Q. Should the debt guarantee fee paid to NLH's equity owner be considered to be a portion of (or in some way related to) the equity owner's return on investment. Please provide a complete explanation of this answer.

A. The debt guarantee fee should not be considered part of the shareholder's return on investment unless the fee is shown to include an amount in excess of that required to assume the risk of default on the debt. That question can be addressed by comparing Hydro's cost of debt inclusive of the guarantee fee to its stand-alone cost of debt.

The typical investor-owned Canadian electric utility is financed with 60% debt and 40% equity. For Hydro, on a stand-alone basis, such a stand-alone capital structure would allow it to achieve debt ratings in the range of BBB(high) to A(low). As a stand-alone Canadian utility with a 60/40 debt/equity capital structure and a split A(low)/BBB(high) rating, Hydro would incur a cost of new long-term debt, under current market conditions, of approximately 175 basis points over 30-year Canadas (cost rate of 7.75% at a 6% 30-year Canada yield).

With the debt guarantee, under current market conditions, Hydro is able to borrow long-term debt at approximately 50 basis points above 30-year Canadas (i.e., at 6.50% assuming a 6.0% 30-year Canada). Hence, at a 60/40 debt/equity capital structure, Hydro should be willing to pay up to 125 basis points for the debt guarantee. Anything in excess of that would need to be considered part of the equity compensation.

At its actual forecast capital structure containing 86% debt, Hydro would be unable to access the long-term debt markets in Canada on a stand-alone basis. Without the Provincial debt guarantee, Hydro would, at its current capital structure, be rated below investment grade (i.e., no higher than BB). To put this in perspective, the recent spreads in the U.S. (where there is an active non-investment grade bond market) between long-term BBB and BB+ bonds has been approximately 200 basis points. Consequently, without the guarantee, it is not unreasonable to conclude that Hydro's cost of long-term debt – assuming a market – would be 350-400 basis points higher than the risk-free rate. Consequently, as long as Hydro pays less than 300 basis points for the guarantee, it would be incurring a lower debt cost than it could obtain on its own. The debt guarantee, however, costs only 100 basis points.

As the Province is assessing a debt guarantee fee that results in Hydro, at its actual capital structure, facing a materially lower cost of debt (including the fee) than it would incur if it attempted to raise debt with no guarantee and an 86% debt ratio, it is clear that the debt guarantee fee does not contain compensation for the required return on the shareholder's equity investment.