

ALBERTA UTILITIES COMMISSION
2009 GENERIC COST OF CAPITAL PROCEEDING
Application No. 1578571 / Proceeding ID. 85

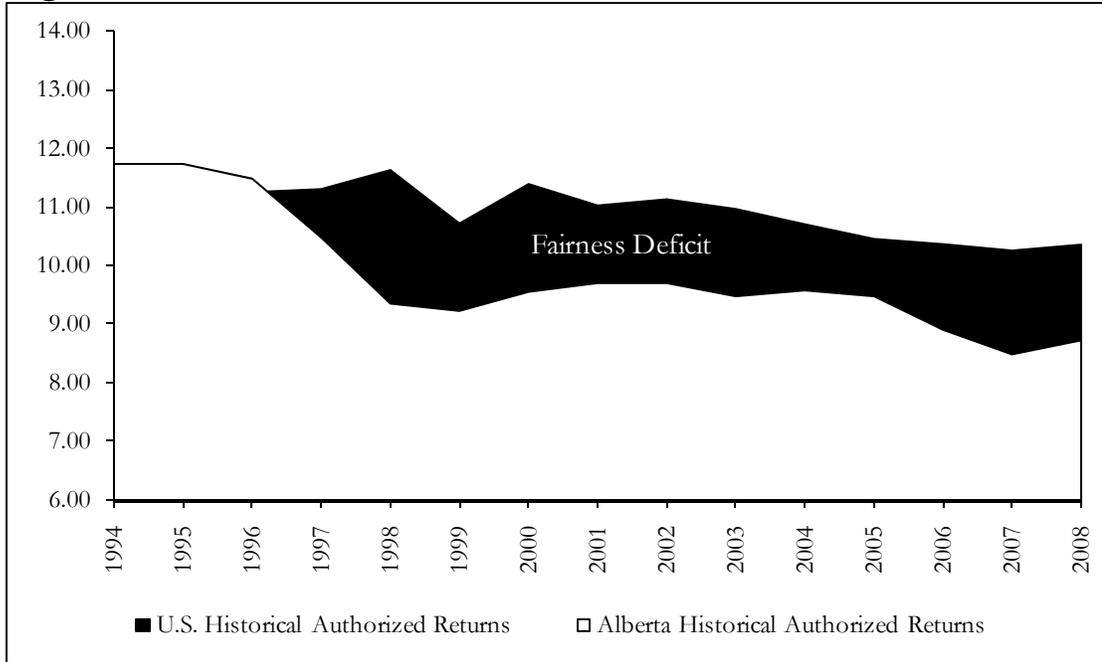
DIRECT TESTIMONY
OF
JAMES M. COYNE

ON BEHALF OF
ATCO UTILITIES
(ATCO ELECTRIC LTD. AND ATCO GAS AND PIPELINES LTD.)

NOVEMBER 20, 2008

1 “fairness deficit” has prevailed for a decade, and has grown in recent years under the current
2 formula.

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4 **Figure 1: Fairness Deficit, U.S. vs. Alberta Historical Authorized Returns**



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7 In researching the causes for the gap in returns, there are no macroeconomic factors,
8 regulatory risks, operating risks, or financial conditions of a sufficient magnitude to justify
9 the disparity in returns between Alberta utilities and their U.S. counterparts. The widespread
10 adoption of a formula tied directly to steadily declining government bond yields in Canada is
11 the principal cause. Exacerbating the gap in allowed ROEs, the allowed equity ratios are also
12 substantially lower. Taken together, the result achieved by the current Alberta formula,
13 measured against the principles of a fair return, is not comparable, and therefore does not
14 satisfy the requirement of a fair return.

