

1 Q. **2013 General Rate Application, Finance**

2 Explain how Hydro determined that the 2013 guarantee fee used in the 2013 Test
3 Year Revenue Requirement was a market rate.

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6 A. As discussed in Section 3.2.3.1 of the 2013 General Rate Application¹, the guarantee
7 fee rate prescribed in the 2011 government directive was based on a market
8 analysis undertaken by Scotia Capital in the fall of 2010². Based on market
9 conditions at the time, it was Scotia Capital's view that the guarantee was worth
10 between 25 bps – 50 bps.

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12 As evidenced by the October 2013 report (PUB-NLH-061, Attachment 1), which
13 Hydro commissioned, Scotia Capital continues to hold the view that based on
14 market conditions, the guarantee is worth between 25 bps – 50 bps, depending on
15 the remaining term to maturity of the underlying debt.

¹ Pages 3.5 – lines 1 through 4

² See also Hydro's response to PUB-NLH-059



Guarantee Fee Analysis

October, 2013

Executive Summary

Request

- Newfoundland Labrador Hydro (Hydro) has requested an update on Scotiabank's thoughts on the value of the guarantee provided by the Province. Previous reviews were provided in November 2008 and October 2010.
- Scotiabank continues to hold the opinion that the best approach of measuring the value of the guarantee is to observe the debt financing costs of regulated utilities with ratings that would be somewhat similar to Newfoundland Hydro's rating without a provincial guarantee.
- We understand that Hydro presently pays the Province an annual fee of 25 bps on the principal amount debt outstanding for ten years and under, and a fee of 50 bps on the principal amount debt outstanding exceeding ten years.

Conclusion

- Scotiabank continues to believe that the guarantee is currently worth between 25 and 50 bps. Given the nature of Hydro's liabilities (across the maturity spectrum) Scotiabank believes that a fee of 25 bps for ten years and under, and a fee of 50 bps for over ten years is still reasonable.

Guarantee Fees Across the Provinces

- For comparison purposes, Scotia understands that other Provinces charge the following fees for use of their respective guarantee:



Province of Manitoba: A fee equal to 1% of their total debt outstanding at year end.



Province of British Columbia: A fee on anything over 1 year. The basis of the charge is a recovery of administrative costs rather than a comparison of the borrowing costs of BC Hydro to a private sector alternative (the fee is nominal).



Province of Quebec: A fee of 50 bps on the principal amount of debt outstanding over one year.



Province of Ontario: 50 bps on maturities over one year.



Province of Alberta: For ATB, a fee on all deposits equal to federal deposit insurance (to create a level playing field with the Banks). For all other provincial agencies such as ACFA or AFC: No fee.



Province of New Brunswick: The fee is driven by a specific annual revenue requirement. Currently this equates to a fee of .6489 of 1% on New Brunswick Power's total debt outstanding.



Province of Saskatchewan: No fee.



Province of Prince Edward Island: No fee.

Newfoundland Spreads vs. Various Corporate Utility Spreads

Bond	For the Year Ending Sep 2013			For the Period Oct 2010 - Sep 2013		
	Average	Median	Standard Deviation	Average	Median	Standard Deviation
Hydro One (A1, A+, A(H)) 3.13% due Nov 2014	26.7	24.7	6.8	32.9	32.9	8.6
Hydro One (A1, A+, A(H)) 7.35% due Jun 2030	44.4	43.6	4.5	47.8	46.1	6.2
Hydro One (A1, A+, A(H)) 5.49% due Jul 2040	38.3	32.8	4.6	40.6	39.9	8.7
Enbridge Gas (A-,A) 5.16% due Sep 2014	25.1	24.7	6.7	33.0	31.2	8.7
Enbridge Gas (A-,A) 5.70% due Jul 2036	33.7	33.8	5.0	41.2	33.8	8.2
Enbridge Pipeline (A-,A) 5.33% due Apr 2040	35.4	34.9	4.7	41.9	40.6	7.9
Canadian Utilities Inc. (A(H)) 5.096% due Nov 2014	24.3	25.6	7.0	31.7	31.7	9.2
Canadian Utilities Inc. (A(H)) 4.543% due Oct 2041	32.4	31.3	3.4	35.6	33.7	6.7
DEX Universe Utility Index	24.6	25.8	7.1	38.7	33.4	18.8

- The chart above shows the spread differences between bonds issued by Hydro One, Enbridge Gas, Enbridge Pipeline, Canadian Utilities and the generic DEX bond universe with similar maturities issued by the Province of Newfoundland and Labrador. The concept was to try and isolate the value of the Provincial guarantee in terms of potential cost savings by comparing bonds issued by the Province with a selection private sector bonds of similar maturity dates.
- Scotia chose Hydro One, Enbridge Gas, Enbridge Pipeline and Canadian Utilities Ltd., as those companies are regulated utilities with ratings that would be somewhat similar to Newfoundland Hydro's rating without a provincial guarantee. This comparison assumes that Hydro continues to benefit from the existing timely cost recovery and a favourable return on equity ruling. It also assumes that Hydro would continue to be owned by the Province even if it was not guaranteed.

