Re: p. 28, lines 6-8

Dr. Vilbert states, "The debt guarantee provided by the Province has no effect on the ATWACC for Hydro because Hydro is paying a debt guarantee premium that compensates the Government for the credit risk to taxpayers of providing the guarantee."

As an independent expert on cost of capital, does Dr. Vilbert believe the guarantee is a component of the return on equity? Please explain the answer.

Response:

The debt guarantee allows Hydro to issue debt at a lower cost (yield) at higher levels of debt than it could without the debt guarantee. Without the debt guarantee, Hydro's interest cost would be higher. If the sum of the debt guarantee fee and the interest cost equals the cost of debt without the guarantee, the guarantee fee would be fair compensation for the risk of default. In this sense, the debt guarantee is a cost of debt.

In Hydro's case, the debt guarantee fee is paid to the equity holder, who is the party providing the guarantee. In this sense, it is compensation to the equity holder. Nonetheless, since the compensation would go to a third party (e.g., the Federal government) if it provided the guarantee, Dr. Vilbert believes it is economically more appropriate to view the guarantee as a cost of debt.