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Scotia Capital

Friday, April 17th, 2009

To: The Board Secretary, Ontario Energy Board
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Re: File number EB-2009-0084

From: Stephen Dafoe
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Dear Mesdames/ Messieurs,

I am responding to the OEB's consultative process, initiated by its letter of March 16th, as an interested citizen. I have published corporate debt research on the subject of formula-based allowed ROEs as it relates to a number of other Canadian energy utility regulators. This research has made my views known to Scotia Capital's Fixed Income Research clients, which are chiefly institutional fixed-income investors. Hence, I feel that I am able to offer to the OEB a view from a perspective of Canadian utility bond holders, and Canadian public debt market participants, for the Board's consideration.

Over the past ten months, I have published research on Canadian regulated utilities that are active Canadian corporate debt issuers that discusses my concerns about the trend of formulaic ROE adjustments. These are attached for your information. Disclosures on the last page of each report were current as of the date of each report, and may not be current as of today.

I note the similarities of the OEB's formulaic ROE mechanism with that of other Canadian utility regulators. I believe that my concerns about the recent results of these adjustment mechanisms, as stated in these attached reports, apply equally to OEB-regulated utilities.

Additionally, I attempt to address the OEB's five questions on this matter directly, by offering my views as a corporate debt analyst, as follows.

The OEB's Questions

1. How do the current economic and financial conditions affect the variables used by the Board's Cost of Capital methodology?

2. In the context of the current economic and financial conditions, are the values produced by the Board's Cost of Capital methodology and the relationships between them reasonable? Why, or why not?

2.1 If the values are not reasonable, what are the implications, if any, to a distributor?

3. What adjustments should be made to the Cost of Capital parameter values to compensate or correct for the current economic and financial conditions?

4. Going forward, should the Board change the timing of its Cost of Capital determination, for instance, by advancing that determination to November?

5. Are there other key issues that should be considered if the Board were to adjust any or all of the Cost of Capital parameter values produced by the application of its established formulaic methodology?

Responses

1. The dramatic fall in Government of Canada of Canada bond yields since early 2008 has, through the Board's Cost of Capital methodology, led to a roughly equally dramatic fall in the target or allowed ROEs for Ontario Energy Board-regulated utilities. In this same period, however, the cost of both short-term debt and long-term debt and equity capital for all Canadian corporate bond market participants, and, I believe, the Ontario LDCs, has risen materially. However, the OEB's Cost of Capital methodology, in particular the ROE formula, has not reflected this real-world increase in the cost of capital. (I discuss my views on the dynamics of Canada bond yields in more detail in several of the attached research publications.)

2. I think the ROE result of the Board's Cost of Capital methodology is no longer reasonable. While the real-world cost of corporate debt and equity was rising sharply, the allowed ROE was falling. While the OEB asserts in its March 26th letter that "The Board's established formulaic methodology itself is not at issue", I think it should be, when the annual ROE adjustment is not even yielding the right direction of change in the cost of capital.

Among the Board's three variables, I think the deemed cost of long term debt of 7.62% is less out of line with what it implicitly represents, the current cost of corporate borrowing. I think this is because it references relatively recent real-world data on corporate bond spreads. In contrast, the ROE formula does not reference recent or current equity market conditions.

I think the deemed cost of short-term borrowing is much lower than current actual all-in costs in the bank market or the commercial paper market (particularly if the cost of the requisite back-up bank lines of credit for commercial paper is factored into the total cost of commercial paper short-term funding.) I think the deemed short-term debt rate is a lesser-order concern for credit quality than the ROE, since the deemed short term debt capitalization of LDCs is only 4%. However, I still think the deemed rate of 1.33% is unreasonably low.

2.1 In my view, a lower-than-appropriate ROE is not solely of concern to utility shareholders. Low ROEs depress credit ratios, such as interest coverage, and thus weaken the credit quality of corporate bonds. This is of great concern to investors in utility bonds. Weaker credit ratios can also result in downgrades of bond ratings by the rating agencies.

I note that weaker credit quality, and lower bond ratings, can raise the cost of a utility's new bank, commercial paper, and bond market borrowing. Under rate regulation which allows for recovery of prudently incurred costs, the cost of debt financing is borne not by shareholders, but by ratepayers.

During 2008 and the beginning of 2009, corporate bond spreads rose to levels far above historical averages, and what came to be considered normal for much of the past decade. As well, at certain times in the last several months, the market demand for new corporate debt issues has dropped to virtually nothing. This has materially decreased the availability of term debt for companies that have previously enjoyed good access to debt capital. While term debt markets have been improving lately, I believe that a material risk persists that the cost of debt may remain high, and availability may remain constrained.

Unfortunately, these debt market conditions arise at the beginning of a period when many of the Ontario LDCs and TFOs will be expected to undertake significant capital spending, for: generational equipment replacement; to improve system safety and reliability; to accommodate residential, commercial, institutional, and industrial load growth; and to accommodate, in a variety of ways, government-mandated "green energy" policies and directives.

3. I think that the deemed cost of short-term debt and the allowed ROE should be raised, prior to or soon after the May 1st rate year begins.

The deemed cost of long-term debt is not as inconsistent with real-world costs, and thus less of a concern for LDCs in our universe of coverage, though there may be LDCs that are sensitive to it, so this could also be adjusted.

I offer two very simple suggestions, which both have the advantage of being expedient. I think the 2007 and 2008 ROEs implied by the NEB's recent Trans Québec & Maritimes Pipeline decision would be reasonable for Ontario LDCs for the 2009 rate year. (While the NEB decision reflects acknowledgment of higher risk at TQM since the RH-2-94 Decision, I believe the majority of the change in TQM's return on capital is due to adjustment for the changes in the relationship between Canada bond yields and the cost of equity capital for all similar firms, including the Ontario utility sector.)

Alternately, the Board's March 16th letter notes that, in 2008, a 247 basis point (bp) difference prevailed between the OEB's deemed cost of long-term debt and the allowed ROE. I think that there is a more direct link between corporate bond yields and the corporate cost of equity capital, than between Canada bond yields and the cost of equity capital. I believe that this more direct link is persistent through time, though I believe that it has become very clear and obvious in the current distressed capital market conditions. I suggest that the Board reinstate the 247 bp difference between the deemed cost of long-term debt and the allowed ROE that prevailed in 2008, for the rate year beginning May 1st, 2009. This would yield an ROE of:

$$7.62\% + 2.47\% = 10.09\%.$$

I think any number of suggested discretionary adjustments to the ROE could be logically supported by sensible rationales. I think an outcome close to the range of my two suggestions, yielding an ROE in the 9.8% to 10.1% range, would be quite easily justifiable under today's economic and financial market circumstances, and would not be an undue exercise of the Board's discretion in these matters.

