14 Carlton Street
Toronto, Ontario
M5B 1K5

Telephone: 416.542.2707
Facsimile: 416.542.3031
psardana@torontohydro.com

toronto hydro corporation

July 5, 2006

via electronic mail to BoardSec@oeb.gov.on.ca and courier

Peter H. O' Dell
Assistant Board Secretary
Ontario Energy Board
PO Box 2319
2300 Yonge Street, Suite 2700
Toronto, ON M4P 1E4

Dear Mr. O'Dell

Re: EB-2006-0088 (Cost of Capital) — Comments on Draft Staff Report — Proposals for Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors

The ensuing presents Toronto Hydro Electric System Limited's ("THESL") initial views on the Cost of Capital material contained in the OEB Staff's above-noted draft report. THESL's comments on the 2nd Generation Incentive Regulation Mechanism ("2nd Generation IRM") will be submitted under separate cover. THESL notes that the time frames around receiving Board Staff's proposal and having to provide comment have not permitted an extensive review of the proposal. THESL intends to provide additional comments on subsequent drafts, and to submit expert reports on the Board's Cost of Capital consultation by August 14th 2006.

In making these comments, THESL acknowledges the difficult task currently facing the Board in balancing myriad, and perhaps competing objectives, to derive just and reasonable rates for all local distribution companies ("LDCs"). Because of the inherent complexity of the topic, and due to the significant departure from the Board's current cost of capital methodology, THESL strongly urges Board staff to amend their proposed process to include a full hearing on cost of capital, rather than settling on a position within a compressed timeframe and without a full testing of evidence relied on by Board Staff in their proposal. The OEB also recently conducted a full hearing on cost of capital for Ontario's natural gas distributors (RP-2002-0158) with a decision rendered in January 2004. This hearing considered various methodologies in establishing a just and reasonable ROE. In light of this recent decision, THESL questions why Board Staff is proposing such a drastic departure from previous consideration of different methodologies for estimating ROE. If the current course of action is pursued, the OEB would also stand in marked contrast to the Alberta Energy and Utilities Board and the British Columbia Utilities Commission which have recently held generic hearings on cost of capital and capital structure matters for electricity and natural gas distribution utilities under their jurisdiction.

Clearly, in THESL's view, "getting it wrong" will have significant consequences for future access to capital for all LDCs, and could also lead to unnecessarily high distribution rates. An elaboration of these points follows.

THESL's comments are organized in a format that follows Board Staff's report. Following some general feedback in the next section, subsequent sections provide feedback on the Approach and Components of the cost of capital, on the Return on Equity and on the Debt Rate. Preliminary recommendations for Board Staff's consideration are listed in Section V.

I. General Comments

Board Staff's draft report states (page 3) that the scope of their review will include a broader examination of risks faced by distributors. Yet, the paper reveals no such examination of the risks in the draft report, or in the consultants' report. Accordingly, an even bigger leap of faith seems to be required to accept that the "β" factor used as a proxy for LDC risk captures all of the risks faced by LDCs. In fact, the CAPM only measures market based risk and assumes all other risk can be mitigated through appropriate diversification. The applicability of this type of risk analysis to non-traded securities is arguable, and, in the view of the LDCs' major suppliers of capital, longer term institutional lenders, and credit rating agencies, the analysis is irrelevant.

Secondly, as one of its guiding objectives, Board Staff indicate that by establishing a common capital structure and incentive framework for all distributors, barriers to consolidation can be avoided within the electricity distribution sector. Currently, THESL is unaware of any barriers to consolidation for distributors as a result of different capital structures. In point of fact, varying capital structures may be attractive to LDCs that are contemplating acquisitions within their sector. For example, "equity-thin" LDCs may find LDCs with (relatively) higher equity ratios to be attractive partners, *ceteris paribus*.

II. Theory of Cost of Capital

i. With respect to the debt:equity ("D:E") split, Board Staff recommend a maximum common equity component of 36 percent, a 4 percent "adder" for preferred shares, and the balance to be held in the form of debt (i.e., depending on the level of preferred shares issued, between 60 percent and 64 percent). In THESL's view, the distinction between common and preferred equity seems to be a matter of accommodation for Hydro One. Other LDCs are unlikely to raise preferred share capital, as this action could raise the issue of tax leakage from LDCs to the federal government. It follows from this that LDCs are limited to an equity base equivalent to 36 percent of rate base. THESL's view is that this level of equity could prove inadequate for maintaining an acceptable credit rating in the face of rising external funding requirements and declining ROEs. If the stated desire is to set the total equity component at 40 percent, then no distinction ought to be made between common and preferred equity. Rather, a specific allowance for up to 4 percent preferred equity should be made within an overall 40 percent equity structure.

ii. Board Staff also note that the justification for recommending an equity component of 36 percent has been based on relying on the regulatory experience gained in the natural gas industry. At least two points are worth noting in this regard. First, the two main regulated gas utilities in Ontario are much larger than all LDCs (save Hydro One), and are owned by even larger, publicly traded, parent companies. Accordingly, the comparison from a capital structure perspective may not be apt. Secondly, the gas distribution companies (and their parent corporations) have access to capital via debt markets *and* equity markets; currently LDCs in Ontario are restricted to debt market financing, or even more restrictive bank market financing. It follows that the amount of equity on LDCs' balance sheets stems almost purely from retained earnings (or "organic" growth in the absence of acquisitions). It is for this reason that debt-to-capitalization covenants have greater import for LDCs' lenders, in both short-term and long-term financing agreements. Therefore, the lower the equity base, the less the leverage room available to an LDC, particularly if the LDC is already at its deemed capital structure.

iii. With respect to the appropriate capital structure, Board Staff note correctly that there is no evidence to suggest that different size-based capital structures are required. The converse is also true that, neither is there evidence to suggest that different capital structures are not required. The evidence in either instance is simply absent, and the need for more comprehensive review via a Hearing process becomes that much more compelling.

III. Return on Equity

In setting the Return on Equity ("ROE") for LDCs, Board Staff propose to rely on the Capital Asset Pricing Model (CAPM) as the only method to determine an appropriate ROE. THESL has several concerns with this approach:

i. THESL is of the view that, determining the just and reasonable ROE for a regulated utility is based on the exercise of "informed judgement" rather than the strict adherence and application of only one financial model. As a result, utility boards in Canada (and, until now, the Ontario Energy Board) generally review the results of several different models to inform their judgement. Staff's proposal would depart from past OEB practice and from the practice in virtually all other significant jurisdictions in Canada, thereby potentially causing substantial differentials between ROEs set for LDCs in Ontario versus utilities in other jurisdictions, and as noted previously, gas distribution utilities in Ontario. Additionally, the strict application of the CAPM developed by Lazar and Prisman results in a range of ROEs (5.78% to 7.02%), which would be insufficient to attract capital to the Ontario electricity distribution industry and is based on a number of untested assumptions.

Further to this, Staff's proposal (7.52% to 8.36%) is based on a lower bound determined by the upper bound of Lazar and Prisman plus 50 basis points and an upper bound based on an (improperly applied) update of Cannon's formula (please also refer to Exhibit J3.1A filed during THESL 2006 EDR Proceeding, and attached to this document as Appendix A). The Cannon formulaic approach, which was deemed to yield a fair and reasonable return by the OEB for the past six years, now appears to set the highest possible return available to Ontario LDCs even while their risk profiles may be increasing. Assuming the selection of the upper end of Staff's range, the ROE would be about 114 basis points below the most recently decided cases in other Canadian jurisdictions. Although this method of establishing ROEs for LDCs in Ontario is at a draft stage, investors have already been alerted to the potential of further deterioration in the regulatory environment in Ontario, and credit rating agencies have begun to make inquiries as to the OEB's intentions. (Please also refer to the Pipelines and Utilities document published by the Bank of Montreal on June 27, 2006, and attached to this document as Appendix B).

ii. THESL notes that the CAPM has been one of the methods used by cost of capital experts to determine ROE in past cost of capital hearings (for example, the OEB's RP-2002-0158 hearing, BCUC's G-14-06 decision, and others). In those cases, both the strengths and weaknesses of the method have been explored in detail. It is largely because of the various strengths and weaknesses of any one method that regulatory bodies have opted to set ROEs based on a variety of methods. However, it is apparent that the same level of rigour in establishing an appropriate ROE is not being applied under Board Staff's proposed process. Clearly, setting the "right" ROE is extremely important, and once this has been done, THESL would support the practice of formulaic adjustments to the measure (subject to this adjustment process also being fully discussed within a cost of capital hearing process).

iii. Further support for not relying on one method of setting ROEs can be derived from the fundamental CAPM formula. Should equity markets go through a sustained period of low or even negative returns, LDC ROEs could be set at levels at which capital could not be attracted. This could be particularly troublesome were this to coincide with LDCs need to access debt capital markets to fulfill incremental capital expenditure needs.

