Volume 3, Section 1 – McShane, Cost of Capital

Q. (page 33, lines 895-900)

a. Please provide the empirical support for the average historical spread of 30 basis points between 10-year and 30-year Canada bonds and explain why the time period chosen to develop this historical evidence is more appropriate for Ms. McShane's equity risk premium test than the most recent time period when the spread has been much lower and even negative.

b. With respect to line 900, why is the Government of Canada bond yield curve typically upward sloping - that is, with long-term yields higher than shorter-term yields?

c. Please explain the apparent inconsistency between Ms. McShane's use of a 30-basis-point spread on page 33 of Volume 3, Tab 1, and the Company's use of a 10-basispoint spread, in footnote 24 on page 50 of Volume 1, Section 3: Finance, to forecast the expected coupon rate on its planned $60 million bond issue for late summer 2007.

A. (a) The 30 basis points represent the average spread for the period June 1982-February 2007. The data is found in Attachment A. The historic average positive spread was used in the absence of a consensus forecast of 30-year bond yields for 2008. The 10-year Canadian bond yield forecast and the 10/30-year spread will be updated to reflect more recent information at the time of the hearing.

(b) Long-term bond yields are typically higher than short-term bond yields because there is greater market risk associated with long-term bonds than short-term securities, i.e., a larger percentage change in price for a given percentage change in the interest rate.

(c) There is no inconsistency. Ms. McShane's forecast 30-year yield was for 2008. The referenced forecast NP bond issue is for summer 2007.