I suspect that an appeal to current (2008 and 2009) relevant recent bond market and equity market data, in a methodology such as that relied upon by the NEB in its TQM decision, or some other objective methodology, would yield implied ROE results (assuming OEB capital structure assumptions) higher than the 9.8% to 10.1% ROE range we suggest above. Such an approach might be preferable, on transparency grounds, if it could be completed quickly, to reach a decision by or shortly after the beginning of the new rate year on May 1st. While transparency objectives might be better achieved by a more lengthy process, I believe delays in implementation may outweigh the perceived transparency benefits, under these difficult capital market circumstances.

I think the current cost of short-term debt is something in the range of Canadian BAs plus 200 bps to 225 bps, for single-"A" category rated utilities. Many LDCs may have ratings lower than single-"A", and could in my opinion face higher short term borrowing costs in either the bank or commercial paper markets.

4. I think the timing of the annual reset of the ROE and the cost of short-and long-term debt should, if anything, be moved closer to the May 1st start of the rate year. Perhaps it makes even more sense to move the start of the rate year to January 1st, for simplicity's sake. In any event, I think there are clear advantages to having as short a time interval as practical between the time of the Cost of Capital parameters' update and the start of the rate year.

Alternately, the Cost of Capital reset could be made more frequently than annually, on a regular basis, or on an as-needed basis, should unusual or extreme circumstances, such as we have today, warrant more frequent adjustment. I think a more pressing concern than moving the timing of the Cost of Capital determination is to have an ROE adjustment mechanism that is both timely, and more responsive to current changes in the real-world cost of capital.

5. While I acknowledge that there are generally a wide range of "issues" to address at any given time in Ontario's regulatory environment, I think the present ROE situation arises directly from the acute gap between the ROE formula results and the real-world cost of capital. As a result, I think that the act of the OEB's addressing ROEs does not trigger other "key issues" that must be addressed simultaneously, as long as there is a sensible rationale for the adjustment.

All the above responses to the OEB's five questions, and the attached research reports, represent my personal opinions as a corporate bond research analyst.

In making this submission, I do not expect that I am eligible for, and in any event I am not applying for, a Cost Award or any other payment.

Please feel free to contact me, by telephone, or by e-mail, if you would like me to clarify any of the above, discuss related matters, or if I can be of any other assistance.

Yours truly,

Stephen Dafoe
Director, Corporate Bond Research

Stephen Dafoe

Trans Québec & Maritimes Pipeline Inc. (A(low)/ BBB+/ n.r.) is an infrequent issuer in the Canadian bond market, and not often the center of attention. Now, however, we think that TQM's 2007 and 2008 rate case before the National Energy Board merits the interest of investors in Canadian utility bonds. TQM is thinly capitalized, at only 30% equity, compared to levels now prevailing at its peers in the Canadian pipeline and gas distribution sector. Yet, it has been receiving the same formula-based ROE as more comfortably capitalized NEB-regulated pipelines, such as TransCanada's Mainline. TQM is requesting a "review and variance" of the NEB's 1994 Multi-Pipeline Cost of Capital Decision ("RH-2-94"), asking for "11 on 40" (an 11% ROE on 40% deemed equity capitalization). This "R&V" is a very unusual request, as the NEB's intent was clearly to have a "one size fits all" formulaic annual ROE adjustment, as defined by RH-2-94, to apply uniformly to the sector. Nonetheless, even though 11 on 40 may seem like a dramatic departure from the 2008 formulaic ROE of 8.71% on 30% equity, we think that TQM has a strong case before the NEB. Because NEB Decisions are viewed by many as influencing the Decisions of provincial regulators, we think this case may have the potential to set a precedent of sorts. Alongside the many reasons detailed in TQM's evidence filed with the NEB, we think the repricing of risk in credit markets is also relevant to TQM's case. Public hearings are scheduled for September, and a Decision anticipated in early 2009. While this may seem a long way off, we think it merits the attention of bond investors, and we will follow the application with great interest. For now, TQM has only 2009 and 2010 maturities in the market, which we have marked at spreads of 95 and 125, respectively. We think that a favourable outcome with the NEB would clearly be positive for TQM spreads.

TQM Business Risk Profile and Performance

TQM has a capacity contract with TransCanada Pipelines that runs to 2013. Hence, in the short run, TQM's revenue risk is consistent with TransCanada's ratings as a counterparty. It thus becomes tempting to infer that TQM's business risk is "low", pure and simple.

We think that such an assumption would be akin to assuming (for example) that Alliance Pipelines' business risk is low, because it is similarly contracted (with shippers) to 2015. However, we believe that recontracting risk is material, in both cases. In the case of Alliance, we have very lately become somewhat more comfortable with recontracting risk, given the explosion of shale gas exploration in the Horn River Basin of Northeast B.C., and the likelihood of this potential new supply seeking the attractive markets Alliance delivers to in the U.S. Midwest, with connections to the U.S. Northeast and eastern Canada. We acknowledge, though, that for now, there is no material commercial shale gas production anywhere in Canada, and thus this supply remains somewhat speculative.

In the case of TQM, it is tempting to assume that recontracting risk is especially low, because TransCanada owns 50% of TQM. However, as with the TransCanada Mainline, declining supply from the Western Canadian Sedimentary Basin, competition for throughput with Alliance, and rising demand for natural gas in Alberta, among other factors, may continue to lead to lower volumes through the Mainline, and consequently higher toll charges per unit volume. This dynamic affects TQM's competitive position, as well as TransCanada's. Additionally, the Canaport LNG terminal is expected to begin delivery of natural gas on the Maritimes and Northeast Pipeline in the very near future. TQM will then face direct competition for its natural gas sales to the New England states, made via the "PNGTS extension", part of the TQM system built in 1998 to connect to the Portland Natural Gas Transmission System. TQM believes its volumes delivered to PNGTS may decline significantly once Canaport is operating in 2009. An LNG terminal (either Rabaska or Gros Cacouna) may be built on the St. Lawrence River. However, neither of these projects is yet certain, and neither would be built before 2012. If one of these terminals is built, deliveries on the PNGTS extension could improve, but would almost certainly remain at lower-than current levels. TQM submits in its evidence that the risk the PNGTS extension may not fully recover its undepreciated costs is material. The PNGTS extension is over 50% of TQM's undepreciated cost base.

TQM submits that its business risk has not declined relative to what it was when the RH-2-94 Decision set its deemed equity capitalization at 30%, and set the NEB's formulaic ROE adjustment.

We calculate TQM's achieved ROE in 2007 as 9.00%, which was higher than the formulaic allowed ROE of 8.46% for 2007, but still low compared to most peers. Its FFO interest coverage was 2.4x, which we believe was lower than almost all of TQM's rated utility-sector peers of similar business risk.

Comparable Investment Standard

In regulatory jargon, the "comparable investment standard", invites comparison of the subject utility's returns with the total returns on investment of an entity with similar risk characteristics. It is widely accepted by regulatory tribunals as a basic fact-finding exercise, that is often very helpful in establishing what is a fair and reasonable return. TQM's application, however, makes the point that the search for comparable enterprises acceptable to the NEB has historically been challenging.