iv. As part of its 2006 EDR, THESL alerted the OEB to the possibility of substantial requirements for new capital expenditures over the next ten years. Even a casual observer would note that the need for significant incremental capital expenditures in the coming years is not limited to THESL's infrastructure needs. The whole Ontario electricity industry, and indeed, much of the province's public infrastructure, has a substantial requirement for new funds and there will be competition for funds between the generation, transmission and distribution sectors. THESL is of the view that, the distribution sector is likely to be the weakest from a credit perspective as new and existing generators will rank higher due to either being contracted at significantly higher ROEs with the Ontario Power Authority (which is viewed to have the credit strength of a *quasi*-government agency), or directly owned by the Province, regulated by the OEB and operating the base load plants in the Province. As Board Staff have correctly noted as one of their guiding objectives, the distribution sector must be awarded returns that maintains its financial integrity and allows it to attract capital on reasonable terms. Further to this point, Lazar and Prisman acknowledged in their remarks on June 19 that they did not consider the issue of capital attraction in developing their recommendations.

v. Neither Staff nor its consultants have carried out a review of the changes in the risk profile of the LDCs since the Cannon report. As acknowledged by Lazar and Prisman, the list of so-called comparables from which they derived their β estimate is simply all publicly traded electricity stocks in Canada. Many of these stocks (or in some cases, income trust units) are not involved in the distribution segment of the broader electricity sector, and so the argument that these stocks are, in fact, comparable is tenuous.

vi. There has been a great deal of confusion with the calculation of the "right" ROE based on Dr. Cannon's formula. THESL has attached Exhibit J3.1 as Appendix A to this document in an attempt to lend some clarity to the confusion, but THESL would encourage Board Staff to issue a clarification notice as to the correct way to calculate ROE using the current methodology. This is important because it seems evident that Board Staff have not completely ruled out the Cannon method since it seems to form the "upper range" of ROE estimates being proposed.

vii. Previously the ROE was determined by adding the utility risk premium to a proxy for the forecast 30 year Government of Canada bond yield. Use of the 30-year proxy reflected the long-term nature of utility investment. Staff now proposes to average 5, 10, and 15-year forward rates for Canada bonds. There are technical issues associated with certain of these maturities, for example the 5-year maturity is influenced by monetary and foreign exchange policy while there is no benchmark 15-year Canada issue since this maturity is not well traded. Setting aside the technical issues, the resulting average of 5, 10 and 15-year bond yields does not contain an appropriate term premium reflecting an equity investment in utility assets.

viii. The risks faced by LDCs have very likely increased since the release of the Cannon report due to much higher regulatory uncertainty, the increased focus on conservation, significantly higher commodity prices and increasing capital requirements. All of these points argue for higher ROEs for LDCs and ROEs that are at least derived following a more fulsome discussion of the inherent risks in LDCs, and certainly not based on an academic proxy model of risk for (largely unrelated) companies with publicly traded equity.

IV. Debt Rate

i. With respect to the cost of debt, THESL agrees with Board Staff that existing embedded long-term debt rates should be carried forward as long as the debt is on the company's books. THESL also agrees that new third party debt should be factored in at the actual rate (including any issuance and/or amortization costs).

For new long-term debt held by affiliates, THESL believes that the correct cost would be determined using an equivalent, benchmark Government of Canada bond rate plus a specific corporate spread. For example, if THESL were to issue 10-year debt, it would be priced based on the equivalent "on -the-run" benchmark Government of Canada bond (10-year) plus Toronto Hydro's credit spread. If the Board wishes to minimize the amount of company specific spreads, THESL believes that an alternative may be to establish a range of corporate spreads that would be indicative of spreads for small, medium and large LDCs.

V. **Recommendations**

In reviewing Board Staff's draft report on cost of capital, it is apparent to THESL that the OEB faces a somewhat daunting task of finding the right balance between competing objectives. THESL commends Board Staff for starting a long overdue review of an extremely important issue for LDCs. Nevertheless, THESL would strongly urge Board Staff to consider the following recommendations.

- The significance of cost of capital to LDCs' overall distribution revenue requirement necessitates a full hearing process with expert opinions from all sides.

- THESL encourages Board Staff to not rely only on one method to derive ROE. Rather, the CAPM should be considered along with other, widely used, methods for deriving ROE. This is particularly important for Ontario's electricity distributors, as none of them has publicly traded equity. In THESL's view, using an average *Beta* from companies within the broader sector as the appropriate measure of LDC risk is, quite simply, wrong.

THESL looks forward to reviewing submissions from other parties in this matter, and looks forward to Board Staff's report on the same due out in late July 2006.

Yours truly,

P. Sardana, Vice-President, Treasurer
Toronto Hydro Corporation

Cc:: Anthony Haines, Chief Administrative Officer, Toronto Hydro Corporation
JS Couillard, Chief Financial Officer, Toronto Hydro Corporation
Richard Zebrowski, Vice President, Regulatory Affairs, Toronto Hydro Corporation
Darryl Seal, Manager, Treasury Operations, Toronto Hydro Corporation

Appendix A

Exhibit J3.1 Filed by THESL During its 2006 EDR Proceeding

FOSTER
ASSOCIATES
INCORPORATED
ECONOMIC CONSULTANTS

4550 Montgomery Avenue, Suite 350N
Bethesda, Maryland 20814
(301) 664-7852 • Fax (301) 664-7810

KATHLEEN C. McSHANE
EXECUTIVE VICE PRESIDENT

January 19, 2006

Mr. Anthony M. Haines
Chief Administrative Officer
Toronto Hydro Corporation
14 Carlton Street
Toronto, Ontario
M5B 1K5

Dear Mr. Haines:

In response to your request to calculate the updated allowed ROE for the electricity distributors according to the Board's Guidelines, I have constructed the attached Table. Some explanation is in order.

Column 2 of the table shows the initial ROE of 9.88% set in the Rate Handbook dated March 9, 2000. It was, as indicated in the Handbook, and in the Ontario Energy Board's *Reasons for Decision* (RP-1999-0034), based on the methodology used in regulating natural gas utilities. That methodology, which was set forth in the Board's *Draft Guidelines on a Formula-Based Return on Equity for Regulated Utilities* (March 1997), and recommended by Dr. Cannon for the Ontario Electricity Distributors in his December 1998 report, entitled *A Discussion Paper on the Determination of Return on Equity and Return on Rate Base for Electricity Distribution Utilities in Ontario*, entails setting an initial ROE by specifying a risk premium and long Canada bond yield, with subsequent changes made by means of an automatic adjustment formula. The automatic adjustment formula ("Cannon Methodology") increases/decreases the allowed ROE by 75% of the increase/decrease in the forecast 30-year Canada yield. The result is that the risk premium increases or decreases by 25 basis points for every one percentage point decrease or increase in the forecast 30-year Canada bond yield.

The 9.88% return on equity set in the 2000 Rate Handbook reflects the implementation of the "Cannon Methodology", with the result that the risk premium (at a 6.2% forecast long Canada yield) was 3.68%. Using the July 2004 forecast of 30-year Canadas of 5.81%, as was done in the first two drafts of the 2006 Handbook, the mechanistic update of the ROE, using the "Cannon Methodology", produces a risk premium of 3.80% (Column 3 of the attached Table).

The 9.0% ROE specified in the final 2006 Handbook uses the April 2005 forecast of long Canadas, but kept the risk premium at the 3.80% set out in the earlier drafts, rather than fully update the ROE using the "Cannon Methodology". Since the forecast 30-year Canada yield based on the April 2005 forecast had declined from 5.81% to 5.21%, a complete mechanistic updating of the ROE using the "Cannon Methodology" would have produced an equity risk premium of 3.93%, rather than the 3.80% specified in Section 5.1 of the Handbook, and an ROE of 9.13%, as shown on Column 4 of the Table, rather than 9.0%.

Similarly, as shown in Column 5, mechanistically updating the ROE with the December 2005 *Consensus Forecast*, consistent with the "Cannon Methodology" (referenced at page 30 of the 2006 Handbook), results in a 30-year Canada bond forecast of 4.56%, a risk premium of 4.09% and a ROE of 8.65%.

