September 22, 2006

Board Staff:

Thank you for following up on the questions posed during the technical conference and for arranging what we hope will be a productive teleconference. We are pleased to be of service and provide clarification of our presentation. As we stated in our presentation, we have not argued with the use of the Capital Asset Pricing Model (CAPM) or with the assumptions of Staff. Rather, as market users of the model, we saw inaccuracies in the application of CAPM which led to counterintuitive results of equity returns less than the cost of debt. Additionally, the results did not reconcile with what we believe are reasonable market returns for similar investments. We worried that these results would bias the Staff (and OEB Board members) toward a false estimate of lower market equity returns. We attempted to outline these issues in our submissions, and again during our presentation.

We are hopeful that our presentation, and the responses submitted herein, will help to clarify the correct use of CAPM and the resulting ROEs. Our responses can be summarized as follows:

- We provide the mathematical proof demonstrating that the asset return does in fact equal the weighted average cost of capital (WACC) and that the three equations questioned by Dr. Lazar are correct.

- As requested by Dr. Lazar, we re-calculate after tax WACC using Cannon methodology assuming a debt rate of 5.8% in all cases. As shown, the decreased WACC is due to the decreased percentage of equity in the capital structure. We demonstrate this through the use of pre-tax interest rates to calculate WACC.

- In response to Dr Lazar's and Jay Shepherd's requests, we provide calculation of the 6.47% asset return and re-lever that asset return with 60% debt with a 6% interest rate to achieve an ROE of 10.4%. We prove that the weighted average of the resulting debt and equity betas equals the asset beta of 0.29 and that the weighted average of the ROE and debt rate equals the 6.47% WACC. These calculations prove the 10.4% ROE is correct.

- Finally, while it was implied during questioning that we would generally expect to see a utility equity beta of less than 1, it is important to note that the equity beta value is dependent upon capital structure. Increased financial leverage raises the equity beta, because it amplifies equity risk and the net income impact of market changes. The 10.4% ROE described above is associated with a 60:40 capital structure, an equity beta of 1.07 and an after-tax debt beta of <0.23>. By way of comparison, the cohort companies have an average equity ratio of 51% and an equity beta of 0.78. We demonstrate that if we raise the debt to equity ratio from 51:49 to 60:40, the comparable companies cohort average equity beta would rise from 0.78 to 1.07.

Please let us know if you have further questions. We look forward to discussing these points on Monday's teleconference.

Sincerely,

Ron Warrington & Michele Smart
Energy and Environmental Economics, Inc.
353 Sacramento Street
Suite 1700
San Francisco, CA 94111