Newfoundland Spreads vs. Various Corporate Utility Spreads

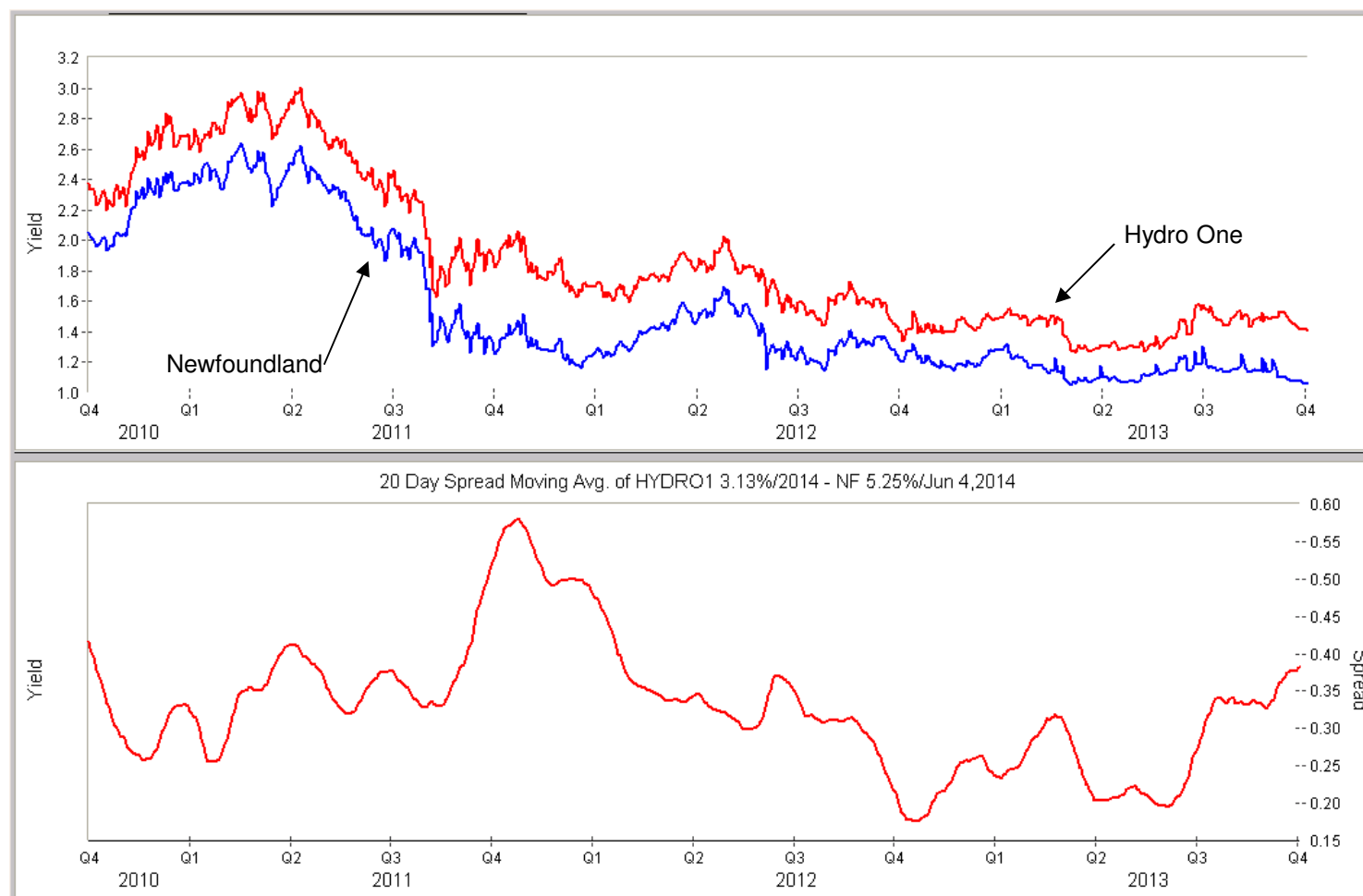
- Of the three Utilities, Scotia believes that Hydro One represents the lower band (in terms of spread over Cda's) given that it is 100% owned by the Province of Ontario. It is important to highlight that Hydro One has a lower debt to equity ratio (approx. 60/40) and does not contain any generation, it's purely transmission. Bond investors typically require higher spreads for regulated generation. Enbridge Gas, Enbridge Pipeline would represent the upper band (in terms of spread) as they have ratings of "A-", are regulated and are owned by private sector investors.
- Where possible, Scotia compared both one year maturities and thirty year maturities. As one would expect, the spread difference for one year maturities was tighter than those spreads for thirty year maturities.
- In addition to Hydro One, Enbridge, Enbridge Pipeline, and Canadian Utilities Inc., Scotia also compared the DEX Bond Universe's "Utility" Index to the DEX Bond Universe's Index for the Province of Newfoundland and Labrador. This comparison includes maturities from 2 years out to 40 years.
- When comparing the current analysis on utility spreads with the previous analysis in 2010 and 2008 it is interesting to note that these spreads continue the trend of moving tighter from the lofty levels reached in the "Credit Crunch" of 2007-2009.
- We also note that the pace of utility spread tightening has slowed down in the period 2010-2013 vs. 2008-2010. Credit spreads have generally stabilized over the last three years and the relative volatility has also decreased significantly.
- It is difficult to predict the future path of utility credit spreads; however, Scotiabank's analysis of spreads from 2008 through 2013 suggests that while these spreads may be subject to temporary swings, they will benefit from the process of "mean reversion" over the medium term.

Conclusion

- It is important to consider that the Province has not issued in the public debt markets since 2007. Thus, its spreads benefit from a certain degree of scarcity value. Recently, the Province's long bonds were quoted on a broker screen at a spread that was through the spread for a comparable Province of Ontario bond. Scotia would suggest that scarcity value is worth approximately 5 bps in a spread adjustment.
- There are two additional features of a Guarantee has that are very difficult to value, namely; that during periods of stress in the credit markets, a guarantee from a government entity provides for unrestricted market access and that a guarantee allows for more flexibility as to maturity.

