Reference: Volume 3, Cost of Capital Report by James Coyne

Q. Volume 3, Cost of Capital Report by James Coyne, page 54, Figure 30. Explain why, in Mr. Coyne's opinion, the approved equity ratio as shown in Figure 30 and the approved return on equity shown on Figure 29 have both been historically higher for the U.S. electric group if the Canadian and U.S. capital markets are highly integrated as stated on page 27, lines 5-15 and no adjustment is required in the DCF analysis to reflect adjustments for use of U.S. data.

A. The gap between allowed ROEs for Canadian and U.S. utilities has narrowed considerably over the past decade. One primary factor has been the suspension of formula-based ROEs used by most Canadian regulators up through the 2008-2010 period. Recognizing these formulas were producing unreliable returns, Canadian regulators (with the exception of Ontario, which revised its formula in 2009) have since returned to adjudicated proceedings.

The gap between allowed equity ratios for Canadian and U.S. utilities persists. In the U.S., regulated utility companies are typically allowed to manage their ratemaking capital structure based on their actual book capital structure within a reasonable range in relation to peer companies unless the company has credit metrics under pressure or other circumstances warranting a re-examination of the capital structure.

In Canada, regulators tend to deem equity ratios with a focus on the minimum necessary to maintain investment grade credit ratings, and remain lower than those in the U.S. The risk of the Canadian approach is that an unforeseen event at the utility or a disruption in the economy/financial markets may inhibit the utility's ability to raise capital on reasonable terms when needed if the equity ratio is too near the lower limit.

Lower equity ratios and greater debt levels place equity investors at greater risk. U.S. utilities with higher equity ratios have less financial risk than their Canadian peers, without evidence of greater business risk, thereby offering a preferred equity investment. In Concentric's view, this has been an influential factor in the growth of investment by Canadian based utility companies in U.S. jurisdictions.