TQM notes, for example, that the NEB has been reluctant to accept U.S. data or comparisons in recent cases. Limiting comparison to Canadian pipelines, however, not only narrows the potential universe considerably, but may create a kind of circular feedback in results. Many of TQM's Canadian pipeline peers are regulated by the NEB. Their capitalization, ROEs, and total returns are set by the same RH-2-94 Decision. Hence, they provide no independent comparison of "market" rates of return. Other peers are largely regulated by the provincial regulators. The provincial regulators are legally and functionally independent of the NEB, but many industry observers believe that their rulings on "fair return" questions tend to follow the lead set by the NEB. Hence, admission of only Canadian entities as appropriate comparisons may limit the field too much to achieve robust and independent results. Additionally, we think that the recent relaxation of Canadian pension fund investment eligibility criteria, to eliminate foreign investment restrictions, makes U.S. comparisons more appropriate than ever. Canadian utilities must now compete head-to-head with U.S. pipelines for equity capital, in what has increasingly become a common market for energy.

TQM's rate application notes as well that, for some years now, new pipeline construction in Canada has proceeded only where shippers and the pipeline constructor/operator have agreed to negotiated settlements. Typically, these negotiated settlements have equity capitalization similar to or higher than TQM's, and very materially higher target ROEs. Maritimes & Northeast's 2007 return was 12.0%, on 29.27% equity. Alliance's Taylor Expansion has 11.0%, on 30% equity. Trans Mountain has 10.5%, on 45% equity. Alberta Clipper and the Enbridge Line 4 extension have the NEB formula plus 225 bps, on 45% equity. Southern Lights has locked in 12.0% on 30% equity for 15 years. TQM submits that these negotiated settlements may even underestimate a true "market" return, as these pipelines all fall within NEB jurisdiction. The NEB must approve the negotiated settlements, and notionally, the NEB formula "ought to" or could conceivably apply, which notionally gives shippers bargaining leverage in negotiations. However, it seems to us that the shippers understand that these new lines would not get built at the NEB's assumed cost of capital. The settlements are compelling evidence that they are willing to pay a higher allowed ROE in tolls, to reflect current overall investment market conditions.

Capital Attraction Standard

A second basic means of testing regulated rates of return is the Capital Attraction Standard, which tests the ability of the regulated entity to continue to attract debt and equity capital on reasonable terms. As noted in the section above, its seems clear to us that shippers on new build Canadian pipelines are prepared to pay, in tolls, much higher than "formula" ROEs, on similar equity capitalization, to ensure that the infrastructure is built. We infer from this that the formulaic ROE is insufficient to attract new equity capital, in a world of higher competing project alternatives.

TQM files further evidence from capital markets experts. This evidence includes the observation that the ROEs of recent pipeline projects have been in the range of 10.75% to 14%, on equity capitalization similar to or higher than TQM's. The evidence observes that the NEB's RH-2-94 formula was set at a point in history when Canadian government debt to GDP was peaking at levels that created concern in financial markets, and Canadian government bonds: a) arguably carried a much greater risk premium compared to U.S. Treasuries than they do now; and, b) had a much greater share of the domestic bond market than today, resulting in a price discount due to abundant supply. Hence, the NEB's RH-2-94 formula implicitly assumes a higher base yield on the "risk free" government of Canada benchmark bond, and thus understates the fair ROE of an equity investment. The 1995 result of the NEB formula was an ROE of 12.25%, a far cry from the 2007 formula-derived 8.46%, and 2008's 8.71%.

TQM's evidence notes that new pipeline investments can affectively sidestep the NEB formulaic approach to negotiate a better return with willing project supporters, usually shippers. TQM, on the other hand, has no such ability of "price discovery" with today's market on the sunk cost of its existing rate base. Furthermore, potential expansion of the TQM system under the current regulatory model would earn the same lower-than-market ROEs, on the same thin equity capitalization. We think this implies a diminished ability for TQM to attract risk capital on favourable terms, as a result of the RH-2-94 formula applied on a thin 30% equity capitalization.

Financial Integrity

The third test of the fairness of regulated returns is to examine the ongoing ability of the regulated entity to maintain its financial integrity.

We consider the rating agencies as widely followed experts on this question. TQM's BBB category rating is defined by S&P as representing "adequate" credit protection, compared to "strong" A category or "very strong" AA category ratings. DBRS's descriptives are similar, and we believe that its rating scale is broadly accepted as analogous to S&P's. In S&P's March 2008 report, TQM's credit ratios, a direct result of deemed equity capitalization and allowed ROEs, are described as "weak for the rating category". In its current report, DBRS describes the financial profile as "relatively weak."

In our view, the rating agencies, and bond investors, can in some circumstances be rather forgiving of weak credit ratios, as long as the stability of regulation does not introduce material downside risk to their investment. However, we think that this is of little comfort to the equity investor who bears the brunt of regulatory risk, as well as operational and business risks.

The Repricing of Credit Risk

Bond investors are more than well aware of the global repricing of credit risk that has taken place over the last year. Credit spreads for all types of corporate debt have widened quite materially over this time. Despite the significant spread recovery that began at the time of the Fed-supported bid by JPMorgan Chase for Bear Stearns, spreads remain substantially wider than they have typically been in the previous five years. We- and, we think, almost all other observers of the bond market- do not expect a return to the low corporate spread environment of the late-2003 to early-2007 period in the foreseeable future.

While we don't believe that TQM's written evidence before the NEB (which was filed in the fall of 2007, and largely prepared in advance of that time) emphasizes this fact, we think it is quite relevant to the questions at hand, and argues strongly for a change in the status quo deemed equity capitalization and ROE for TQM.

Tempering Expectations

TQM is not unique in asking for higher returns from its regulator, as in the last several years we have watched a parade of similar filings before Canadian regulators who have adopted formula-based ROEs. We fully expect that the NEB will hear sophisticated counterarguments from intervenors. Typically, in our view, the resultant regulatory Decisions often seem to effectively gloss over the arguments of both sides, resulting in, more or less, a continuation of the status quo. Such an outcome is certainly possible in TQM's case.

However, we think TQM's position today is akin to that of an investor holding a corporate bond, issued in the relatively calm conditions of the 2003 to early-2007 period, who was faced with a steep and painful mark-to-market correction at year-end 2007. Such investments are a bit better off today, but have yet to fully recover. In TQM's case, in our view, it will require a shift from the NEB's status quo to restore the value of the original investment. Hence, we think that there is a better-than usual chance in this rate case that the NEB will make a material adjustment to TQM's capitalization and/or its allowed ROE.

If the NEB does make a meaningful move, we think it could improve the spreads on TQM's outstanding debt. This could have the effect of lowering TQM's future cost of debt capital. In a cost recovery regulatory regime, where the revenue requirement reflects the actual cost of debt, we think this cost reduction would ultimately accrue to TQM customers.

TQM submitted its application on December 18th, 2007. The public hearings are scheduled for September of this year, and a final Decision expected in early 2009. We hope that, in allowing such an unusually long timeframe to consider that case, the NEB is acknowledging the importance of the case as a potential precedent for subsequent rate decisions by provincial regulators, and that an unhurried consideration of TQM's submission is in order.