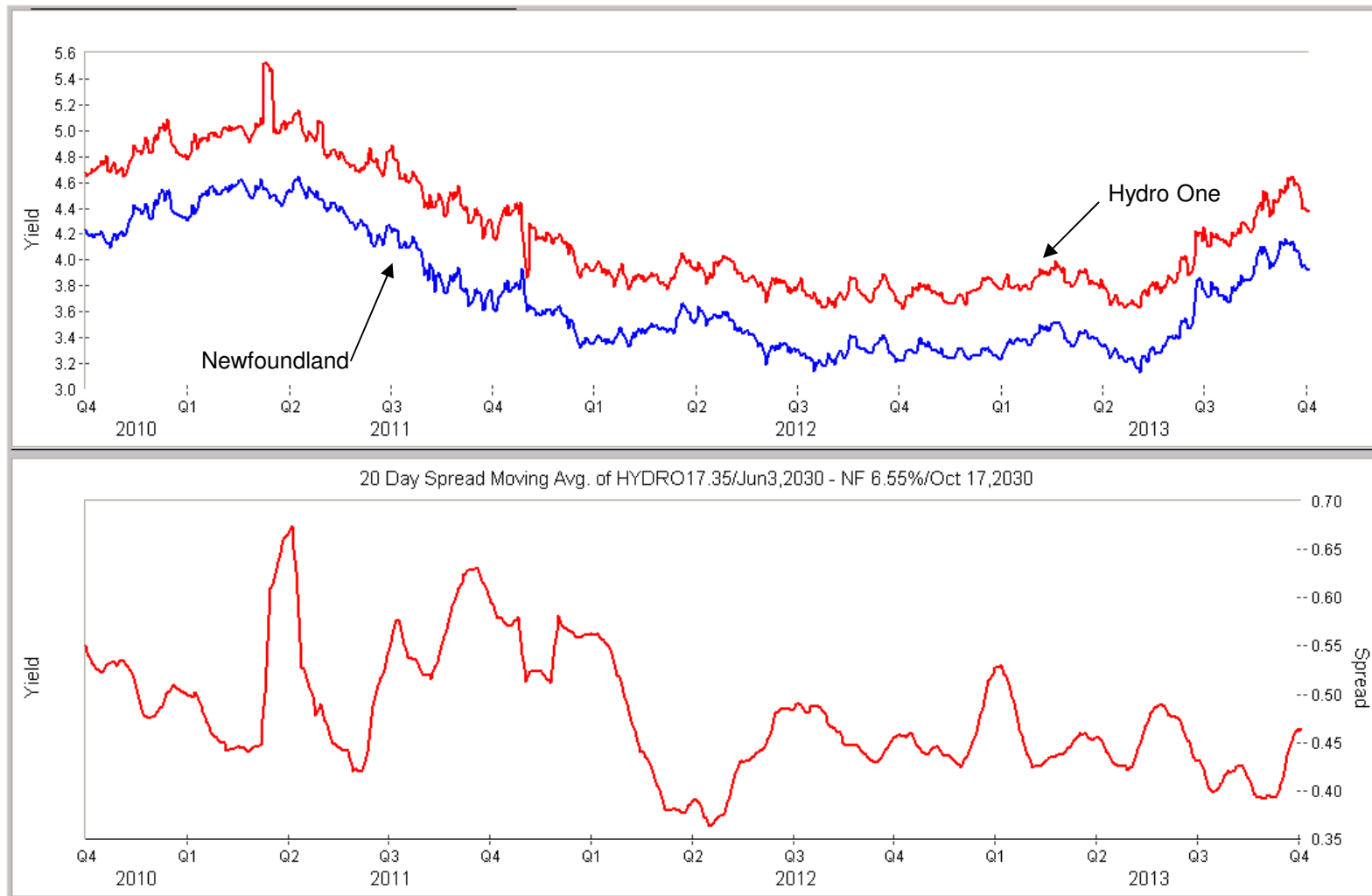
Based on the credit spread analysis of the three utilities and taking into consideration what other Provinces charge their respective Hydro Crown corporations, Scotia Capital believes that a Provincial guarantee fee between 25 and 50 bps depending on maturity is still reasonable.

