Re: p. 6, lines 11-12

Dr. Vilbert states, "Specifically, the revenue requirement is higher, for higher levels of debt in Hydro's capital structure."

(a) Please confirm that this conclusion is a direct result of Dr. Vilbert's belief that the ATWACC is constant across a broad middle range of capital structures. If it cannot be confirmed, please explain why not.

Response:

The conclusion is based in part upon the constancy of the ATWACC but also on the procedure adopted to estimate the cost of equity capital for a Crown Corporation and Hydro's tax status as a Crown corporation. Specifically, the conclusion rests first on the decision to determine the opportunity cost of capital for Hydro's equity in relation to the return on equity available for comparable risk investor owned companies ("IOUs"). If IOU companies with available market data are accepted as a relevant benchmark for the required return on equity for Hydro, the appropriate level of overall risk and return can be estimated from a sample of such companies as measured by the ATWACC. (As mentioned in Dr. Vilbert's evidence on page 6, line 20 through page 7, line 19, the standard approach of adjusting the sample companies' estimated return on equity for differences in capital structure will give the same answer, if implemented properly.) Using the ATWACC method, Dr. Vilbert derives the required return on equity from the constancy of the ATWACC across a broad middle range of capital structures. Finally, the revenue requirement for Hydro increases with increasing amounts of debt because of the tax disadvantage of debt for Hydro relative to equity. Debt is more expensive for Hydro than to an IOU because the IOU can deduct its interest expense from its income taxes. See the response to NLH-27 for a discussion of the tax advantage of equity and the tax disadvantage of debt for Hydro relative to investor owned utilities.

Re: p. 6, lines 11-12

(b) In light of the conclusion referenced in the preamble, what recommendation would Dr. Vilbert make to the Board with respect to the amount of debt which should be included in Hydro's capital structure?

Response:

Dr. Vilbert has not studied the issue of the optimal amount of debt that Hydro should use in its capital structure, or even whether there is an optimal capital structure. However, note that reducing the amount of debt from the forecast level of 83 percent by substituting equity will reduce Hydro's revenue requirement, and therefore, the tolls for ratepayers, if the reduction in financial risk is properly reflected in the return on equity. The ATWACC for investor owned utilities is constant over a range with substantially more equity than Hydro's forecast level of equity.