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In today's troubled credit market environment, **AltaLink, L.P. (A/ A-/ n.r.)** bond spreads have widened even more dramatically than its closest peers, since its rate application was filed with the Alberta Utilities Commission on September 16th. DBRS responded with a negative trend on September 18th. AltaLink's filing details that the borrowing demands of its capital program, together with recently-mandated changes in AltaLink's recovery of federal income taxes, will place pressure on established credit metrics, and threaten its ratings. While S&P has yet to comment, we think AltaLink's concerns, which are carefully documented in its filing, are not trivial. A regulatory response to AltaLink's requests for an offsetting increase in deemed equity, and a delay in making the tax changes, is not expected until spring at the earliest. This may prolong a period of unusual uncertainty for AltaLink spreads. We think AltaLink has made a strong case in its application. However, we also think this situation uniquely concentrates regulatory risk for bondholders, with the potential for binary outcomes. We think it is impossible to accurately predict the regulators response, and thus, for now, impossible to make an accurate call on AltaLink spread direction.

Regulatory Rate Applications in Changing Conditions

Canadian utility rate applications, typically several hundred pages or more of rather dry reading, have tended to come and go with little notice from the capital markets. This year, however, we think at least three utility filings merit the attention of the corporate bond market. Nova Scotia Power's 2009 rate application seeks to finally enact a long-discussed fuel adjustment mechanism, and mitigate increasingly volatile fuel costs. NSPI's fuel price exposure triggered an S&P downgrade in 2006, and we think the adoption of a fuel adjustment mechanism has the potential to eventually reverse the downgrade. Trans Quebec & Maritime Pipeline's rate application asks (among other things) that the National Energy Board review its RH-2-94 multi-pipeline cost of capital decision, which established deemed capital structures (of around 30% equity) for major pipelines, and a formulaic adjustment to ROEs, a method that has since been widely adopted by provincial regulators. We think that TQM's evidence is very strong, perhaps enough to persuade the NEB to update its formula, in order to respond to significant changes in the real world since the NEB's 1994 decision. If the NEB materially changes TQM's deemed equity capitalization and updates its own ROE adjustment formula, we think provincial regulators would be influenced to reconsider their own formulas, to better reflect actual financial market conditions.

AltaLink's current rate application (for 2009-2010) is, in our view, potentially at least as important for bond investors as TQM's application before the NEB. AltaLink faces a capital spending program of unprecedented magnitude, at the same time it has been directed to change its income tax recovery methodology in a way that will weaken cash flow. Yet, rating agency reports have long cited AltaLink for having "historically low ROEs" and "low deemed common equity" (DBRS), and "cash flow credit metrics weak for the rating" (S&P). In its rate filing, AltaLink explicitly cautions the AUC that it's single-A category ratings may be at risk, unless it is granted specific relief.

Capital Expansion

Much has been written in the public policy sphere about Canada's critical infrastructure deficit. At the micro level, we can think of no company in our regulated utility universe which faces as sharp a rise in its capital spending as AltaLink. TransCanada and Enbridge also have very large capital programs. However, their investments are being made voluntarily, with much higher negotiated ROEs than the regulated ROEs AltaLink currently stands to receive, on new investments it is being directed to undertake. Both TransCanada and Enbridge have suffered downgrades in the past 18 months, largely as a result of thin deemed equity capitalization, low regulated ROEs, and the resultant effect on cash flow and debt-related credit metrics.

AltaLink's capital spending has trended gradually up from $71 million in 2003, the year of its bond market IPO, to $230 million last year. However, beginning in 2009, annual capital spending will grow from $456 million to over $1 billion per year. This capital expansion is necessary, in the view of the Alberta Electric System Operator, to maintain system integrity in the face of growing provincial energy demand, and to connect increasingly diverse sources of renewable energy generation to the grid.

As is common regulatory practice in Canada, AltaLink's new assets do not begin generating revenue until they are placed in service. Interest paid on borrowings to finance work-in-progress is capitalized, as part of the asset's total cost, and is eventually fully recovered through depreciation, over the life of the asset. But since actual cash interest costs are not included in the revenue requirement prior to placing a new asset in service, cash interest coverage suffers during the construction period, as does the cash flow-to-debt ratio. Since many of the projects AltaLink is expected to build over the next several years are expected to have long time lines between the commencement of contracting for materials and construction, and project completion, AltaLink will have to finance a number of unusually large projects, for unusually long periods of time.

Flow Through versus Future Income Tax Methodology

An AUC decision from February, 2007 directed AltaLink to change its method of estimating its federal income tax expense allowable in the revenue requirement. AltaLink had been using the future tax method, which calculates the allowable income tax expense according to its total tax liability, which includes current cash taxes and a deferred tax liability. An intervener in the rate case requested a change to the flow through method, under which only current taxes payable are included in the revenue requirement. The flow-through method significantly reduces revenue, net income, and reduces cash flow interest coverage. At the time, AltaLink noted that the Board had already considered the question in 2003, and allowed the future tax method for federal income taxes. As well, AltaLink pointed out that adoption of the flow through method would weaken its ratios at a time of heightened capital spending. In its decision, the regulator acknowledged AltaLink's circumstances, and allowed AltaLink to continue to use the future tax method in 2007 and 2008. Nonetheless, the EUB ruled that "the use of the flow-through method…would be beneficial to customers", and directed AltaLink to begin using flow-through, beginning in the 2009 rate year.

We calculate the difference between the two tax methods as about .12x of cash flow interest coverage in 2007 and 2008, though this amount will grow as new assets are added. For most companies, we think this magnitude of a reduction in interest coverage might be material to bond spreads, though would probably not be enough to trigger a downgrade. However, given the rating agencies' repeated assertions that AltaLink's "ratios are weak for the ratings", we think that any erosion in coverage has to be viewed as potentially placing one or both ratings at risk. Furthermore, this roughly .12x reduction in coverage will grow materially as assets are added. In concert with the dramatic increase in capital spending, we think the risk of a downgrade, as AltaLink elaborates on in its rate application, is clear.

Ratio Deterioration

In its rate application, AltaLink estimates that two key credit ratios, funds from operations interest coverage, and funds from operations to total debt, will deteriorate during the pending intensive capital build period, to levels weak enough to risk downgrades. AltaLink based its estimates on the AESO's 10-year transmission plan, and its best estimate of costs. There was no contingency built into AltaLink's estimates for higher than anticipated costs due, for example, to unforeseen planning, approval, or construction delays, which we observe have become common and troublesome for several other large energy projects in Canada.

