Consumer Advocate's Comments on Undertaking 11 filed on 13 November, 2009

We have examined the undertaking response by NP which addressed the Chairman's request of November 10, 2009 asking why Fortis would not be included as a comparable for NP and for both NP and Fortis' relative risk and returns on equity. We comment as follows:

1. Fortis is clearly useful as a proxy for NP since it is predominantly regulated and NP's parent. Dr. Booth used Fortis in his sample of Canadian holding companies, where he estimated their betas as well as in his price charts where he tracked the performance of Canadian UHCs during the recent financial crisis. The comment about an "element of circularity" is specious. While it is true that the market price reflects an expectation about the future allowed ROE, this does not in any way invalidate using Fortis' beta or DCF estimated fair return as a proxy for NP.

    a. Fortis' beta will reflect prior market expectations (guesses) about the allowed ROE and capture the impact of regulation in previous periods. It will thus take into account what the market has expected the regulator to do in the past.

    b. In terms of DCF estimates, the Ontario Energy Board specifically dropped reliance on DCF estimates after the public float of Consumers Gas was taken out by Enbridge since it felt that DCF estimates were most useful when derived from the regulated enterprise. By implication the OEB saw no "circularity" and there should not be any since the market price will adjust causing the dividend yield to offset any change in growth expectation.

c. The unregulated operations would increase Fortis' risk relative to the regulated operations. As a result any estimate for Fortis would be higher than the corresponding estimate for NP. This is particularly true for Fortis since as the undertaking notes Fortis' physical assets are limited as its main interest is in the equity ownership in other companies. Holding company (Holdco) debt is almost always riskier than subsidiary debt, since it largely relies on the dividend payments from the sub to service the interest on the Holdco debt. This double leverage means that there is more financial risk at the Holdco level than the subsidiary level, which again makes Fortis riskier than NP.

d. Further as the BMO report indicates Fortis' common equity ratio (1 minus the debt ratio) is forecast to decline to only 31.3% in 2010 versus the much higher allowed rate for NP.

2. In terms of market versus book returns the undertaking response is correct. The fair return standard means estimating a market return and applying this to the book equity, which is why comparable earnings estimates like those in Ms. McShane's testimony are not relevant. However, it is incorrect in implying that there are no implications from observing Fortis' 8.30-8.50% ROEs; there are.

a. First we look at whether investors are satisfied with the 8.30-8.50% ROE. We do this by looking at the market to book ratio. If they were dissatisfied they would sell the stock and it would sell at a discount to book value, but for Fortis this is not the case as it is selling on a market to book of 1.40 and BMO has put a "market outperform" on the stock.

b. Further Fortis' market to book is depressed as a result of the acquisition of Terasen Gas Inc (TGI). This was at a 1.7X book value indicating how highly Fortis valued the BCUC's allowed ROE. This is because the 0.7X premium is a non-earning asset and only the 1.0 earns the BCUC allowed ROE, which was confirmed just the year before Fortis bought TGI. However, the important point is that all of the acquisition value was included on Fortis' balance sheet. We can clearly see this on page 3 of the BMO report as Fortis' market to book ratio drops from the 2.4 level in 2005 before the TGI acquisition.

3. With respect, the assessment that the market expected rate of return on Fortis stock is 12.0% rising to 20.2% is highly misleading. While it is true that the fair return can be estimated as the dividend yield plus the expected capital gain, we are not aware of anyone that would put any weight on one analyst forecast and such an estimate is highly misleading for the following reasons:

a. First, the estimate is derived from a "target" price. The BMO report gives no indication of the time horizon for this forecast. Obviously if it is a two year target price the estimated return is proportionately lower.

b. Second, it is unclear whether this is what the analyst ***expects*** Fortis stock price to be. Unlike the dividend and earnings per share, which are clearly labelled E for expected, the share price is a target indicating the analyst's personal judgment.

c. Third, while the analyst has upped his target price by $2, Fortis stock price very marginally declined between the time of the two reports.

d. If a DCF estimate for Fortis is needed it should be done as in Ms. McShane's evidence based on growth estimates for dividends and earnings. While we believe that analyst estimates are over optimistic, for 2010 BMO is forecasting a 3.85% ($1.08/$1.04) dividend increase. If this is combined with the 4.2% dividend yield we get an estimate of the fair return of 8.0%. While we would not put any weight on this estimate since it is a one year forecast from one analyst, it is consistent with the ROE testimony sponsored by NP, whereas the use of the target price is not.

Dated at St. John's, in the Province of Newfoundland and Labrador, this 18th day of November, 2009.

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