Sincerely,

Kathleen C. McShane

KCM:psg

ROEs FOR ELECTRICITY DISTRIBUTORS
(Based on Board's Draft Guidelines)

	2000 Handbook	Drafts 1 & 2 of 2006 Handbook	2006 Handbook	Most Recent Forecast
Date of Forecast	**December 1999**	**July 2004**	**April 2005**	**December 2005**
(1)	(2)	(3)	(4)	(5)
10-Year Canada	6.15%	5.30%	4.75%	4.45%
Spread	0.05%	0.51%	0.45%	0.11%
30-Year Canada	6.20%	5.81%	5.20%	4.56%
Risk Premium (based on Guidelines)	3.68%	3.80%	3.93%	4.09%
ROE	9.88%	9.61%	9.13%	8.65%

Appendix B

Pipelines & Utilities, June 27, 2006

2007 ROE Preview —The Ugly Get Uglier and Is There Trouble Brewing in Ontario

A Report by the BMO Capital Markets

Pipelines
& Utilities

BMO Capital Markets

2007 ROE Preview – The Ugly Get Uglier and Is There Trouble Brewing in Ontario?

Industry Rating: Market Perform

June 27 2006
Toronto, Ontario

Karen Taylor, CFA
(416) 359-4304
karen.taylor@bmo.com

Michael McGowan, CA, CFA
(416) 359-5807
michael.mcgowan@bmo.com

Highlights

- The ugly are getting uglier – 2007E ROEs are expected to decline by an average of 10bp. The average expected 2007 ROE is approximately 8.95% versus slightly over 9% in 2006.
- We have reviewed a proposal by Staff of the OEB to set allowed returns for electric distribution utilities in the range of 7.52% to 8.36%, a range we believe to be confiscatory.
- Lower ROEs may put pressure on expected EPS growth for companies such as Pacific Northern Gas, Gaz Metro, Fortis Inc., and TransCanada Corporation.
- Companies with limited exposure to ROE adjustment mechanisms include Duke Energy, Enbridge Inc. and TransAlta Corporation.
- A number of names in our coverage universe do not have exposure to ROE adjustment mechanisms.
- We rate the shares of Enbridge Inc., Duke Energy, Fortis Inc., and Caribbean Utilities Limited Outperform. We also rate the units of Gaz Metro Outperform.
- We remain restricted on the units of Calpine Power Income Fund and the shares of Canadian Utilities Limited.

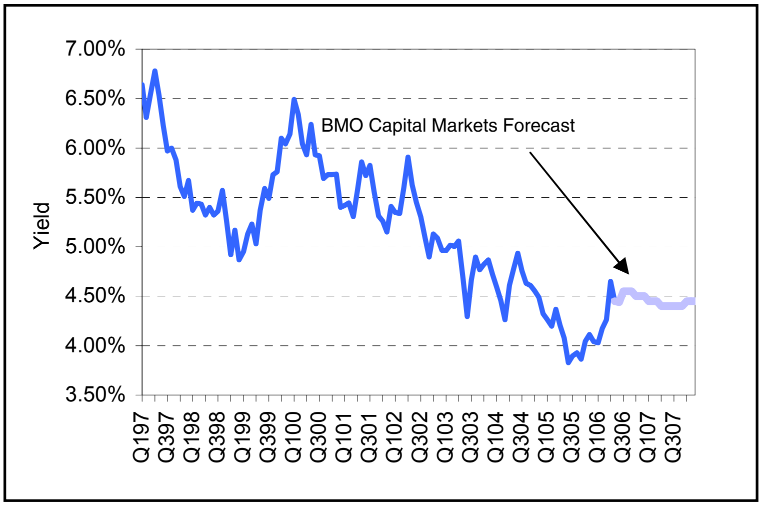
We have assessed the 2007E ROE reset using an implied 30-year Government of Canada yield of 4.65%. We believe that the following observations are relevant with respect to this exercise:

- The ugly are getting uglier - marginally. In our 2005 assessment of prospective 2006 ROEs published on June 10, 2005, we stated that ROEs were looking "ugly" and presented two 30-year bond scenarios: 5.20% and 4.60%. The latter scenario was closest to reality. Based on the National Energy Board's multi-pipeline decision 2006 reset, which used a forecast bond yield of approximately 4.78%, 2007E ROEs are poised to fall by an average of 10 basis points. The ugly are getting marginally uglier.
- Lower ROEs may put limited pressure on expected EPS growth (2007 versus 2006) rates for those companies such as Pacific Northern Gas, Gaz Metro, Fortis Inc., and TransCanada Corporation. At the same time, interest rates have bottomed and have increased by approximately 24% versus the low yield of 3.73% reached in September 2005.
- Companies without exposure to ROE adjustment mechanisms include: Canadian Hydro Developers, Caribbean Utilities Company, Ltd., Creststreet Power Income Fund, L.P., Emera Inc., Enbridge Income Fund, Great Lakes Hydro Income Fund, Innergex Power Income Fund, Fort Chicago Energy Partners, L.P., Inter Pipeline Fund, and Pembina Pipeline Income Fund.
- We have set out our view herein of a proposal made by Staff of the Ontario Energy Board (OEB) to establish the return on equity for local electricity distribution companies in Ontario within a range of 7.52% and 8.36%. We believe this range is confiscatory and likely violates the fair return standard.

The allowed rates of return on equity (ROE) allowed by utility regulators are typically established in the fall of each year and are highly dependent on forecast interest rates for the prospective fiscal period. As we have stated in previous versions of this ROE preview, we believe that interest rates:

- Help establish the relative value of the sectors versus other income-producing investments (i.e., bonds, income trusts and limited partnerships, and other high yielding common stocks). We believe it is consistently understood in the interest sensitive segment of the market that low prevailing and forecast interest rates (i.e., 10-year Government of Canada yields) are positive for income producing investments and result in relatively high valuations, when expressed on a price-to-earnings and price-to-book value basis;
- Are the key variable in the various automatic adjustment mechanisms that have been adopted by the various federal and provincial regulators. Interest rates are therefore important drivers of our earnings per share outlook for a number of companies in the pipeline and energy utility sectors; and
- As illustrated in Chart 1, the 10-year Government of Canada bond yield bottomed in 2005 at approximately 3.73% and has since increased by approximately 0.92%, closing on June 26 at a yield of approximately 4.65%. This is a 24.66% increase in yields since September 2005.

***Chart 1:** 10-Year Government of Canada Bond Yield*



Source: Fame, BMO Capital Markets

- Tables 1 and 2 contain the key assumptions and parameters embedded in each of the automatic adjustment mechanisms used by federal and provincial regulators:
  - Equity Risk Premium Assumptions in Each Formula: Table 1 contains the equity risk premium that is inherent in each of the formulas used. The return on equity for a period can be calculated "on the fly" by simply making an assumption about the prospective 30-year bond yield and adding it to the spread for the corresponding rate level and the regulator in the table.
  - Indicative Calculated Return on Equity: Table 2 contains the calculated return on equity by regulator and a quick look-up table for those who simply "want the answer", being the expected return on equity for a designated 30-year bond yield.

***Table 1:** Equity Risk Premium Inherent in Formula*

Regulator		30-Year Government of Canada Bond Yield									
		4.50%	5.25%	6.00%	6.75%	7.50%	8.25%	9.00%	9.75%	10.25%	10.75%
National Energy Board		4.19%	4.00%	3.81%	3.63%	3.44%	3.25%	3.06%	2.88%	2.75%	2.63%
British Columbia Utilities Commission -	Terasen Gas (BCGU)	4.08%	3.90%	3.71%	3.52%	3.33%	3.15%	2.96%	2.77%	2.65%	2.52%
British Columbia Utilities Commission -	Terasen Gas (Centra)	4.78%	4.60%	4.41%	4.22%	4.03%	3.85%	3.66%	3.47%	3.35%	3.22%
British Columbia Utilities Commission -	PNG West Division/Tumbler Ridge	4.73%	4.55%	4.36%	4.17%	3.98%	3.80%	3.61%	3.42%	3.30%	3.17%
British Columbia Utilities Commission -	PNG Ft. St. John/Dawson Creek/FortisBC	4.48%	4.30%	4.11%	3.92%	3.73%	3.55%	3.36%	3.17%	3.05%	2.92%
Alberta Energy and Utilities Board		4.22%	4.03%	3.84%	3.65%	3.47%	3.28%	3.09%	2.90%	2.78%	2.65%
Ontario Energy Board -	Enbridge Gas Distribution[1]	4.09%	3.90%	3.71%	3.53%	3.34%	3.15%	2.96%	2.78%	2.65%	2.53%
Ontario Energy Board -	Union Gas[2]	4.24%	4.05%	3.86%	3.68%	3.49%	3.30%	3.11%	2.93%	2.80%	2.68%
Regie de l'energie		4.16%	3.97%	3.78%	3.59%	3.41%	3.22%	3.03%	2.84%	2.72%	2.59%
Nova Scotia Utilities and Review Board		Formula Not Presently In Use									
Island Regulatory and Appeals Commission		Formula Not Presently In Use									
Newfoundland and Labrador Board of Commissioners of Public Utilities[3]		4.37%	4.22%	4.07%	3.92%	3.77%	3.62%	3.47%	3.32%	3.22%	3.12%