Newfoundland 5.25% due June 2014 vs. Hydro One (A+) 3.13% due Nov 2014



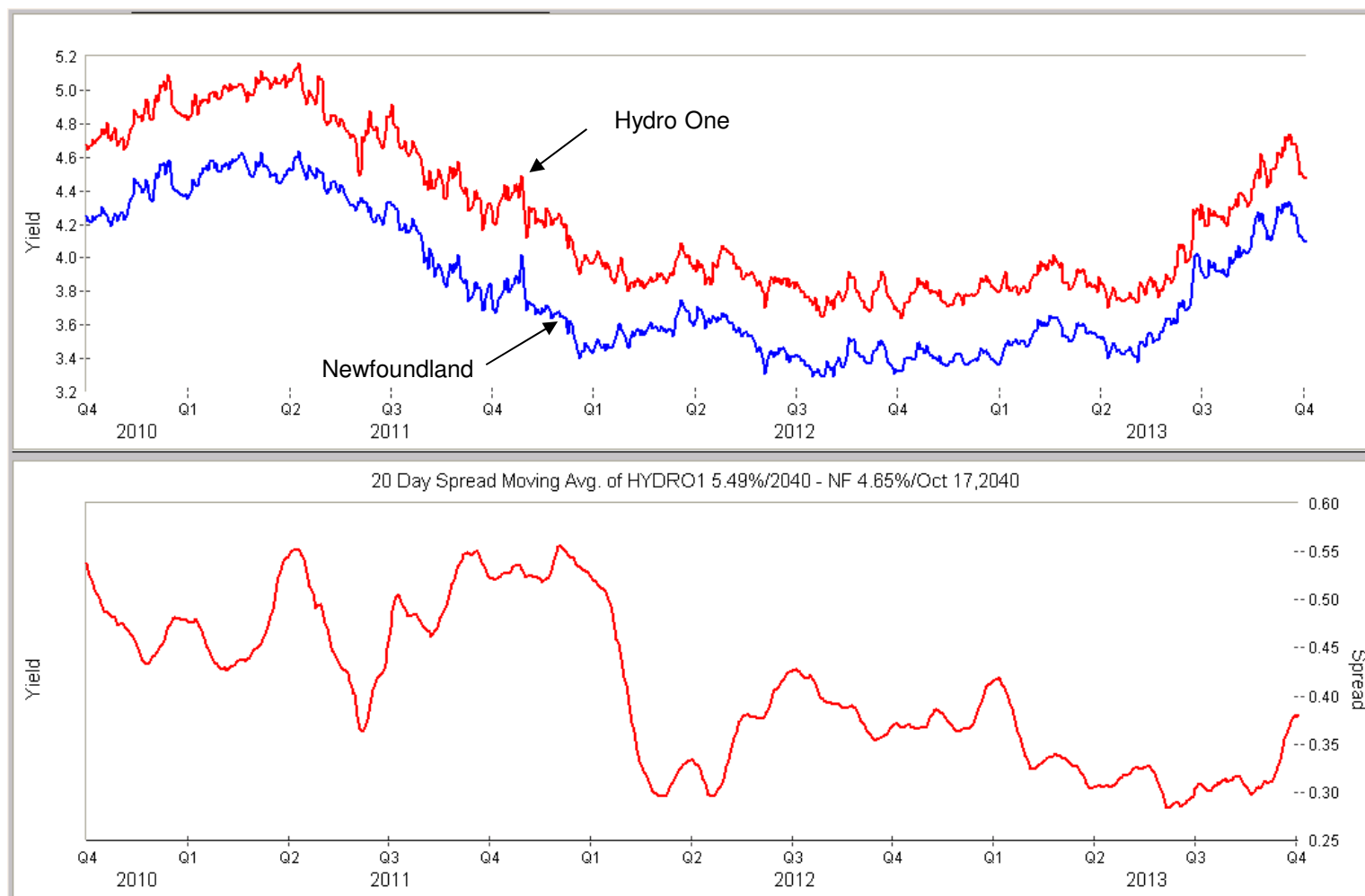
Starting Oct 2010: Average: 32.9 bps, Median: 32.9 bps, Std Deviation: 8.6 bps, Max: 57.9bps, Min: 17.5 bps

Newfoundland 6.55% due Oct 2030 vs. Hydro One (A+) 7.35% due Jun 2030



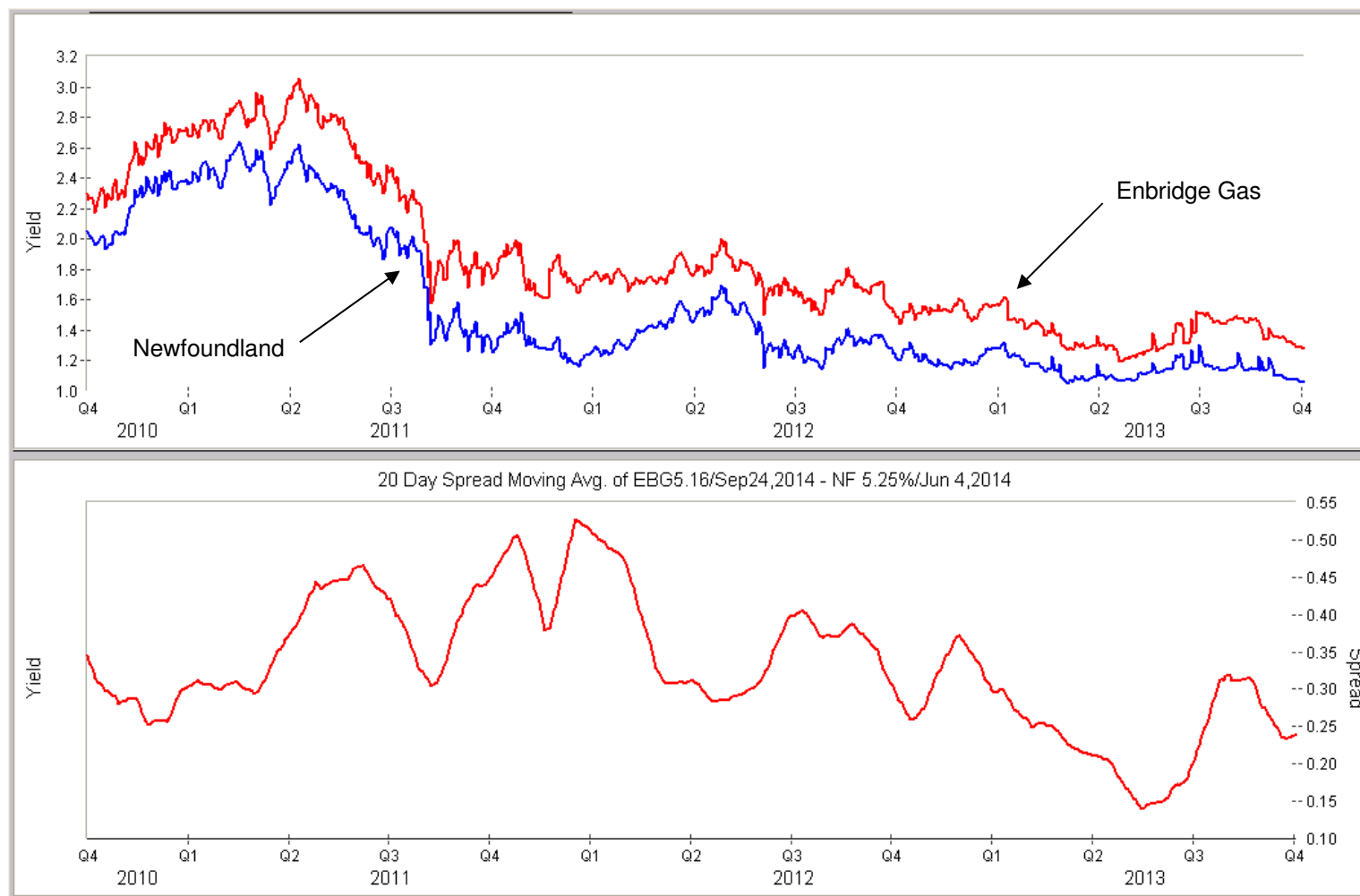
Starting Oct 2010: Average: 47.8 bps, Median: 46.1 bps, Std Deviation: 6.2 bps, Max: 67.4 bps, Min: 36.3 bps