15
16 Some argue that Canada’s utilities are less risky or that the regulatory environment is more
17 supportive as a basis for this gap. I have examined the operating and financial characteristics
18 of the utility companies, the regulatory regimes in which they operate, the macro-economic
19 environment, and the ability of utilities to recover expenses and adjust revenues in the U.S.
20 and Canada. The results of this analysis repeatedly indicate that there is sufficient basis for
21 comparison between the two countries and in my view, there are no appreciable differences

1 in regulatory risk, financial risks, operating characteristics, tax structure, legislation, oversight,
2 or in the frequency of ROE decisions that would justify the disparity that currently exists
3 between the U.S. and Canadian ROE awards.
4

5 Overall, the evidence I have analyzed suggests that Canadian utilities are subject to more
6 financial risk than U.S. utilities as a direct result of the greater debt they carry. The financial
7 risk comparison of Canadian and U.S. utilities does not support the disparity in ROEs. To
8 the contrary, this analysis suggests that Canadian returns should compensate the investor for
9 greater exposure on the basis of this financial risk comparison. Additionally, current
10 conditions in financial markets are making it difficult to raise debt or equity capital on
11 reasonable terms. Utilities must maintain their financial flexibility in order to meet their
12 continued obligations to provide safe and reliable service to their customers. Some degree
13 of regulatory support during this turbulent economic period would help to assure the
14 continued financial viability of Alberta's utilities. Considering the capital needs of the
15 Province's utilities to fund system expansions to accommodate economic growth, this is
16 particularly important.

17
18 In responding to the issues raised in the Commission's scoping document for this
19 proceeding, I have developed estimates of the generic cost of equity and recommended
20 capital structure for Alberta's utilities based on an analysis that incorporates electric, gas, and
21 pipeline proxy groups, and the broader assessment of Canadian and U.S. utilities and their
22 financial, regulatory, and operating environments. On balance, my recommendations are
23 based on a synthesis of a considerable amount of financial, macroeconomic, and industry
24 data, and broadly utilized methods for estimating capital costs. I recommend the
25 Commission adopt the following range of generic sector-specific ROEs consistent with the
26 corresponding equity ratios. As discussed later in my Testimony, this range is bordered by
27 credit rating metrics on the lower threshold and comparable utility capital structures on the
28 other.
29

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Table 1

SUMMARY OF RECOMMENDED COMMON EQUITY RATIOS AND APPLICABLE ROES							
	COMMON EQUITY PERCENTAGE IN BOOK CAPITAL STRUCTURE						
	38%	40%	42%	44%	46%	48%	50%
Electric Transmission	10.5%	10.2%	9.9%	9.7%	9.5%		
Electric Distribution	10.8%	10.6%	10.3%	10.1%	9.8%		
Gas Transmission	11.6%	11.3%	11.0%	10.8%	10.5%	10.3%	10.1%
Gas Distribution	11.2%	11.0%	10.7%	10.5%	10.2%		

2

3 Next, I consider alternative approaches to updating the cost of equity over time. I have put
4 forward four approaches that would all be superior to the current method, and recommend
5 an option based on a weighted index of Canadian utility bond yields and U.S. utility awards.
6 Taken together, these recommendations would restore a fair cost of capital for Alberta’s
7 utilities and ensure the continued financial health of these companies under reasonable
8 market expectations. I also believe the recommended process for updating the capital costs
9 will provide regulatory flexibility and efficiency.

10

11 **Q: HOW IS THE REMAINDER OF YOUR TESTIMONY ORGANIZED?**

12 **A:** The remainder of my testimony is organized as follows: in Section III, I will discuss the role
13 of return on capital in setting utility rates; in Section IV, I set forth the methodologies I have
14 applied for the estimation of the Alberta utilities’ cost of capital; in Section V, I provide a
15 comparison between Canadian and U.S. utilities; in Section VI, I analyze the business and
16 economic climate for utilities in Canada and the U.S.; in Section VII, I present evidence that
17 current returns do not satisfy tests for the Fair Return Standard; in Section VIII, I compare
18 the relative risks between Canadian and Alberta utilities; in Section IX, I make a
19 determination of the appropriate cost of equity and capital structure for Alberta’s four utility
20 sectors and I recommend a new formulaic approach for Alberta; and in Section X, I state my
21 conclusions.

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