Notes:
(1) Assumed to use the October or November issue of Consensus Economics.
(2) Uses the October or November issue of Consensus Economics
(3) Total Return Calculation; June 20, 2003 Decision reflected in calculation
Source: BMO Capital Markets

Table 2: *Indicative Calculated Return on Equity by Regulator*

Regulator		30-Year Government of Canada Bond Yield									
		4.50%	5.25%	6.00%	6.75%	7.50%	8.25%	9.00%	9.75%	10.25%	10.75%
National Energy Board		8.69%	9.25%	9.81%	10.38%	10.94%	11.50%	12.06%	12.63%	13.00%	13.38%
British Columbia Utilities Commission -	Terasen Gas (BCGU)	8.58%	9.15%	9.71%	10.27%	10.83%	11.40%	11.96%	12.52%	12.90%	13.27%
British Columbia Utilities Commission -	Terasen Gas (Centra)	9.28%	9.85%	10.41%	10.97%	11.53%	12.10%	12.66%	13.22%	13.60%	13.97%
British Columbia Utilities Commission -	PNG West Division/Tumbler Ridge	9.23%	9.80%	10.36%	10.92%	11.48%	12.05%	12.61%	13.17%	13.55%	13.92%
British Columbia Utilities Commission -	PNG Ft. St. John/Dawson Creek/FortisBC	8.98%	9.55%	10.11%	10.67%	11.23%	11.80%	12.36%	12.92%	13.30%	13.67%
Alberta Energy and Utilities Board		8.72%	9.28%	9.84%	10.40%	10.97%	11.53%	12.09%	12.65%	13.03%	13.40%
Ontario Energy Board -	Enbridge Gas Distribution	8.59%	9.15%	9.71%	10.28%	10.84%	11.40%	11.96%	12.53%	12.90%	13.28%
Ontario Energy Board -	Union Gas	8.74%	9.30%	9.86%	10.43%	10.99%	11.55%	12.11%	12.68%	13.05%	13.43%
Regie de l'energie		8.66%	9.22%	9.78%	10.34%	10.91%	11.47%	12.03%	12.59%	12.97%	13.34%
Nova Scotia Utilities and Review Board		Formula Not Presently In Use									
Island Regulatory and Appeals Commission											
Newfoundland and Labrador Board of Commissioners of Public Utilities		8.87%	9.47%	10.07%	10.67%	11.27%	11.87%	12.47%	13.07%	13.47%	13.87%

Source: BMO Capital Markets

- Table 3 contains a list of the key variables that drive the adjustment mechanisms, by regulator.

Table 3: *Key Input Assumptions*

Regulator		Year Formula Effective	Month of Consensus Economics	Base GOC Yield	Equity Risk Premium	Adjustment Factor	2002A ROE	2003A ROE	2004A ROE	2005A ROE	2006A ROE	2007E ROE	Change 2007 vs 2006
National Energy Board		1995	November	9.25%	3.00%	75%	9.53%	9.79%	9.56%	9.46%	8.88%	8.79%	-0.09%
British Columbia Utilities Commission -	Terasen Gas (BCGU)	2006	November	5.25%	3.90%	75%	9.13%	9.42%	9.15%	9.03%	8.80%	8.70%	-0.10%
British Columbia Utilities Commission -	Terasen Gas (Centra)	2006	November	5.25%	4.60%	75%	NA	9.92%	9.65%	9.53%	9.50%	9.40%	-0.10%
British Columbia Utilities Commission -	PNG West Division/Tumbler Ridge	2006	November	5.25%	4.55%	75%	9.88%	10.17%	9.80%	9.68%	9.45%	9.35%	-0.10%
British Columbia Utilities Commission -	PNG Ft. St. John/Dawson Creek/FortisBC	2006	November	5.25%	4.30%	75%	9.63%	9.82%	9.55%	9.43%	9.20%	9.10%	-0.10%
Alberta Energy and Utilities Board		2005	November	5.68%	3.92%	75%	N/A	N/A	9.60%	9.50%	8.93%	8.79%	-0.14%
Ontario Energy Board -	Enbridge Gas Distribution	1998	October	7.25%	3.40%	75%	9.66%	9.69%	9.69%	9.57%	8.74%	8.71%	-0.03%
Ontario Energy Board -	Union Gas[1]	1998	October	7.25%	3.55%	75%	9.95%	9.95%	9.62%	9.63%	8.92%	8.85%	-0.07%
Regie de l'energie[2]		1999	August	5.76%	3.84%	75%	9.67%	9.89%	9.45%	9.69%	8.95%	8.77%	-0.18%
Nova Scotia Utilities and Review Board		Formula Not Presently In Use											
Island Regulatory and Appeals Commission													
Newfoundland and Labrador Board of Commissioners of Public Utilities[3]		2000	Oct/Nov	5.60%	4.15%	80%	9.05%	9.75%	9.75%	9.24%	8.77%	8.99%	0.22%

(1) Issue of Consensus Economics used to calculate allowed ROE has varied. Assume October or November prospectively (reflects change in year-end).
(2) Excludes 0.57% of Allowed Incentive Return in 2003, 1.51% in 2004, 1.95% in 2005, 0.38% in 2006, and approximately 0.75% in 2007
(3) Return on Equity for Newfoundland Power Inc. Fixed for two-years at 9.75% in decision dated June 20, 2003. Total Return Calculation methodology.
Source: BMO Capital Markets

- Table 4 highlights the anticipated change in the allowed return on equity as would be determined by the automatic adjustment mechanism in each regulatory jurisdiction, given the implied forecast 30-year bond yield of 4.65%. The average anticipated change in ROE is a reduction of approximately 10 basis points (exclusive of the change in ROE for Newfoundland Power). The reduction in estimated 2007 ROEs is largely attributable to a decline in the observed spread between the actual 10-year and 30-year Government of Canada bond yields to approximately 5 basis points (for the 30-day period ending June 23) versus approximately 23 basis points in November 2005.

Table 4: *Change in 2007E Allowed ROE by Regulator*

Regulator		Change 2007 vs 2006
National Energy Board		-0.09%
British Columbia Utilities Commission -	Terasen Gas (BCGU)	-0.10%
British Columbia Utilities Commission -	Terasen Gas (Centra)	-0.10%
British Columbia Utilities Commission -	PNG West Division/Tumbler Ridge	-0.10%
British Columbia Utilities Commission -	PNG Ft. St. John/Dawson Creek/FortisBC	-0.10%
Alberta Energy and Utilities Board		-0.14%
Ontario Energy Board -	Enbridge Gas Distribution	-0.03%
Ontario Energy Board -	Union Gas	-0.07%
Regie de l'energie		-0.18%
Nova Scotia Utilities and Review Board		
Island Regulatory and Appeals Commission		
Newfoundland and Labrador Board of Commissioners of Public Utilities		0.22%

Source: BMO Capital Markets

- Tables 5, 6, 7 and 8 highlight the calculation of the allowed 2007E ROE for the National Energy Board, Alberta Energy and Utility Board, the British Columbia Utilities Commission and the Ontario Energy Board.

Table 5: *Calculation of the 2007E ROE – NEB Multi-Pipeline Cost of Capital*

Description		
2006 Calculated Return on Equity		8.88%
2006 Forecast Yield		4.78%
June 2006 Consensus Forecast - 3 Months Out		4.60%
June 2006 Consensus Forecast - 12 Months Out		4.60%
	Average	4.60%
Average Spread between 10-year and 30-year GOCs[1]		0.05%
Forecast Long-Term (30-year) GOC Bond Yield - 2007		4.65%
	2007 Forecast Yield	4.65%
	Less: 2006 Forecast Yield	4.78%
	Difference	-0.13%
	Times 75% Adjustment Factor	-0.09%
	Plus: 2006 Approved Return on Equity	8.88%
	Equals 2007E Approved Return on Equity	8.79%

Notes:

(1) Calculated by using the 10-year and 30-year Government of Canada bond yields published daily in the National Post throughout October of the current year

Source: BMO Capital Markets, National Energy Board

Table 6: *Calculation of the 2007E ROE – AEUB Generic Return on Equity*

Description		
2006 Calculated Return on Equity		8.93%
2006 Forecast Yield		4.84%
June 2006 Consensus Forecast - 3 Months Out		4.60%
June 2006 Consensus Forecast - 12 Months Out		4.60%
	Average	4.60%
Average Spread between 10-year and 30-year GOCs(2)		0.05%
Forecast Long-Term (30-year) GOC Bond Yield - 2007		4.65%
	2007 Forecast Yield	4.65%
	Less: 2006 Forecast Yield	4.84%
	Difference	-0.19%
	Times 75% Adjustment Factor	-0.14%
	Plus: 2006 Approved Return on Equity	8.93%
	Equals 2007E Approved Return on Equity	8.79%