Newfoundland 4.65% due Oct 2041 vs. Hydro One (A+) 5.49% due July 2040



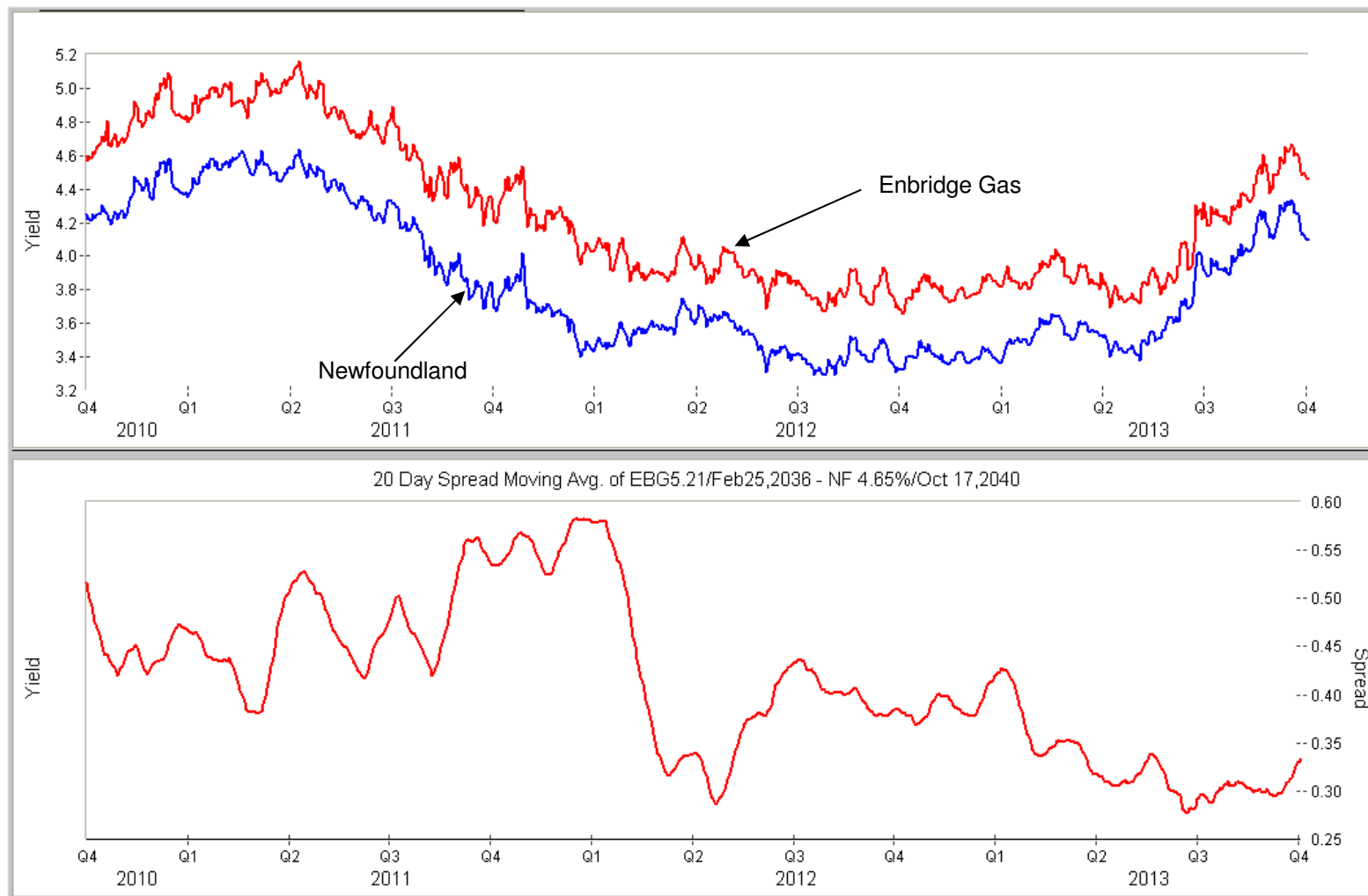
Starting Oct 2010: Average: 40.6 bps, Median: 39.9 bps, Std Deviation: 8.7 bps, Max: 55.6 bps, Min: 28.3 bps

