Re: p. 6, lines 5-7

Dr. Vilbert states, "Even though Hydro pays no corporate income taxes, the benchmark sample companies used by cost of capital witnesses do; therefore, an appropriate opportunity cost of capital for evaluation is the ATWACC."

(a) Please explain in further detail why the ATWACC of utilities who are taxable is the appropriate cost of capital for Hydro, which is not taxable.

Response:

The ATWACC approach has nothing to do with the selection of a sample of companies to benchmark the cost of capital for Hydro. It is a method to estimate the cost of capital once appropriate samples have been selected.

Please refer to Section II.B., "Absence of Pure Plays" of Dr. Vilbert's written evidence and page B-16, lines 10-18. As noted in that section, the difficulty facing a cost of capital witnesses for a Crown Corporation is selecting benchmark samples of comparable risk. Under the rate of return on rate base methodology, Dr. Vilbert believes that the equity invested in Hydro should expect to earn a return equal to the expected return on equity invested in comparable risk companies. Therefore, samples of investor owned regulated utility companies in Canada and the U.S. are reasonable starting points to estimate the overall cost of capital for Hydro. This is also the approach used by Ms. McShane, although she does not use the ATWACC method to estimate the cost of capital. Even though Ms. McShane does not explicitly consider the capital structure and tax rate of the companies in her samples, her sample companies are taxable corporations with market value capital structures that vary from each other. The returns on equity estimated by Ms. McShane (or any other cost of capital witness using market data) are a function of both the business risk and the financial risk of the companies. The ATWACC approach is simply a method to insure the consistency of the estimated return on equity and the financial risk (capital structure) of the sample companies. As noted in Dr. Vilbert's evidence on page 6, line 20 through page 7, line 19, the ATWACC and the standard approach will give the same answer if the standard approach is properly implemented.

Re: p. 6, lines 5-7

(b) Dr. Vilbert's qualifications in Appendix A indicate that the he has given expert evidence on cost of capital in both Canada and the U.S. Would Dr. Vilbert use different tax rates for Canadian companies than for U.S. companies to estimate their ATWACCs?

Response:

Yes, if the marginal corporate income tax rates differ. The appropriate tax rate to use to estimate the cost of capital for investor owned utilities is the marginal corporate tax rate of the company whose cost of capital is being determined ("the target company"). When Dr. Vilbert estimates the ATWACC for a Canadian company, he relies on the target company's marginal Canadian corporate tax rate for all companies included in his sample(s) whether the sample companies are Canadian or U.S. companies. When Dr. Vilbert estimates the ATWACC for a U.S. company, he relies on the target company's U.S. marginal corporate tax rate for all companies included in his sample(s).

The target company's tax rate is the appropriate rate because the sample is providing evidence regarding the ATWACC for the target company as if it had the sample company's capital structure, bond rating and estimated cost of equity. In other words, the estimation procedure is estimating the cost of capital for the target company, not the sample companies.