(2) Calculated by using the 10-year and 30-year Government of Canada bond yields published daily in the National Post throughout October of the current year
Source: BMO Capital Markets, Alberta Energy and Utility Board

Table 7: *Calculation of 2007 ROE – BCUC Low-Risk Benchmark Utility*

Description		
2006 Calculated Return on Equity		8.80%
June 2006 Consensus Forecast - 3 Months Out		4.60%
June 2006 Consensus Forecast - 12 Months Out		4.60%
	Average	4.60%
Average Spread between 10-year and 30-year GOCs(2)		0.05%
Forecast Long-Term (30-year) GOC Bond Yield - 2007		4.65%
	Benchmarket Return per G-14-06	9.145%
	Long-Term (30-year)GOC Bond Yield Decision	5.25%
	2007 Forecast Yield	4.65%
	Less: Bond Yield from Decision	5.25%
	Difference	-0.60%
	Times 75% Adjustment Factor	-0.45%
	Plus: Approved Return on Equity Decision	9.145%
	Equals 2007E Approved Return on Equity	8.70%

Source: BMO Capital Markets, British Columbia Utilities Commission

Table 8: *Calculation of 2007E ROE – OEB Enbridge Gas Distribution*

Description		
2006 Calculated Return on Equity		8.74%
2006 Forecast Yield		4.70%
June 2006 Consensus Forecast - 3 Months Out		4.60%
June 2006 Consensus Forecast - 12 Months Out		4.60%
	Average	4.60%
Average Spread between 10-year and 30-year GOCs[1]		0.05%
Forecast Long-Term (30-year) GOC Bond Yield - 2006		4.65%
	2007 Forecast Yield	4.65%
	Less: 2006 Forecast Yield	4.70%
	Difference	-0.05%
	Times 75% Adjustment Factor	-0.03%
	Plus: 2006 Approved Return on Equity	8.74%
	Equals 2007E Approved Return on Equity	8.71%

(1) Average of the actual observed spreads between 10- and 30-year or long term bonds for the last 20 business days that correspond to the Consensus Forecast used (September 9 - October 6)
Source: BMO Capital Markets, Ontario Energy Board

The anticipated change in estimated 2007 EPS by company arising from the marginally lower ROEs is set out in Table 9.

Table 9: *Change in 2007E EPS*

Company	Regulator	2007E Ratebase (millions)	Deemed Equity (%)	Sensitivity to 100 bp change in ROE (millions)	Estimated Change ROE (%)	Avg Diluted Shares 2007E (millions)	Estimated Change in 2007 EPS Estimates	Current Diluted 2007E EPS	Proforma Diluted 2007E EPS	% Change in 2007E EPS
Canadian Utilities Ltd.[1]										
ATCO Gas Ltd.	AEUB	1,100.2	38.0%	4.2	-0.14%	127.7	($0.00)			
ATCO Pipelines Ltd.	AEUB	522.4	43.0%	2.2	NA	127.7	$0.00			
ATCO Electric (Transmission) Ltd.	AEUB	950.0	33.0%	3.1	NA	127.7	$0.00			
ATCO Electric (Distribution) Ltd.	AEUB	740.1	37.0%	2.7	NA	127.7	$0.00			
							($0.00)	$2.16	$2.15	-0.21%
Emera Inc.										
Nova Scotia Power Inc.[2]	UARB	2,826.4	37.5%	10.6	NA	110.9	$0.00			
Bangor Hydro[3]	MPUC	356.9	40.0%	1.4	NA	110.9	$0.00			
							$0.00	$1.16	$1.16	0.00%
Enbridge Inc.										
Enbridge Gas Distribution	OEB	3,632.4	35.0%	12.7	-0.03%	342.9	($0.00)			
Non-Routine Adjustments - Liquids Pipeline System	NEB	225.2	45.0%	1.0	-0.09%	342.9	($0.00)			
System Expansion Plan II[4]	NEB	140.0	45.0%	0.6	-0.09%	342.9	($0.00)			
							($0.00)	$1.78	$1.78	-0.09%
Fortis Inc.										
Newfoundland Power[5]	BCPU	811.0	45.0%	3.6	0.22%	123.7	$0.01			
Maritime Electric[6]	MEA	253.2	45.0%	1.1	NA	123.7	$0.00			
FortisAlberta	AEUB	929.9	37.0%	3.4	-0.14%	123.7	($0.00)			
FortisBC	BCUC	752.5	40.0%	3.0	-0.10%	123.7	($0.00)			
Fortis Ontario[7]	OEB	NA	NA	NA	NA	123.7	$0.00			
							$0.00	$1.26	$1.26	0.01%
Gaz Metropolitain & Company, L.P.										
Gaz Metropolitain (Distribution)[8]	Regie	1,711.4	38.5%	10.2	-0.18%	120.6	($0.01)			
Trans Quebec & Maritimes Pipeline (50%)[9]	NEB	440.2	30.0%	1.1	-0.09%	120.6	($0.00)			
							($0.02)	$1.24	$1.22	-1.25%
Pacific Northern Gas Ltd.										
PNG West Division/Tumbler Ridge	BCUC	130.0	40.0%	0.5	-0.10%	3.6	($0.01)			
PNG Fort St. John & Dawson Creek	BCUC	29.3	36.0%	0.1	-0.10%	3.6	($0.00)			
							($0.02)	$1.59	$1.58	-1.08%
Terasen Inc.										
Terasen Gas (BCGU)	BCUC	2,468.5	35.0%	8.6	-0.10%	106.8	($0.01)			
Terasen Gas (Centra)	BCUC	483.9	40.0%	1.9	-0.10%	106.8	($0.00)			
Terasen Corridor Pipeline[10]	AEUB	672.0	24.0%	1.6	-0.09%	106.8	($0.00)			
							($0.01)	$1.38	$1.37	-0.82%
TransCanada Corporation										
Canadian Mainline	NEB	7,508.5	36.0%	27.0	-0.09%	493.5	($0.00)			
Alberta System	AEUB	4,129.8	35.0%	14.5	-0.09%	493.5	($0.00)			
BC System	NEB	252.0	36.0%	0.9	-0.09%	493.5	($0.00)			
Trans Quebec & Maritimes Pipeline (50%)	NEB	440.2	30.0%	0.7	-0.09%	493.5	($0.00)			
Foothills PipeLines. Ltd.[11,12]	NEB	770.0	36.0%	2.8	-0.09%	493.5	($0.00)			
							($0.01)	$1.76	$1.75	-0.48%

Notes:

(1) The AEUB established a fomula to determine Return on Equity in its Generic Cost of Capital Decision dated July 2, 2004. Only if a utility files for new utility rates will the recalculated return on equity apply. ATCO Pipelines has not filed for new 2006 rates. Pursuant to the AEUB Janury 27, 2006 decision relating to ATCO Gas' 2005 to 2007 General Rate Application, the generic ROE formula will apply for the purpose of determining 2005 to 2007 rates. Pursuant to the AEUB decision dated March 17, 2006 relating to ATCO Electric's 2005 to 2007 General Tariff Application, while the generic ROE forumula applies for the purpose of determining 2005 and 2006 rates, it does not apply for 2007.

(2) ROE for NSPI is presently set as an allowed range of 9.30% to 9.80% (as per 2005 rate decision). Rates reflect an ROE of 9.55%

(3) Multi-year Alternative Rate Plan in effect from Jun 6, 2002 to December 31, 2007. ROE allowed to vary between 5% and 17%, subject to performance.

(4) System Expansion Plan II is subject to volumetric thresholds, with the allowed return ranging from the Multi-Pipeline Return less 3.00% to the Multi-Pipeline Return Plus 3.00%.

(5) Allowed ROE fixed for fiscal 2003 and 2004 at 9.75%. Subject to ROE Adjustment Mechanism thereafter and Total Cost of Capital Methodology.

(6) Maritime Electric is subject to regulation under the new Electricity Act, effective Janary 1, 2004. Under the new Electricity Act, the company is now subject to a more conventional regulatory process (return on rate base) versus the previous approach involving a rate cap methodology. Customer rates could not exceed 110% of the rates charged by NB Power, subject to two adjustments: an Energy Cost Adjustment and a Cost of Capital Adjustment, both of which were designed to smooth actual performance. Applied for Return on Equity of 10.00% to 10.50%, with rates calculated in the application to reflect an allowed return of 10.25%

(7) Fortis Ontario includes the operations of Cornwall Electric, Canadian Niagara Power and various operating arrangements on MEUs owned by 3rd parties. Cornwall Electric's distribution rates are regulated by the 35-year Franchise Agreement between the utility and the City of Cornwall dated July 31, 1998. Utility operations are otherwise subject to regulatory oversight by the Ontario Energy Board. Until May 1, 2006 the allowed ROE is capped at 9.88%.