Newfoundland 5.25% due June 2014 vs Enbridge Gas (A) 5.16% due Sept 2014



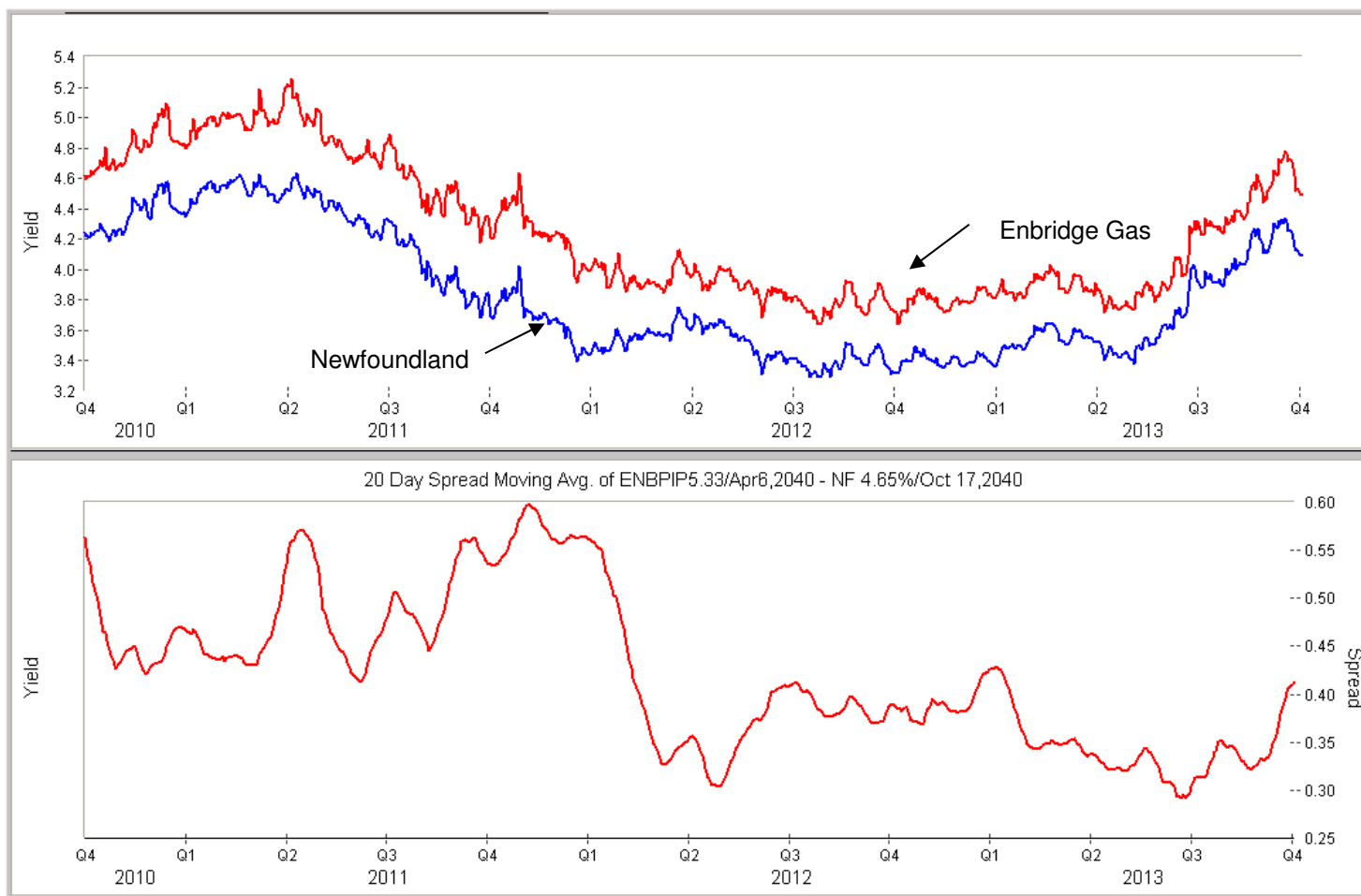
Starting Oct 2010: Average: 33.0 bps, Median: 31.2 bps, Std Deviation: 8.7 bps, Max: 52.7 bps, Min: 14.0 bps