AltaLink, L.P

Forecast of Key Credit Ratios

	2009	2010	2011	2012	2013	2014	2015	2016
FFO/Debt	9.0%	7.7%	7.5%	8.2%	9.2%	9.5%	10.3%	11.6%
FFO Int. Cov.	2.74	2.53	2.52	2.65	2.78	2.76	2.85	3.03

Source: AltaLink 2009 to 2010 General Tariff Application to the Alberta Utilities Commission

For comparison, S&P calculates FFO/Debt of 11.1% for 2007, and FFO interest coverage of 3.0x. S&P includes adjustments for operating leases, postretirement benefit obligations, and asset retirement obligations in its estimate of AltaLink debt. DBRS calculates cash flow/debt of 12.5% and cash flow interest coverage of 3.5x for 2007. As AltaLink's expert witness on debt ratings notes in AltaLink's rate application, S&P guidelines for utilities with a similar business risk profile to AltaLink would yield a BBB rating for an FFO/Debt ratio below 10%. We note that, even with an FFO/Debt ratio above 15%, vertically-integrated Nova Scotia Power has a BBB+ rating. We thus think that both these key ratios will fall into territory that threaten AltaLink's S&P rating. We think that the risk of downgrades to AltaLink, if the estimated ratios are realized, is quite real.

AltaLink notes that, should its rating be downgraded to the BBB category, its cost of borrowing is likely to increase materially. We concur. We note that, in the days following its rate application being made public, indicative spreads for the AltaLink 5.249% September 2036 bond have jumped roughly 80 bps. General credit market distress is undoubtedly a significant factor in the rise in spreads, not only of financial institutions, but of all credit, in Canada and globally. Still, we note that AltaLink spreads have already widened significantly more than its immediate peers since the filing. Also, whereas AltaLink spreads have typically been close to, and at times tighter than comparable CU Inc. bonds for the past several years, the gap is now roughly 50 bps in favour of CU.

AltaLink also notes that, should its borrowing costs rise, this unavoidable cost will, in the long run, be shifted to ratepayers. Perhaps even more significant, with such a quantum jump in the size of its capital market borrowing requirement above currently anticipated levels, AltaLink may face a more limited number of lenders, since many Canadian market buyers have strict limits on their portfolio exposure to BBB or lower credits. Such a narrowing list of willing buyers of its bonds could potentially result in a continual ratcheting up of borrowing costs with each new issue, should the Canadian public bond market as a whole become "full on the name." Private placements, or accessing the US market with a currency hedged offering, could be even more expensive.

AltaLink's Request from the AUC

AltaLink has requested two key actions from the AUC. First, a delay in implementation of the flow-through method of calculating the federal income tax expense, until it is over the hump of its capital spending program, and financial ratios stabilize at levels acceptable for a single-A category credit. Second, AltaLink requests an increase in its deemed equity capitalization to 38%, form the current 33%. AltaLink also requests acceptance of other items in its rate application, noting particularly items that may not be very significant for earnings, but that may still have a material effect on cash flow.

A complicating factor in AltaLink's request for an increase in its deemed equity is the AUC's February 21, 2008 announcement that it will convene a Generic Cost of Capital Hearing, involving all the utilities it regulates. The generic hearing will take deemed equity levels into account as the fairness of the current formulaic ROE adjustment is considered. This hearing is not expected to commence until well into 2009. We think it quite possible that the AUC may defer judgement on AltaLink's equity request until the generic hearing is decided. AltaLink's application anticipates this possibility as well. However, AltaLink's expert witness notes that, absent a clear sign in the rate application decision that the AUC is favourably inclined to help AltaLink avoid a downgrade, rating agencies and capital markets may assume that relief on equity thickness may not be forthcoming, resulting in downgrades or spread widening (or both).

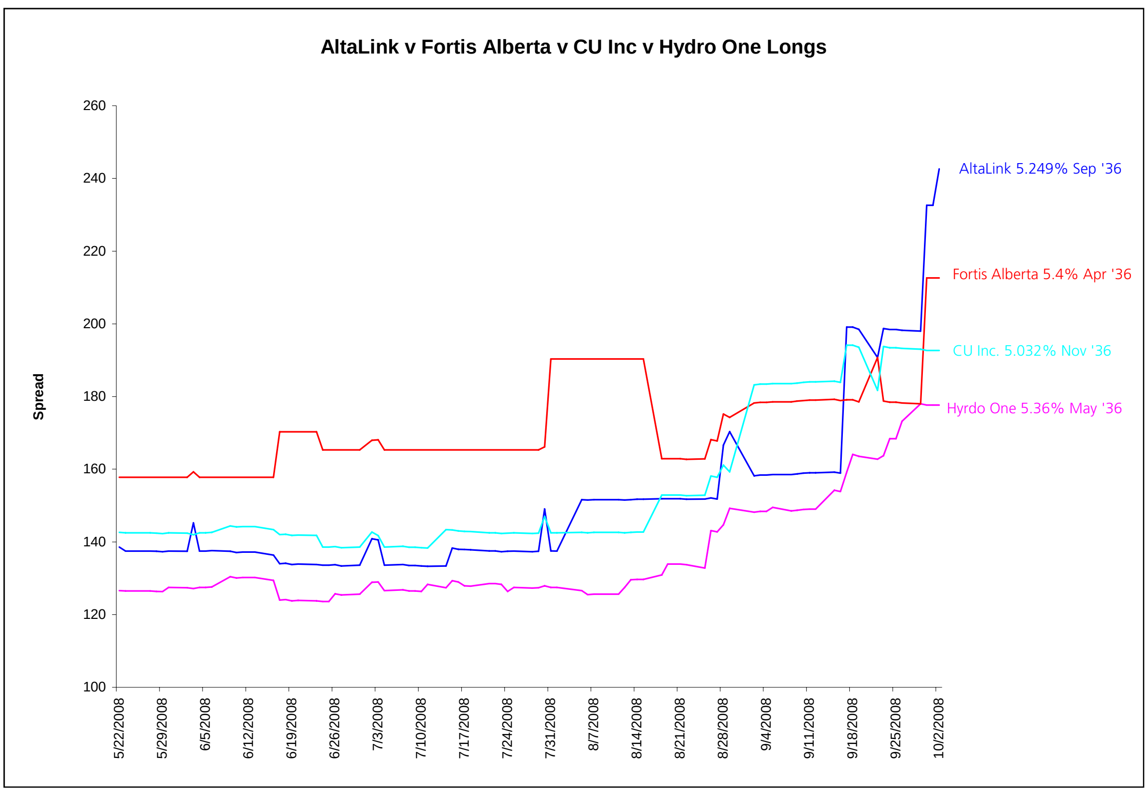
We observe that, within the past two years, a number of investment grade-rated Canadian utilities have sought and received increased equity capitalization from their regulators, to similar degrees as AltaLink is now requesting. This gives us some optimism that the AUC will respond favourably to AltaLink's request. The NEB hearings on the important TQM application are ongoing, and a decision is not expected in that case until the new year. We continue to think that the evidence of TQM is compelling, and we expect material relief on both equity thickness and ROE, even if the NEB does not grant the full requested "11 on 40" (11% ROE on 40% deemed common equity). We think that while some of TQM's evidence is specific to TQM, most of the arguments in TQM's evidence applies to all Canadian utilities, including AltaLink. We thus anticipate that the AUC's generic hearing will bring similar evidence to the table.