(8) Sensitivities are expressed on a pre-tax basis.

(9) Sensitivities reflect a 50% ownership interest in the pipeline.

(10) The Capital structure and ROE mechanism are confidental. We have assumed that the NEB Multi-Pipeline Decision is used.

(11) On December 21, 2005 the National Energy Board approved tolls on the Foothills Pipe Lines Ltd systems and the BC System which included 36% deemed equity.

(12) Reflects 100% ownership interest. Regulated on actual capital cost of service basis. Subject to O&M, G&A Incentive Agreement effective January 1, 2003 to December 31, 2015. Incentive benefit capped at $45 million over the term of the Agreement. NEB Multi-Pipeline decision remains relevant.

Source: BMO Capital Markets

Is There Trouble Brewing in Ontario?

On April 27, 2006, the Ontario Energy Board issued a letter to interested parties describing the process it intends to use to review the allowed cost of capital and to develop a 2nd generation incentive regulation mechanism. On June 19, the Board posted on its website a report on the cost of capital prepared by Dr. Fred Lazar and Dr. Eli Prisman of the Schulich School of Business dated June 14, 2006 and Staff's Draft Report regarding Proposals for Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors.

Our comments will focus primarily on Board Staff's recommendations for the equity cost of capital.

- Staff proposes that both the riskless rate of equity and the Equity Risk Premium should be determined in the manner recommended by Lazar and Prisman; i.e., relying exclusively on the Capital Asset Pricing Model or CAPM, which divides ROE into the sum of two terms: the riskless rate and a risk premium, which reflects the risk of the distributor, measured by Beta. Lazar and Prisman do not consider the discounted cash flow test, which measures the equity investors' expected return as the dividend yield on a stock or group of stocks plus the expected growth in dividends in the long term, or the comparable earnings test, which measures the experienced returns on book equity of firms that are of similar risk to the utility for which the regulator is setting the fair return.
- Staff recommends replacing the use of the proxy 30-year Government of Canada bond yield derived from the *Consensus Forecasts* publication with the forward rate and proposes that forward rates are a better indicator of the future cost of riskless capital. The riskless rate would be set by the average of 5, 10 and 15 year forward rates for Government of Canada bonds.
- Staff does not favour an annual review of the riskless rate by a panel of experts.
- Staff is undecided about the most appropriate way of estimating the equity risk premium or ERP – a panel of experts to select an appropriate sample of corporate comparators for estimating beta or a formulaic approach to adjust the annual allowable riskless rate for annual differences between the calculated rates.
- Staff recommends the continued inclusion of a 50-basis-point allowance for floatation and other transactions costs over and above a risk premium calculation.
- Staff proposes a return on equity of 7.52% to 8.36% and further recommends an annual formula-based update.

We believe that the following points are relevant about Staff's proposals and the supporting Lazar and Prisman study:

- It is unclear whether Lazar and Prisman have filed evidence in other regulatory proceedings and whether their combined recommendations have been reflected or have been given weight in the resulting panel decision.

- The use of the capital asset pricing model as the sole determinant of the equity cost of capital is fraught with difficulty, as illustrated by the Lazar and Prisman analysis, which we believe has the following deficiencies:

  1. The 60-month study period to determine beta and market returns is too short; it does not capture a full business or a full capital markets cycle. We note that evidence filed in conjunction with the recently completed British Columbia Utilities Commission cost of capital proceeding used observation periods of approximately 50 years for the Canadian comparable universe – 1956 to 2004.

  2. Study authors mix apples and oranges in the determination of the key variables in the CAPM equation. The beta was calculated using two 60-month periods ending 2004 and 2005. The Market Return was calculated over the January 2000 to April 2006 period. However, to determine the risk free rate and therefore the market risk premium, the authors use a current forward rate of 5.01%. We believe that the risk free return over a comparable study period should have been used to determine the market risk premium.

  3. The forward rate is not an unbiased estimator of future expected rates. The forward rate is the rate of interest for a future period that would equate the total return of a long-term bond with that of a strategy of rolling over a series of shorter-term bonds. The forward rate is inferred from the term structure and the actual future rate can vary from the theoretical forward rate. We believe that it is inappropriate to use the forward rate and note that the National Energy Board previously considered this approach and rejected it.

  4. The study uses 11 TSX listed entities as a proxy to determine the beta for Ontario electric distribution utilities. The proxy group includes: TransAlta Corporation, Canadian Utilities Limited, Fortis Inc., Emera Inc., Great Lakes Hydro Income Fund, Atlantic Power Corporation, Algonquin Power Income Fund, Boralex Power Income Fund, Canadian Hydro Developers Inc., EPCOR Power L.P., and Northland Power Income Fund. With the exception of Canadian Utilities, Fortis and Emera, none of the other members of the proxy group have substantial exposure to rate-regulated entities. In fact, all or substantially all of the remaining peer group are essentially unregulated, pure-play electric power generating entities. Furthermore, 6 of the entities in the comparables universe are essentially securitization vehicles (i.e., trust/limited partnership/IPS structures). We believe that it is no more appropriate to use these securitization vehicles to construct a proxy portfolio for the purpose of determining beta, the resultant cost of equity, and assume it to be comparable to the cost of equity for an electric distribution utility, than it is to calculate the CAPM cost of equity for a GMAC securitization vehicle and assume that it is the cost of equity for General Motors.

  5. The study does not acknowledge that the TSX is not likely to meet the CAPM requirement for a diversified market portfolio. At the beginning of the study period, the index was highly concentrated in technology stocks, namely Nortel. In recent years, the relative weights of the financial services and energy have increased dramatically. These sectors represent 29.5% and 27.9% of the S&P/TSX index, respectively, as at June 8, 2006.

6. Lazar and Prisman reject the use of other methods of determining the cost of equity on the basis that the other two methods (highlighted above) require estimates of future cash flows and their likelihoods. This is, of course, the essence of the exercise in the first place and should not be assumed away.

7. Lazar and Prisman are unable to "reverse engineer" the beta used in the current Board-approved equity risk premium ROE method, highlighting the inherent difficulties with the CAPM approach.

8. The range of ROEs highlighted in the study – 6.52% to 6.71% using the Lazar and Prisman determined variables (beta of 0.357) and 6.74% to 10.09% using the Lazar and Prisman determined variables and the original beta of 0.8 to 0.9, is too wide to narrow the cost of equity capital debate, focus the issues and add incremental value to the equity cost of capital discussion. The range also inherently highlights the weakness in the CAPM approach – the determination of beta. To reiterate, betas are inherently unstable and are influenced by a number of factors, including the sample group and time horizon used in the calculation.

- In framing its proposal, Staff should have made use of the extensive evidentiary record that was established in conjunction with the National Energy Board's Fair Return proceeding (decision dated June 21, 2002), the Alberta Energy and Utilities Board Generic Cost of Capital Proceeding (decision dated July 2, 2004) and the British Columbia Utilities Commission March 2, 2006 decision relating to an application by Terasen Gas Inc. and Terasen Gas (Vancouver Island) Inc. to determine the appropriate return on equity and capital structure and to review and revise the automatic adjustment mechanism. The cumulative record for these proceedings is comprehensive and complete and is superior to the Lazar and Prisman study commissioned by the Board.

- A more thorough review of this body of evidence would suggest the following:

1. That there is considerable debate about the actual value of the variables critical to the CAPM approach.

2. Beta is not transparent, is subject to adjustments and these adjustments can be biased by the point of view of the individuals undertaking the review.

3. CAPM is not widely used by the capital market to determine the relevant cost of equity. While it may be true that beta is a published statistic and used by market participants as a measure of the covariation of a stock in the context of the variance of the market portfolio for use in hedging or derivatives based activities, it does not imply that CAPM is widely used by capital markets participants to determine the cost of equity of a particular security. We do not believe that CAPM is widely used without substantial modification in the "real-world" capital budgeting process.

4. Other methods must be used to compensate for the deficiencies of CAPM.

- The Staff proposed return on equity range of 7.52% to 8.36% is unsupportable and confiscatory. It is a setback for the Board for the process to have resulted in this proposal. The proposed range likely violates the fair return standard, as established by Canada's Supreme Court and accepted by the National Energy Board in 1971, which states that a fair or reasonable rate of return should:

a. Be comparable to the return available from the application of the invested capital to other enterprises of like risk (the comparable earnings standard).

b. Enable the financial integrity of the regulated enterprise to be maintained and permit incremental capital to be attracted to the enterprise on reasonable terms and conditions (the financial integrity and capital attraction standards).

c. Achieve fairness both from the viewpoint of the customers and from the viewpoint of present and prospective investors (appropriate balance of customer and investor interests).