Newfoundland 4.65% due Oct 2040 vs Enbridge Gas (A) 5.21% due Feb 2036



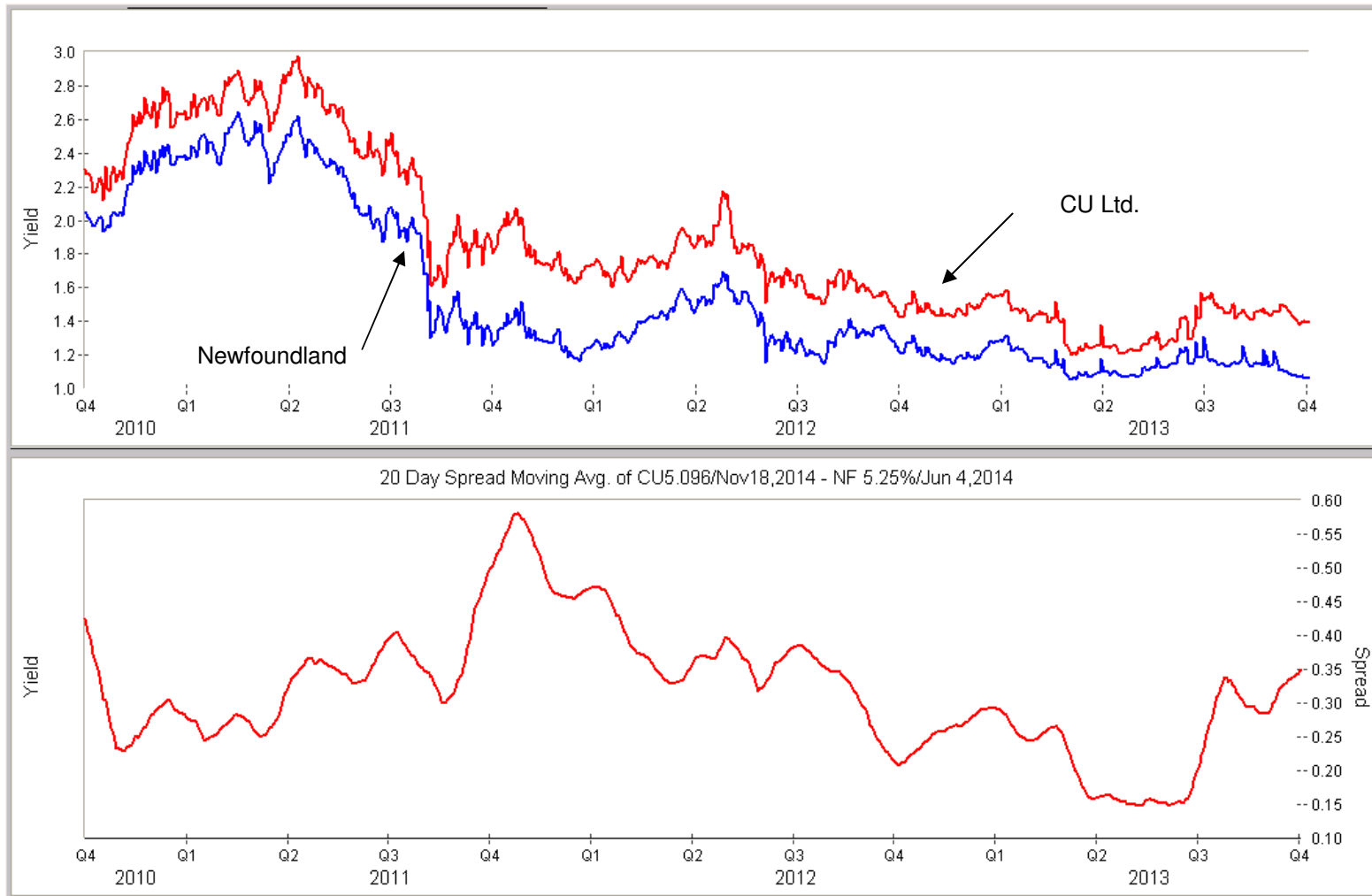
Starting Oct 2010: Average: 41.2 bps, Median: 40.5 bps, Std Deviation: 8.2 bps, Max: 58.2 bps, Min: 27.6 bps

Newfoundland 4.65% due Oct 2040 vs. Enbridge Pipeline (A-) 5.33% due April 2040



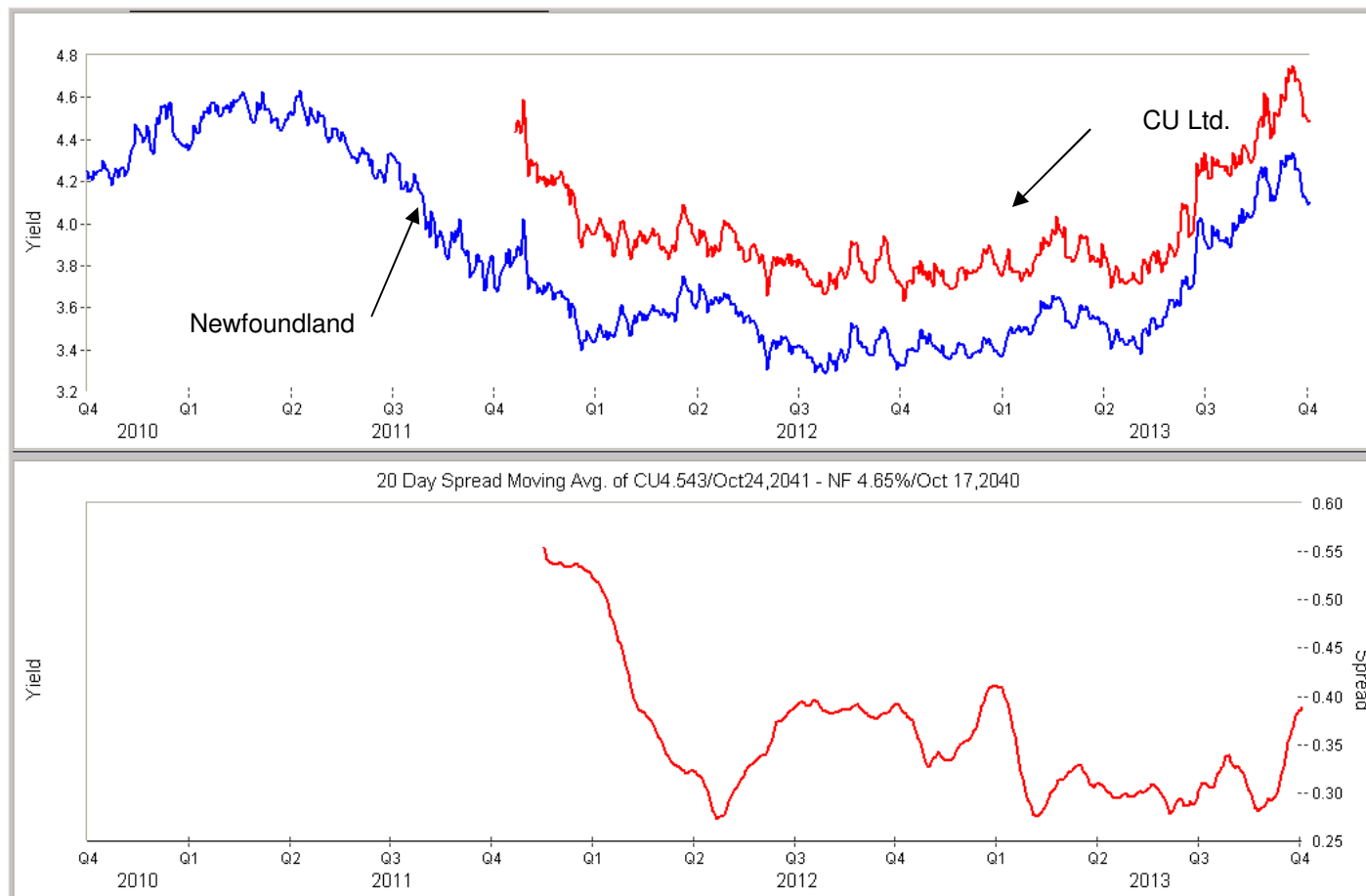
Starting Oct 2010: Average: 42 bps, Median: 40.7 bps, Std Deviation: 7.9 bps, Max: 59.7 bps, Min: 29.1 bps