The Sorry State of Credit Markets

The arguments for more robust equity capitalization and higher ROEs are made all the more persuasive, in our view, given the past year's tremendous upheavals in capital markets, which up to this week, continue to worsen. Even when credit markets begin to recover, we expect that credit investors will subject all new issues to more exacting scrutiny than ever before. While we expect an eventual recovery, it is in our view impossible to predict when or to what degree credit spreads will improve, even for the high-quality utility sector. We do expect that credit availability is likely to remain very tight, and spreads will likely remain materially wider than AltaLink's historic borrowing costs, for the foreseeable future. In such an environment, we would further expect AltaLink's borrowing cost to be at least as sensitive, and perhaps much more sensitive to its ratings, than it has been historically.

We think that AltaLink's case to the AUC for specific relief to maintain its ratings is comprehensive and compelling. At the same time, we also expect that interveners (and their chosen expert witnesses) may take a different view. We understand that hearings on the application may not take place until March, with a decision sometime later.

We think that this rate application clearly places the concerns of bond investors in the regulatory mix in a manner that has no recent precedent. For this reason, we expect that both the rating agencies and credit investors will follow the case with interest, and await the AUC's decision with great anticipation.



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TransCanada PipeLines Ltd. (senior unsecured A/ A-/ A3) has an impressive array of capital projects currently underway, as well as a couple of huge potential projects that are in a prolonged early state of development. Financing this growth was a key theme at TransCanada's recent investor meetings in Toronto and New York. In today's distressed capital markets, financing such a capital program can't be taken for granted, though we continue to view TransCanada as a premium credit in the Canadian corporate market, with exceptionally strong fundamental asset quality, a credible commitment backed by a track record of prudent balance sheet and credit capacity management, and impressive expertise in large project management. We also continue to think that, rather than being purely negative for credit quality, TransCanada's aggressive growth, which offers shareholder rewards in future, will in the long run prove to be good for credit quality as well. The new assets will not only diversify cash flows, but in our view also bolster TransCanada's independence, and thus help to minimize takeover risk. We now think TransCanada's current ratings are sure to be maintained at least until 2010, when there may be more clarity on how sure the Alaska pipeline is to proceed, and if it does go ahead, how it will be financed. While we can't say that the current financial market turmoil is over, we are confident that, longer-term, current spreads on TransCanada will prove to have been a very attractive opportunity, for those investors who have the flexibility to add to positions, despite the obvious prospects of more new issuance to fund capex for 2009.

TQM Rate Application

The return on investment of TransCanada's regulated Canadian operations are increasingly out of step with the rest of the company's assets. This is illustrated by TransCanada in a slide from its most recent investor meeting, as reproduced on the following page (Large Portfolio of Attractive, Low-Risk Projects). The expected unlevered after-tax returns from Canadian regulated projects are shown as 6.0%, which is 100 to 300 bps less than TransCanada's other pipeline projects. This reflects Canadian regulation, and in particular the resultant allowed ROE and deemed leverage environment that has evolved since the National Energy Board's Multi-Pipeline Cost of Capital Decision (RH-2-94, released in March 1995).

As a joint owner with Gaz Metro, TransCanada has participated in Trans Québec & Maritime Pipeline's application to the NEB for rates for 2007 and 2008. TQM has had a 30% deemed equity capitalization since the 1990s, and its most recent allowed ROE (for 2008) has been set by the NEB formula at 8.71%. TQM is requesting "11 on 40", and has produced what we think is strong evidence that a significant departure from the current NEB deemed equity capitalization and formula-set ROE is warranted, on fairness grounds.

We think an important element in TQM's evidence is, quite simply, reference to current conditions in financial markets. While the NEB formula appears set to reduce ROEs for next year, to reflect the lower government bond yields caused by the recessionary economic environment, the stunning equity market weakness is signalling a dramatic rise in the real cost of equity capital.

Appearing before the NEB hearings held in Montreal in September, TransCanada's President, Pipelines Russ Girling testified thus:

"Our evidence shows there are other factors in the marketplace in addition to a change in long term bond rates, and those other factors haven't been taken into account in changing the (NEB deemed) ROE. The formula assumes a linear relationship between long bond rates and ROE. Our evidence would show that there are many factors that determine ROE. As we can see in the marketplace, bond rates continue to decline, yet the stock market is going down, which implies an increased return on equity. That's why we believe that the formula is not generating a fair return when you combine that with the equity thickness. The overall return is less than we would achieve on similar investments of similar risk."

"In 1994 the formula generated an ROE of 12.25%, which was coincidentally relatively close to our range of capital. If you pick that instant in time of about 1995 (and up to that point in time we were achieving returns that were similar to what we could achieve on similar investments of similar risk...If you take the formula out to 2001, which is the first time we had a lengthy conversation about this (an application asking for substantially more) we dropped from double digit ROEs to about 8.5%. Our equity returns dropped 350 to 400 bps over that period of time."

TQM witnesses also testified that "if TQM had been earning a higher rate of return (since the RH-2-94 Multi-Pipeline Cost of Capital Decision) the cost of its debt would be less. ROEs have a direct impact on the cost of debt." We concur with this assessment, as regulatory allowed ROEs and deemed capital structures are clearly the most important drivers of credit metrics, such as the most widely-used leverage and interest coverage ratios. These ratios have a direct bearing on credit ratings and the risk perceptions of the corporate bond investor, which together drive the pricing of new issuance.

TransCanada Assistant Treasurer Sean Brett also appeared before the NEB, testifying that:

"(Since the RH-2-94 Decision) we at TransCanada have learned that the narrow focus on one number and one academic approach (a Capital Asset Pricing Model determination of a utility's Beta as a key determinant of a fair equity return) of trying to figure out what a fair return is, is not appropriate. Its important to adjust for financial risk, and to talk about equity risk premiums without allowing for leverage is meaningless. More importantly, we've learned that the whole academic approach isn't how the real world works. We've learned that the fair return is set in the marketplace for investments of comparable risk. You need to look at what's happening in the real world."

Mr. Girling added: "You need to take more than one approach, and look at the reasonableness of the CAPM." We believe that Mr. Brett and Mr. Girling were referring to other widely-accepted regulatory standards of fairness, such as comparing the subject utility's financial performance to the performance of comparable investments; the financial integrity standard; and the attraction of capital on reasonable terms and conditions standard. The slide below, from TransCanada's investor meeting, was not part of TQM's evidence. However, we think that the column showing expected unlevered after-tax returns illustrates the returns gap between Canadian regulated projects, and other North American pipeline projects of comparable risk characteristics. This gap in returns, in our view, begs the question of the ongoing ability of TQM to attract capital at a reasonable cost.

The NEB is not expected to rule on TQM's 2007 and 2008 rate application until sometime in Q1 of 2009. We continue to follow the application with interest, since we think that the NEB's TQM decision will eventually have bearing on the TransCanada Mainline, and the Alberta System (which seems likely to transition from Alberta Utilities Commission regulation to NEB regulation in the near future). Together, the Mainline and the Alberta system make up roughly one-third of TransCanada's pipeline segment earnings. We also think the NEB decision on TQM may influence other Canadian regulators, as most have adopted similar formulaic ROE adjustments since the NEB's Multi-Pipeline Decision.