We note that the lower end of the proposed range may be approximately equal to the embedded cost of debt of many distribution utilities. We also point out with respect to the third standard that the Federal Court of Appeal stated in its decision dated April 6, 2004 that, "the cost of equity capital does not change because allowing the Mainline to recovery it would cause an increase in tolls…The cost to the Mainline of providing that rate of return on the equity component of its deemed capital structure is unaffected by the impact of tolls on customers or consumers".

- We do not use CAPM to calculate the cost of equity or the expected return associated with the purchase of an equity security. Rather, we essentially use the Discounted Cash Flow approach. As highlighted above, this approach measures the equity investors' expected return as the dividend yield on a stock or group of stocks plus the expected growth in dividends in the long term. We typically do not have an "Outperform" rating on a name in our coverage universe unless the total return (target yield plus the anticipated capital appreciation arising from higher dividends) is at least 10%.
- The Lazar and Prisman study did not provide the theoretical or practical foundation from which to deviate from the allowed return on equity used in the 2006 Electricity Distribution Rate proceedings: 4.75% 10-year Government of Canada bond yield (from Consensus Forecasts), plus the average difference during April 2005 between 10- and 30-year Government of Canada bond yields of 0.45% and an equity risk premium of 3.80%, for a total allowed return on equity of 9.0%.

We believe that the following points are relevant about the current methodology used by the Ontario Energy Board:

1. The Ontario Energy Board is the only regulatory authority that does not publish the calculation of the allowed ROE for the utilities subject to its oversight. We do not believe this is acceptable and believe it to be inconsistent with the Board's focus on transparency.

2. The monthly edition of Consensus Forecasts to be used varies from one utility to another and may be inconsistently applied per utility. We believe that the relevant monthly reference point should be disclosed, applied consistently for each utility and if possible, used on a comprehensive basis across all entities subject to the Board's regulation.

With respect to the automatic adjustment mechanisms highlighted in this report broadly, we set out the following points that we made at the recently concluded CAMPUT conference in Ottawa regarding the ROE formulas currently used by the various provincial and federal utility regulators:

1. We like them. The formulas are transparent; we can calculate them and the resulting returns can therefore be fully anticipated and priced into our reasonable expectations.
2. The resulting ROEs are too low.
3. The formulas cannot be overturned. The evidentiary standard is too high and is impossible to meet. In some jurisdictions, the utility has to prove that the formula no longer results in a fair return before it can get into the hearing room to have the formula reviewed.
4. All other regulators have reverted to the mean – the National Energy Board Multi-Pipeline decision.
5. Even though every regulator would contest this, we suggest that the ROEs allowed are trending toward the "Bare Bones" level, not the level established by the fair return standard that we all know and love, largely due to the potential adverse effect on customers. And we remind the reader that the courts have specifically prohibited this practice.

Our remarks elicited the following responses from various regulators:

1. Can the utilities still issue equity? The answer is yes; however, in the last five years, we have difficulty providing an example in which a publicly traded entity has issued common equity solely for the purpose of investing the monies raised in fully regulated operations at the allowed rates of return highlighted in this report. The ability of a utility to issue equity to fund general corporate purposes, including non-regulated operations, does not demonstrate the adequacy of the allowed return on equity of its rate regulated entity. It also does not indicate whether or not the issuance of equity dilutes existing equity investors.
2. They are still investing in system assets. This is also true. Utilities will likely continue to invest in rate base despite an unsatisfactory ROE for a number of reasons: (1) requirement to be the supplier or supply of last resort and fulfil the obligation to serve; (2) maintain the safe and reliable operation of the utility; and (3) remain in compliance with a governing licence. It should not be presumed that continued investment is an acquiescence that the allowed ROE adequately meets the fair return standard.
3. The benchmark formula, the National Energy Board's Multi-Pipeline decision, has not been challenged. We believe that regulatory proceedings such as the Fair Return proceeding undertaken by TransCanada PipeLines in 2001/2002 have the potential to seriously impair customer relationships and relationships with the regulator.

Table 10: Comparable Equities

Company	TSX Ticker	Price (C$) 26-Jun-06	Shares O/S (mm)	Market Cap. (mm)	Earnings per Share 2004A	2005A	2006E	2007E	P/E Ratios 2004A	2005A	2006E	2007E	Dividend Rate	Yield	12-Month Target	Total Return	Rating
Canadian Gas Utilities																	
Duke Energy Corp. [2]	DUK [5]	$28.52	1089.6	$31,074	$1.32	$1.73	$1.89	$2.00	21.7	16.5	15.1	14.3	$1.26	4.4%	$31.50	14.9%	Outperform
Enbridge Inc.	ENB	33.78	337.7	11,408	1.56	1.56	1.68	1.78	21.6	21.7	20.1	19.0	1.15	3.4%	36.00	10.0%	Outperform
Enbridge Income Fund	ENF.UN	12.55	34.6	435	0.30	0.44	0.51	0.56	41.9	28.6	24.7	22.3	0.92	7.3%	11.50	-1.0%	Underperform
Fort Chicago Energy Partners L.P.	FCE.UN	11.27	133.7	1,506	0.74	0.59	0.51	0.46	15.2	19.2	21.9	24.2	0.93	8.3%	11.50	10.3%	Market Perform
Gaz Métro [4]	GZM.UN	16.03	117.5	1,884	1.40	1.30	1.24	1.26	11.4	12.3	12.9	12.7	1.30	8.1%	17.25	15.7%	Outperform
Inter Pipeline Fund	IPL.UN	9.39	199.5	1,873	0.46	0.48	0.45	0.45	20.4	19.4	20.7	20.7	0.78	8.3%	9.00	4.2%	Market Perform
Pacific Northern Gas Ltd.	PNG	18.50	3.6	67	1.38	1.72	1.60	1.59	13.4	10.8	11.5	11.6	0.80	4.3%	19.00	7.0%	Market Perform
Pembina Pipeline Income Fund	PIF.UN	15.38	120.4	1,852	0.53	0.65	0.81	0.83	29.0	23.6	18.9	18.5	1.14	7.4%	14.00	-1.6%	Underperform
TransCanada Corp.	TRP	32.23	487.7	15,719	1.55	1.70	1.85	1.76	20.8	18.9	17.4	18.3	1.27	3.9%	34.50	11.0%	Market Perform
Group Average (Excl. ENF, FCE, GZM, IPL and PIF)									19.4	17.0	16.0	15.8		4.0%		10.7%	
Canadian Electric Utilities																	
Caribbean Utilities Co. Ltd. [2, 3]	CUP.U	$11.77	25.2	$297	$0.77	$0.13	$0.87	$0.86	15.3	NMF	13.6	13.6	$0.66	5.6%	$12.75	13.9%	Outperform
Emera Inc.	EMA	18.58	110.4	2,050	1.16	1.04	1.11	1.16	16.0	17.9	16.7	16.0	0.89	4.8%	19.25	8.4%	Market Perform
Fortis Inc.	FTS	22.44	103.4	2,321	0.99	1.10	1.17	1.26	22.6	20.4	19.2	17.8	0.64	2.9%	22.50	3.1%	Outperform
Group Average									18.0	19.1	16.5	15.8		4.4%		8.5%	
Canadian Multi-Utilities																	
ATCO Ltd. [1]	ACO/X	$35.03	60.0	$2,101	$2.17	$2.46	$2.68	$2.74	16.1	14.2	13.1	12.8	$0.82	2.3%	NA	NA	NR
Atlantic Power Corporation [6]	ATP.UN	9.78	45.8	447	(0.57)	(0.01)	0.26	0.12	NMF	12.2	10.8	15.3	$1.03	2.6%	$9.75	10.2%	Market Perform
Calpine Power Income Fund	CF.UN	9.60	61.7	593	0.81	0.76	R	R	11.9	12.6	R	R	R	R	R	R	Restricted
Cdn Hydro Developers, Inc.	KHD	5.07	120.5	611	0.06	0.00	0.07	0.15	85.9	NMF	75.4	33.7	NA	NA	6.00	18.3%	Market Perform
Canadian Utilities Ltd.	CU	36.92	127.0	4,687	1.98	2.03	R	R	18.6	18.2	R	R	R	R	R	R	Restricted
Creststreet Power & Income Fund LP	CRS.UN	5.33	11.5	61		(0.54)	(0.04)	0.02		NMF	NMF	NMF	0.69	13.0%	5.00	6.8%	Market Perform
Great Lakes Hydro Income Fund	GLH.UN	17.71	48.3	855	1.03	0.75	1.06	1.02	17.2	23.5	16.7	17.4	1.25	7.0%	17.00	3.0%	Market Perform
Innergex Power Income Fund	IEF.UN	12.60	24.7	311	0.46	0.46	0.49	0.47	27.3	27.2	25.7	27.1	0.97	7.7%	12.50	6.9%	Market Perform
TransAlta Corp.	TA	22.99	199.2	4,579	0.62	0.88	0.98	1.25	37.1	26.2	23.4	18.3	1.00	4.3%	20.00	-8.7%	Underperform
TransAlta Power L.P.	TPW.UN	8.54	74.8	639	0.48	(0.04)	0.57	0.42	18.0	NMF	15.0	20.4	0.80	9.3%	8.00	3.0%	Underperform
Group Average (Excl. CF, GLH, IEF and TPW)									23.9	19.5	37.3	21.6		3.3%		4.8%	

Notes:
NA = Not Applicable, NMF = Not Meaningful, NR = Not Rated
[1] Estimates from First Call
[2] All figures in US Dollars
[3] Caribbean Utilities' year end is April 30
[4] Gaz Metro's year end is Sept. 30
[5] Ticker on the New York Stock Exchange
[6] Represents Income Participating Securities (IPS). Share price, Market Cap and Dividend in C$; all else in US$.

