

1 **Q. Please provide information on the interest rates used when determining the value of**
 2 **stock options?**

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 4 A. Hay Group Limited uses a proprietary model based on binomial distribution in its
 5 determination of stock option values. Stock option values are not calculated based on a
 6 discounted cash flow methodology. The stock option value is instead determined based
 7 on an assessment of economic and current grant value.

8
 9 The determination of stock option value is based on a number of variables. The variables
 10 include both standard (i.e. variables common to all companies in the database) and
 11 company specific variables. Standard variables include the risk-free rate and the
 12 forfeiture rate. Company specific variables include term of options, volatility of stock
 13 price, dividend yield and vesting schedule.

14
 15 A brief description of the variables is provided below.

16 *Standard Variables*

17
 18 *Risk-free Rate* – The risk-free rate is used as a variable in the binomial model to estimate
 19 the economic value of the option. It is set at the beginning of each calendar year and is
 20 based on a 1.5 year rolling average of 10-year Government of Canada Bonds. Most of the
 21 stock option plans in the database have 10-year terms. The risk-free rate used is 3.75%.

22
 23 *Forfeiture Rate* - The forfeiture rate is used to recognize the probability of non-vesting of
 24 options. The forfeiture rate currently used is 5.0%.

25 *Company Specific Variables*

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 27 *Term of Options* – The term of option for Newfoundland Power's stock option plan is 7
 28 years.

29
 30 *Volatility of Stock Price* – The volatility factor for Newfoundland Power's stock option
 31 plan is 26.06% and is based on average daily returns of Fortis stock for the last 3 years.

32
 33 *Dividend Yield* – The dividend yield factor for Newfoundland Power's stock option plan
 34 is 3.05% and is based on the annual average of dividend yields of Fortis stock for the last
 35 3 years.

36
 37 *Vesting Schedule* – The option valuation includes the Newfoundland Power vesting
 38 schedule which is 25% in each of the first 4 years of the plan.