Capital Spending Plans

The Keystone Phase I oil pipeline project, with a total expected cost of US$5.3 billion, is the single largest TransCanada project currently under construction. ConocoPhillips owns 20% of the project, and TransCanada 80%. Ownership of the approximately US$7 billion Keystone XL is not yet fully committed, though two entities (which we assume to be producers) together have an option on a 15% stake, which could leave TransCanada with 65%. (In its latest presentation, TransCanada shows Keystone and Keystone XL as one project, with the TransCanada share of capital cost shown as C$10.6 billion.) The next largest pipeline project currently underway is the Alberta System North Central Corridor project, with an estimated cost of C$983 million, with roughly $1.0 billion of various other Canadian regulated projects also in the queue. Other U.S. regulated projects and Bison are also planned for 2009-2012.

Large Portfolio of Attractive, Low-Risk Projects

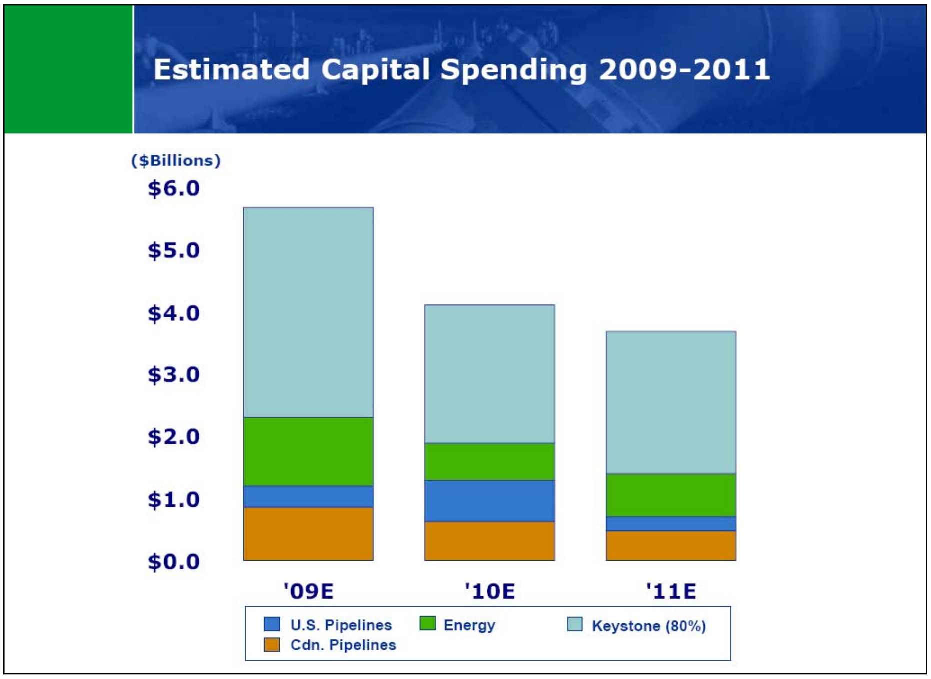
Project	Capital Cost Estimate* ($billions)	In-Service Date	Expected Unlevered After-tax Returns	Revenue Stream	Capital Cost Risk
Pipelines:					
Keystone (80%)	10.6	2009 - 2012	7.0 - 9.0%	83% contracted	partial
Canadian Regulated	1.9	2009 - 2011	6.0%	Cost of service	no
U.S. Regulated	0.7	2009 - 2011	7.0 - 8.0%	FERC reg., contracted	yes
Bison	0.6	2010 - 2011	8.0%	100% contracted	yes
	13.8				
Energy:					
Portlands (50%)	0.4	2009	7.5 - 8.5%	100% contracted	no
Bruce Power Units 1 & 2 (50%)	1.7	2010	9.5 - 11.5%	100% contracted	partial
Halton Hills	0.7	2010	7.5 - 8.5%	100% contracted	no
Kibby Wind	0.4	2009 - 2010	9.5 - 10.5%	30% contracted	yes
Cartier Wind Phases 4-6 (62%)	0.4	2010 - 2012	7.5 - 8.5%	100% contracted	yes
Coolidge	0.6	2011	7.5 - 8.5%	100% contracted	partial
Other	0.2	2009 - 2011	7.5 - 8.5%	100% contracted	yes
	4.4				
	18.2				

*TransCanada share in CAD dollars. Assumes a US$ to CAD$ exchange rate of 1.1.
Approximately $3.5 billion is expected to be spent by the end of 2008 on multi-year projects.

Source: TransCanada November 6th Investor Meeting presentation

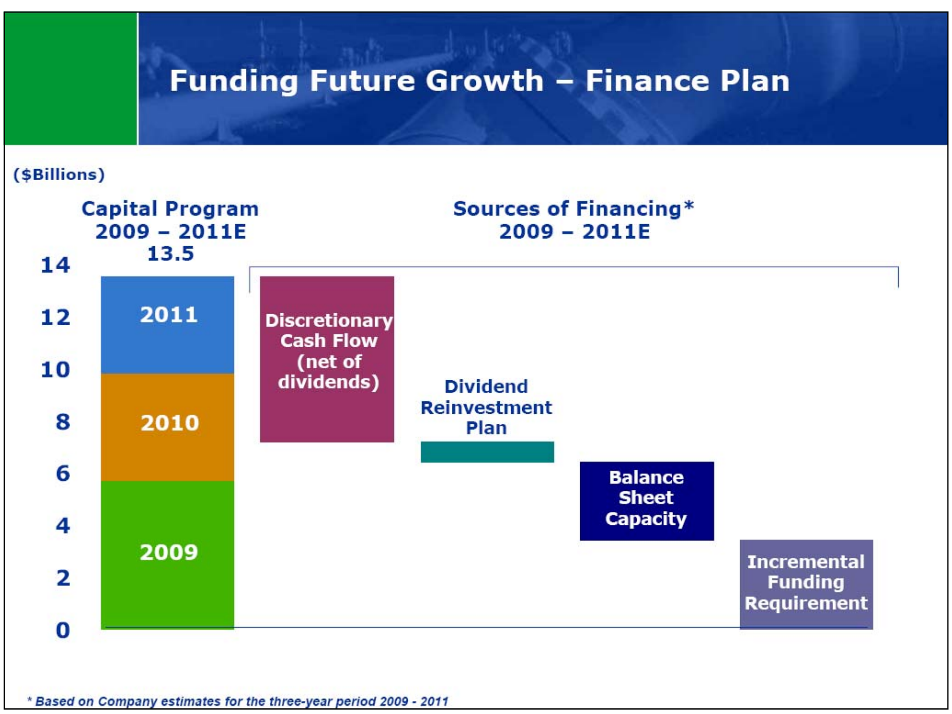
Power projects, with the exception of Bruce A Units 1 & 2, are all considerably smaller than the large pipeline projects, but still contribute $4.4 billion in aggregate to the $18.2 billion total estimated capex spend for the next roughly four years.