Source: BMO Capital Markets

Analyst's Certification

I, Karen Taylor, CFA, hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities or issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

I, Michael McGowan, CFA, CA, hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities or issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

General Disclosure

The information and opinions in this report were prepared by BMO Nesbitt Burns Inc. and BMO Nesbitt Burns Ltée./Ltd., collectively ("BMO NB"). BMO NB is not subject to U.S. rules with regard to the preparation of research reports and the independence of analysts. "BMO Capital Markets" is a trade name used by the BMO Investment Banking Group, which includes the wholesale/institutional arms of Bank of Montreal and BMO NB in Canada, and BMO Capital Markets Corp. in the U.S. BMO Capital Markets Corp. is an affiliate of BMO NB. BMO NB and BMO Capital Markets Corp. are subsidiaries of Bank of Montreal. Bank of Montreal or its affiliates ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO NB research. A significant lending relationship may exist between BMO Financial Group and certain of the issuers mentioned herein. The reader should assume that BMO NB, BMO Capital Markets Corp., Bank of Montreal or their affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein. The opinions, estimates and projections contained in this report are those of BMO NB as of the date of this report and are subject to change without notice. BMO NB endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO NB makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO NB or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This material is for information purposes only and is not an offer to sell or the solicitation of an offer to buy any security. The research analyst and/or associates who prepared this report are compensated based upon (among other factors) the overall profitability of BMO NB and its affiliates, which includes the overall profitability of investment banking services. BMO NB, or its affiliates expect to receive or will seek compensation for investment banking services within the next 3 months from all issuers covered by BMO NB. BMO NB or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO NB or its affiliates, officers, directors or employees may have a long or short position in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon.

Company Specific Disclosures

Atlantic Power Corp. (ATP.UN-TSX)	9, 10C	Fortis Inc. (FTS-TSX)	
Calpine Power Income Fund (CF.UN-TSX)	1, 3, 9, 10AC	Gaz Metro Limited Partnership (GZM.UN-TSX)	1, 3, 9, 10AC
Canadian Hydro Developers Inc. (KHD-TSX)	2, 3, 10A	Great Lakes Hydro Income Fund (GLH.UN-TSX)	
Canadian Utilities (CU-TSX)	2, 3, 9, 10AC, 11, 12	Innergex Power Income Fund (IEF.UN-TSX)	2, 3, 9, 10AC
Caribbean Utilities Co. Ltd. (CUP.U-TSX)	5, 7, 9, 10AB	Inter Pipeline Fund (IPL.UN-TSX)	2, 3, 9, 10AC
Countryside Power Income Fund (COU.UN-TSX)	2, 3, 10A	Macquarie Power Income Fund (MPT.UN-TSX)	2, 3, 10A
Creststreet Power & Inc. Fund (CRS.UN-TSX)	2, 3, 9, 10AC	Pacific Northern Gas (PNG-TSX)	
Duke Energy Corp. (DUK-NYSE)	2, 3, 9, 10AC	Pembina Pipeline Income Fund (PIF.UN-TSX)	9, 10C
Emera Inc. (EMA-TSX)	9, 10C	TransAlta Corporation (TA-TSX; TAC-NYSE)	2, 3, 4, 5, 9, 10AC, 11
Enbridge Inc. (ENB-TSX; ENB-NYSE)	2, 3, 4, 9, 10AC	TransAlta Power L.P. (TPW.UN-TSX)	9, 10C
Enbridge Income Fund (ENF.UN-TSX)		TransCanada Corporation (TRP-TSX; TRP-NYSE)	1, 2, 3, 5, 9, 10AC, 12
Fort Chicago Energy L.P. (FCE.UN-TSX)	9, 10C		

Disclosure Key

BMO NB uses the following Company Specific Disclosure Key. Please refer to the Company Specific Disclosure section above for specific disclosures applicable to issuers discussed in this report:

1 - BMO NB has provided advice for a fee with respect to this issuer within the past 12 months.

2 - BMO NB has undertaken an underwriting liability with respect to this issuer within the past 12 months.

3 - BMO NB has provided investment banking services with respect to this issuer within the past 12 months.

4 - BMO NB, BMO Capital Markets Corp. or an affiliate beneficially owns 1% or more of any class of the equity securities of this issuer.

5 - BMO NB, BMO Capital Markets Corp. or an affiliate makes a market in this security.

6 - BMO Capital Markets Corp. or an affiliate has managed or co-managed a public offering of securities with respect to this issuer within the past 12 months.

7 - BMO Capital Markets Corp. or an affiliate has received compensation for investment banking services from this issuer within the past 12 months.

8 - BMO Capital Markets Corp. or an affiliate or its officers or partners own options, rights, or warrants to purchase any securities of this issuer.

9 - BMO Capital Markets Corp. or an affiliate received compensation for products or services other than investment banking services within the past 12 months.

10A - This issuer is a client (or was a client) of BMO NB, BMO Capital Markets Corp. or an affiliate within the past 12 months: Investment Banking Services

10B - This issuer is a client (or was a client) of BMO NB, BMO Capital Markets Corp. or an affiliate within the past 12 months: Non-Investment Banking Securities Related Services

10C - This issuer is a client (or was a client) of BMO NB, BMO Capital Markets Corp.or an affiliate within the past 12 months: Non-Securities Related Services

11 - An employee, officer, or director of BMO NB is a member of the Board of Directors or an advisor or officer of this issuer.

12 - A member of the Board of Directors of Bank of Montreal is also a member of the Board of Directors or is an officer of this issuer.

13 - A household member of the research analyst and/or associates who prepared this research report is a member of the Board of Directors or is an advisor or officer of this issuer.

14 - The research analysts and/or associates (or their household members) who prepared this research report directly or beneficially own securities of this issuer: [Specify nature of interest: long, short, debt, equity, futures, options, or other derivatives]

Distribution of Ratings

Rating Category	BMO Rating	BMO Universe	BMO I.B. Clients*	First Call Universe**
Buy	Outperform	40%	49%	48%
Hold	Market Perform	50%	47%	45%
Sell	Underperform	10%	4%	7%

* Reflects rating distribution of all companies where BMO Capital Markets has received compensation for Investment Banking services.

** Reflects rating distribution of all North American equity research analysts.

Ratings Key

We use the following ratings system definitions:

OP = Outperform - Forecast to outperform the market;

Mkt = Market Perform - Forecast to perform roughly in line with the market;

Und = Underperform - Forecast to underperform the market;

(S) = speculative investment;

NR = No rating at this time;

R = Restricted – Dissemination of research is currently restricted.

Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company. Prior to September 1, 2003, a fourth rating tier—Top Pick—was used to designate those stocks we felt would be the best performers relative to the market. Our six Top 15 lists which guide investors to our best ideas according to six different objectives (large, small, growth, value, income and quantitative) have replaced the Top Pick rating.

Dissemination of Research

Our research publications are available via our web site http://bmocapitalmarkets.com. Institutional clients may also receive our research via FIRST CALL Research Direct and Reuters. All of our research is made widely available at the same time to all BMO NB, BMO Capital Markets Corp. and BMO Nesbitt Burns Securities Ltd. client groups entitled to our research. Please contact your investment advisor or institutional salesperson for more information.

Additional Matters

TO U.S. RESIDENTS: BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd., affiliates of BMO NB, furnish this report to U.S. residents and accept responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal. Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd.

TO U.K. RESIDENTS: The contents hereof are intended solely for the use of, and may only be issued or passed onto, persons described in part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

BMO Nesbitt Burns Inc. and BMO Nesbitt Burns Ltée/Ltd. are Members of CIPF. BMO Capital Markets Corp. and BMO Nesbitt Burns Securities Ltd. are Members of SIPC.

R36663