newfoundland Power's return on equity.[3] The OEB automatic adjustment formula (the "OEB Formula") incorporates utility bond spreads, as well as long-term government bond yields in determining an estimated return on equity applicable to Ontario utilities.

Challenges inherent in using a formulaic approach for determining a utility's return on equity can be observed in decisions of the British Columbia Utilities Commission ("BCUC"). In 2013, the BCUC introduced a new formula to determine a utility's return on equity between cost of capital proceedings (the "BCUC Formula").[4] Similar to the OEB Formula, the BCUC Formula considered utility bond spreads, as well as long-term Canada bond yields in estimating a utility's return on equity. Unlike the OEB Formula, and in recognition of the effect of monetary policy on bond rates, the BCUC directed that the operation of the BCUC Formula be subject to an actual long-term Canada bond yield of 3.8% being met or exceeded.[5]

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1 In Order No. P.U. 13 (2013), pages 36-37, the Board accepted that the Automatic Adjustment Formula may not result in a fair return for Newfoundland Power in the circumstances that existed at the time. The Board indicated that, in the absence of a clear relationship between long Canada bond yields and the cost of equity, it was difficult to see that the established return could be appropriately adjusted without exercise of further judgment. Accordingly, the Board could not conclude that *any* formula could be relied upon to establish a fair rate of return after a test period.

2 The OEB's current policy on cost of capital is detailed in the *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities,* December 11, 2009 (EB-2009-0084).

3 See Attachment A of response to Request for Information PUB-NP-042 for a *pro forma* calculation of Newfoundland Power's 2021 cost of equity based on operation of the Automatic Adjustment Formula.

4 A formulaic approach based on changes to long-term Canada bond rates was first implemented by the BCUC in 1994. It was eliminated in 2009 per BCUC Order G-158-09.

5 See BCUC *Decision and Order G-129-16*, August 10, 2016, page 87.

The BCUC Formula was reviewed in 2016. In its Decision and Order on the matter, the BCUC stated:

> *"In the Panel's view, there is limited benefit to continuing to apply the AAM for the next period of time and there may be potentially undesirable consequences with its continued use. In addition, there has been little examination of the formula itself and no further evidence to suggest a 3.80 percent trigger point is as valid today as it was considered to be in the 2013 GCOC Decision. Therefore, the Panel is persuaded that a suspension of the AAM is warranted. However, once there is a return to more certain economic conditions with more normal interest rates, the Panel believes the re-implementation of an AAM is worthy of further consideration."*[6]

The BCUC was not persuaded that continuing to rely on a formulaic approach was appropriate or would necessarily meet the Fair Return Standard. Further use of the BCUC Formula was therefore suspended.[7]

Since the BCUC's Decision and Order in 2016, long-term government bond yields have remained low.[8] Economic conditions also continue to be uncertain, particularly given the ongoing COVID-19 pandemic. Low long-term government bond yields and uncertain economic conditions are not conducive to the reinstatement of any formula for estimating Newfoundland Power's cost of equity at this time, including the OEB Formula.

If the OEB Formula were adopted by the Board following Newfoundland Power's *2019/2020 General Rate Application*, the Company's return on equity would have declined from 8.50% in 2020 to 7.72% in 2021.[9]

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6 Ibid., page 89.

7 Ibid., page 89.

8 For example, on March 9, 2020, at the onset of the COVID-19 pandemic, the 30-year long Canada bond yield reached a historic low of 0.71%. For the month of August 2021, the 30-year long Canada Bond yield was 1.80%, 200 basis points below the BCUC trigger point.

9 The base 30-year Canada bond yield forecast used by Newfoundland Power in the OEB Formula is 3.10% and is based on the *April 2018 Consensus Long Term Forecast* 10-year Canada bond yields for 2019 and 2020 and the average observed spread between 10-year and 30-year Government bonds in March 2018. The base A-rated utility bond yield spread used by Newfoundland Power is based on the difference between 30-year Government bond yields and A-rated utility bond yields in March 2018. For utilities in Ontario, the base 30-year Canada bond yield forecast and base A-rated utility bond yield spread continue to reflect the values determined in 2009 when the OEB Formula was last revised.