Newfoundland 5.25% due June 2014 vs. Canadian Utilities Inc. (A(H)) 5.096% Nov 2014



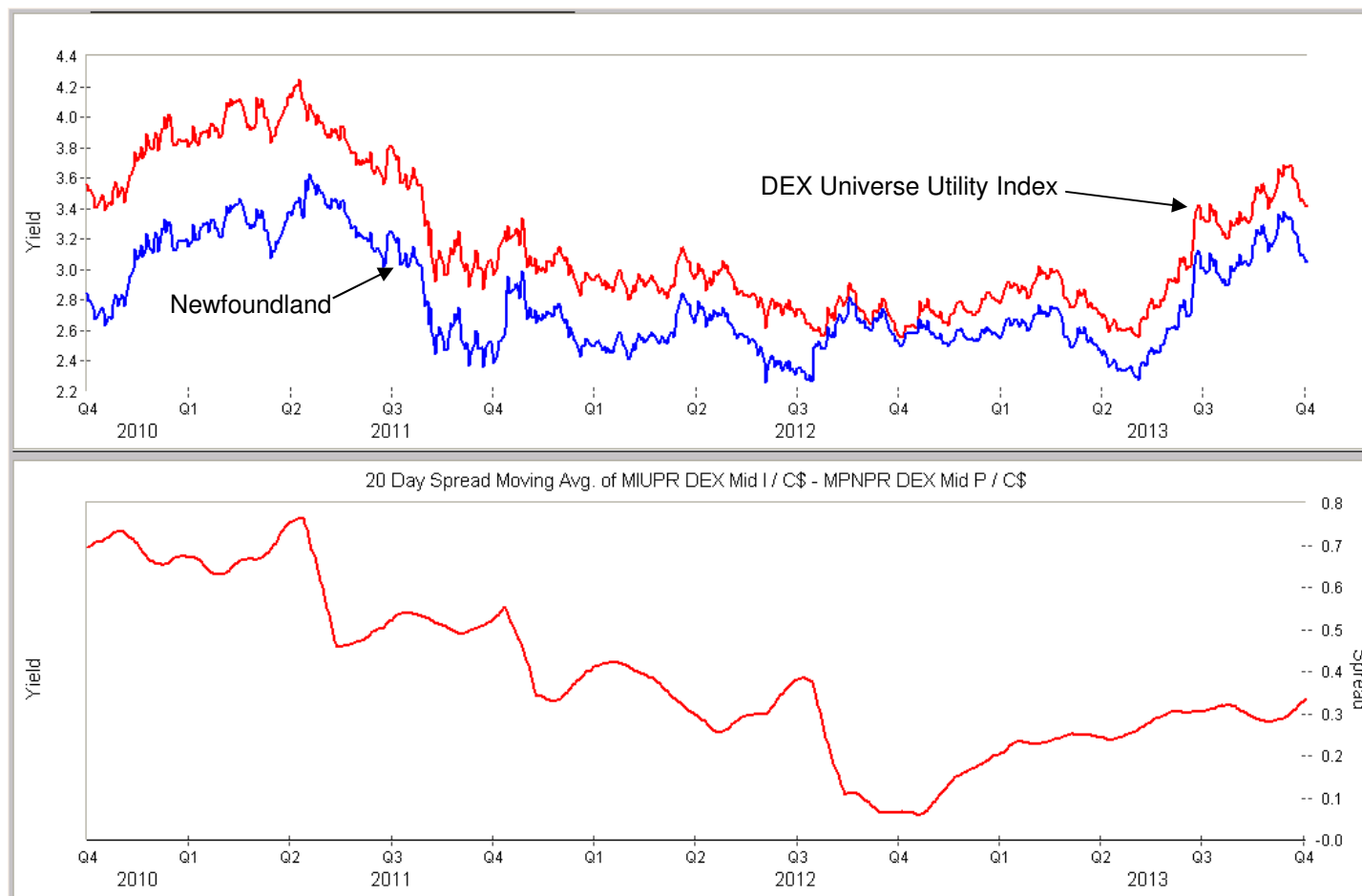
Starting Oct 2010: Average: 35.6 bps, Median: 33.7 bps, Std Deviation: 6.7 bps, Max: 55.3 bps, Min: 27.3 bps

Newfoundland 4.65% due Oct 2041 vs. Canadian Utilities Inc. (A(H)) 4.543% Oct 2041



Starting Oct 2010: Average: 35.6 bps, Median: 33.7 bps, Std Deviation: 6.7 bps, Max: 55.3 bps, Min: 27.3 bps

Province of Newfoundland vs. DEX Bond Utility Index



Starting Oct 2010: Average: 38.7 bps, Median: 33.4 bps, Std Deviation: 18.8 bps, Max: 76.5 bps, Min 5.7 bps