# Bluewater Power

**Page 1** **Q3** *To Dr Lazar:* Do you agree that such an analysis would be of assistance to the Board in determining whether it is appropriate to move from the current deemed debt/equity structures? Why or why not?

**A3** We do not believe that there is merit in conducting this type of study at this time because there are insufficient data available to reach any definitive conclusions If such data had been available, we would have examined them in detail.

**Q4** *To Dr. Lazar:* Please confirm that your recommendation for two debt/equity structures is warranted based on risk differences between larger and smaller LDCs.

**A4** Not necessarily on risk differences, but differences in various measures of financial performance as outlined in our report.

**Page 2** **Q1** *To Dr. Lazar*: Please confirm that your recommendation for 2 debt/equity structures was justified based on "actual reported data".

**A1** Yes, but with the proviso that there were only a limited amount of data available, and some of the data were of questionable quality.

**Q2** *To Dr. Lazar*: According to Mr. Fogwill, as referenced above, your recommendation for 2 debt/equity structures was "more from a transitional point of view than anything else". Is Mr. Fogwill's description of your recommendation correct? Why or why not?

**A2** We arrived at our conclusion based on reviewing the financial information for the LDCs in Ontario. While there appeared to be differences in financial performance between the utilities with less than $300 million in total assets and those with more than $300 million, the differences did not always indicate that the "smaller" utilities fared worse or faced greater financial risks. In our report we did not comment, nor were we asked to comment on whether there should be a transitional period towards a single or different capital structure for the LDCs. However, we believe that we did comment at the Technical Conference that there were too many LDCs in the province and that consolidation probably was warranted and likely would occur if the rules governing acquisitions were to be changed. So even though our recommendations did not address the transition issue and were intended to set out what we believe would be the appropriate size-related capital structures going forward, our recommendation should not be viewed as ruling out a single capital structure when consolidation reduces the number of LDCs. At that time, possibly when a new review of the cost of capital (perhaps in three years time) would be undertaken, the capital structure debate should be reviewed.

**Q3** *To Dr. Lazar*: If the answer to #2 is affirmative, please explain why your June 14, 2006 report *Calculating the Cost of Capital for LDCs in Ontario* did not indicate that transitional reasons contributed to your recommendation for 2 debt/equity structures.

**A3** No need to comment further.

**Page 3** **Q1** *To Dr. Prisman:* Do you agree with Mr. Fogwill that your recommendation for 2 debt/equity structures was "more of a transitional type of approach". Why or why not?

**A1** Please see response to Bluewater Page 2 - Q2.

**Q2** *To Dr. Prisman:* If #1 is confirmed, please explain why transitional considerations were not mentioned in your June 14, 2006 report *Calculating the Cost of Capital for LDCs in Ontario* or in Dr. Lazar's June 18, 2006 presentation at the technical conference.

**A2** Please see response to Bluewater Page 3 – Q1, above.

**Q3** *To Dr. Prisman:* Please confirm that the RRR data for 2002, 2003 and 2004 was used as the basis for your report *Calculating the Cost of Capital for LDCs in Ontario*?

**A3** We believe that we used the EDR data.

**Q5** *To Dr. Prisman and Dr. Lazar*: Please explain how the conclusions in your report *Calculating the Cost of Capital for LDCs in Ontario* would differ if they were based on 2006 EDR data instead of RRR data.

**A5** Since we only used one data set, we do not know how our conclusions might change if we had used the other data set instead.

**Page 4** **Q1** *To Dr. Prisman and Dr. Lazar:* Please provide all background information, reports, data, etc. that you relied on to derive your findings/conclusions contained in the paragraph from your report *Calculating the Cost of Capital for LDCs in Ontario* referenced above.

**A1** We will track down the S&P report(s) that we cited.

**Page 6** **Q1** *To Dr. Prisman:* Please reconcile your response to Mr. Shepherd's question above with Dr. Lazar's explanation as to how you and he concluded that stratified deemed debt/equity structure is appropriate.

**A1** Given the division of labour between us, Dr. Lazar analysed these data and Dr. Prisman reviewed verbally with Dr. Lazar his findings and conclusions regarding size-related capital structures.

# Hydro One Networks, Inc.

Cost of Capital – Specific Request for Clarification

**Q1** Reference: Lazar and Prisman Report dated June 14, 2006, p. 39, Table 10

Could Drs. Lazar and Prisman please explain why the levered betas for 2004 and 2005 are identical?

**A1** The betas were obtained from the FP Advisor which reported the betas (as of the date requested). Hence we used their betas for both years. We however did have the D/E ratios for each of the years and this was the only different between the years. It is possible to redo the analysis using their betas for both years, although we do not believe that this will significantly alter the results.

**Q2** Reference: Lazar and Prisman Report dated June 14, 2006, p. 19, Table 4

a) Are the after-tax ROEs shown in this table real or nominal returns?
b) What were the final proposals by OFGEM for the ROE for the distributors?
c) If the answer in part (b) is expressed in real terms, what would be the approximate corresponding nominal ROE?

**A2**
a) Nominal terms.
b) Don't remember, but the ROE would have been in nominal terms to avoid estimating future rates of inflation.
c) see a)

**Q3** Reference: Lazar and Prisman Excel interest rate file

Preamble: The raw data in the excel file show a 10- year zero coupon yield of 4.75% and a 30-year yield of 4.946% for May 19, 2006. The Bank of Canada shows yields of 4.3217% and 4.2557% for the same day.

a) Can Drs. Lazar and Prisman explain why the differences are so significant?
b) If Drs. Lazar and Prisman were using a different series of data than appears on the Bank of Canada website (e.g., one that includes more than just Government of Canada bonds), could they either explain why that would be appropriate or, if it is not appropriate, re-estimate the forward rate using the correct series?
c) Would they also provide the forward rate for the longest available period?

**A3** a) The data for the yields are derived from prices of outstanding bonds after solving an optimization problem. The differences are the results of the choice of the smoothing methods (the functional choice etc.).

b) The data we used were from a third party since at that time of the report, the data for that date were not available form the Bank of Canada. These data were, to the best of our knowledge, generated only from Government of Canada bonds, even though they report yields for more dates than the data from the Bank of Canada.

c) Forward rate can be generated for any period – past a certain date extrapolation should be used. We see no value in generating the forward rate for infinity.

**Q4** Reference: Lazar and Prisman Report dated June 14, 2006, p. 46

Preamble: Drs. Lazar and Prisman report five and ten year market returns of 7.17% and 10.65% respectively. These returns are geometric averages.
Could Drs. Lazar and Prisman please provide the corresponding arithmetic average returns for the same periods?

**A4** We believe these are reported in the excel file submitted.

**Q5** Reference: Lazar and Prisman Report dated June 14, 2006 and Presentation dated June 20, 2006.

In the Report dated June 14, 2006, Drs. Lazar and Prisman recommend an unlevered beta of .357. In the June 20, 2006 presentation, they appear to recommend betas in the range of .2033 and .357. Could they please explain why their recommended beta changed?

**A5** There was no change. In the June 14 Report, we used only the 52-week beta estimates. In the June 20 Presentation, we used the 52-week estimates (producing 0.357) and the 60-month estimates, which also were reported in the June 14 Report (producing 0.2033).