Cost of Capital for Ontario LDCs

Presentation on Behalf of Hydro One Networks

Kathleen C. McShane, CFA
Executive Vice President
Foster Associates, Inc.
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Capital Structure

- Board Staff proposes 60% debt and 40% equity including up to 4% preferred equity for all LDCs
- Common Equity ≠ Preferred Equity
- Appropriate Capital Structure for Hydro One
  - 40% common equity
  - Plus up to 4% preferred equity
- Importance of a strong financial structure and debt ratings
  - Global competition for capital
  - LDC and industry-wide capital requirements

Ability to Attract Capital

- Board's decision will be setting stage for utilities' ability to obtain financing on reasonable terms and conditions

- LDCs' ability to raise significant capital not yet seriously tested

- Debt rating agencies have expressed concern about the potential impact of the Board Staff's proposals on Hydro One's cash flows.

- Importance of attraction of both debt <u>and</u> equity capital

Return on Equity

- Current Methodology
  - Produces return in line with Canadian peers
  - Returns are low relative to U.S. peers
- Proposed Change in Methodology
  - Proposed ROE based on mechanistic application of a single test
  - Return would be well below Canadian peers
  - ROE would not meet comparable earnings standard
  - Ability to access debt capital on reasonable conditions at risk
  - Concerns with Staff's version of CAPM
    - Inputs
      - market return
      - beta
      - risk-free rate
    - Future Results

Approach to Determining ROE

- Use of Multiple Tests
  - All models are simplifications of reality
  - Fair ROE determination requires
    - Analysis of all relevant information
    - Judgment

- Each Test has Strengths and Challenges
  - Capital Asset Pricing Model
  - DCF
  - Comparable Earnings

Recommended Return on Equity

- Fair return for an Ontario LDC
  - 10.5% at a 5.0% Long Canada yield
  - Assumes an appropriate capital structure

- Return should be adjusted using existing automatic adjustment formula.