Q. Provide support for the position that Hydro's cost of debt would be more than 100 basis points higher in the absence of the Government guarantee (KCM, page 26, lines 29-32).

A. The conclusion was based on Ms. McShane's judgement, based on her analysis and knowledge of the financial parameters and debt ratings of Canadian utilities, that, at the proposed financial parameters (i.e., a common equity ratio of 15%, a return on equity of 3% and interest coverage of approximately 1.1 times), Hydro would not be able to achieve an investment grade debt rating on a stand-alone basis. "Stand-alone" in this context means without any government backing or financial support from unregulated operations. Investment grade is considered to include debt ratings of BBB- and above. At its forecast financial parameters Hydro would be unlikely to be rated higher than BB+.

The typical utility rating in Canada is A-; recent spreads between long-term utility debt rated in the A category and 30-year Canadas have been close to 140 basis points (recently about 7.40% versus 6.0%). Hydro's long term debt, which trades at yields similar to those of the Province of Newfoundland, has been trading at yields about 60 basis points below the yields on A rated investor-owned utility debt.

Since the market for both BBB and BB debt is relatively thin in Canada, there is little empirical evidence of the spreads Hydro would encounter as a stand-alone entity. However, the broader U.S. market provides an indication of the size of the spreads that would be encountered by companies raising debt at BBB and BB ratings. For a utility, the incremental spread between a BBB rating and an A rating has averaged about 25 basis points over the past five years. However, the incremental spread encountered once a company is no longer investment grade is likely to be at least 75 basis points. That estimate was derived by comparing spreads on BB+ and BBB industrial bonds over the past five years as reported by Standard & Poor's; the average spread was 82 basis points. [Standard & Poor's maintains no indices for BB+ rated utility bonds] Consequently, at a BB+ rating – assuming the market were receptive to an issue – Hydro would likely encounter spreads of no less than 100 basis points above the yields on A rated Canadian utilities, and, under current market conditions, no less than 150 basis points above the yields at which it can currently raise debt with the benefit of the Provincial guarantee.