Funding Requirements
TransCanada indicates that its expected spend on Keystone dominates total capital spending for the 2009 to 2011 period, especially in 2009, where Keystone appears to be about 60% of the roughly $5.7 billion in total capital spending for that year.



Source: TransCanada November 6th Investor Meeting presentation

To fund its growth, TransCanada notes that it expects to generate roughly $6 billion in free cash flow for the three-year period, approximately $700 million from the dividend reinvestment plan, and balance sheet (debt) capacity of roughly $3 billion due to growth in retained earnings, leaving an incremental funding requirement of just over $3 billion. This incremental funding is expected to be some combination of debt and equity, so as to maintain appropriate balance sheet metrics to keep the ratings intact. Hybrid securities, or some other form of subordinated capital, could form a portion of this tranche of expected funding, depending on the market's appetite and pricing of such instruments.



Source: TransCanada November 6th Investor Meeting presentation

TransCanada has considerable committed bank facilities, which gives it what we view as quite adequate flexibility in timing its public market financings. While the turmoil in public financial markets shows only tentative signs of dissipating, we have seen corporate bond issuance by comparable companies in both Canada and the U.S. in recent weeks. While the new issue concession has narrowed in the most recent Canadian market deals, the potential for a new issue concession had not vanished completely, in our view, and likely won't, until secondary market spread volatility diminishes significantly from where it is now. We expect that the overall bond market's tone is likely to continue to improve, but only gradually. We see TransCanada's ability to access both U.S. and Canadian bond markets as a seasoned issuer as enhancing its funding flexibility, which these days, in itself, is a valuable feature of credit quality.

Committed Bank Facilities
($millions) [maturity]

$3.7 Billion Unutilized Revolving Bank Facilities

Committed

TCPL	
- revolving [Dec 2012]	**2,000***
TCPL USA US$	
- revolving [Feb 2013]	**300**
TransCanada-Operated Affiliates [Sep 2010 - Apr 2012]	**400**
Keystone, LP US$ [Nov 2010]	**1,000****

* *Backstops Canadian commercial paper program*
** *Seeking to establish by end of November*

Source: TransCanada November 6th Investor Meeting presentation

Big Project Risk
Unsurprisingly, the rating agencies have flagged the risk of TransCanada's potential major projects as being material to the ratings. For instance, from Moody's most recent Credit Opinion, immediately following TransCanada's downgrade in June, we quote: "Moody's assessment of TCPL's business risk also reflects the size and complexity of potential future pipeline development projects such as the Mackenzie Gas Pipeline Project and the Alaska Pipeline Project." In the same report, Moody's has also noted that "there are material risks related to the restart/refurbishment of the Bruce A Units 1 and 2."

TransCanada has not shied away from assuming large projects. Indeed, management has asserted that its ability to manage and execute large construction projects is a key skill set, and a very significant competitive advantage for the firm. TransCanada has an impressive track record to back this assertion.

Nevertheless, we think that the potential for financial strain from several very large projects is increasingly topical to the bond investor. We attribute this not only to execution and project cost risks alluded to by Moody's, but also to the prevailing dynamics in the bond market, where new issuance premiums remain large, and carry the potential to re-price secondary spreads.

These large projects, squarely within TransCanada's core franchise and geographic territory, are attractive for the same reasons they would be attractive to any company with experience and expertise in large project execution. In the words of management, such projects, "have an impact on valuations." It is management's goal to maximize shareholder value through pursuing such valuable opportunities.

We think TransCanada has over the past several years managed its ratings, and its credit risk, in a manner that both preserves credit quality (if not all three ratings) and offered shareholders attractive growth potential. We think TransCanada has been exemplary in managing leverage, and issuing common shares in a timely manner to keep leverage moderate, as it did in issuing shares to finance the Ravenswood acquisition. However, the magnitude of the Alaska and Mackenzie pipeline projects, if either of these proceed, could in our view pose a serious test of the ability to manage project cost and execution risk. The Alaska project is expected to benefit from U.S. federal loan guarantees, though details of the financing are years away from being decided and announced. Even though we think the current pressure on TransCanada spreads mainly reflects the overall market disruptions, compounded by market supply expectations for Keystone (and to a lesser extent, Bruce) financing requirements, we suspect that concern over these large projects becoming firm commitments in the next few years are colouring many bond investor's views of TransCanada. However we expect that, as more clarity on the financing of these projects is developed, and as TransCanada executes on its current list of projects, and these assets begin to generate cash flow, market perception of TransCanada's ability to shoulder the next big project will likely improve.

Ratings

The most recent rating change was the Moody's one-notch downgrade in June, which was telegraphed by Moody's placing the rating under review in April. Otherwise, TransCanada has earned a record of ratings stability, with the S&P rating remaining at A- (despite more than one episode with a negative outlook) since 1995. The DBRS rating has been constant since 1998.

With the Moody's downgrade out of the way, we think TransCanada is unlikely to be at risk of rating or outlook changes unless (and until) a new and very material financing commitment emerged. TransCanada is advancing towards an open season to determine its ability to secure sufficient volume commitments from shippers for an Alaska pipeline in 2010. A successful open season on the Alaska pipeline in 2010 could conceivably trigger a negative outlook, though we think this would depend on how the project is evolving, and what prospects are for financing at the time. We expect TransCanada management to have more fully developed financing plans for an Alaska pipeline by this time, as well as having Keystone Phase I complete, or within sight of completion.

A more remote concern we have for the TransCanada rating is the DBRS negative trend on Enbridge Inc. From the November 2007 press release, "DBRS believes that the increasing size of the (Enbridge) capital expenditure initiatives, combined with Enbridge's strategy for funding cash flow deficits, will result in more significant deterioration in credit metrics during the construction period than previously anticipated." Despite DBRS confirming TransCanada's ratings earlier this year, at a time when TransCanada's capital spending plans were well-known, we think the simple fact that TransCanada's capital plans are also large- indeed, larger than Enbridge's- could conceivably argue for similar treatment by DBRS, leading to a negative trend for TransCanada. However, TransCanada's better credit metrics, such as higher funds flow interest coverage (TransCanada had 4.4x LTM FFO interest coverage to Q3 2008, compared to 3.5x for Enbridge Inc.) appears to be sufficient to weigh in TransCanada's favour, and maintain the stable DBRS trend.

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Since the National Energy Board's trend-setting multi-pipeline cost of capital decision of the mid- 1990s, the NEB, and subsequently, most provincial regulators, have adopted a formula-based approach to annually adjusting the return on equity of utilities. These annual adjustments become an important component of setting a utility's annual revenue requirement, and user rates, tariffs, or tolls. The yield (forecast and/or actual) on 10-year and 30-year Government of Canada bonds is typically the key variable in these formula-based annual adjustments. As Canada yields have quite consistently fallen since their relatively high levels of the early to mid-1990s, so has the equity return on investment of Canadian regulated utilities. This decline, until the present, has been gradual. However, the dynamics of global capital markets over the past year, and especially over the past several months since the September failure of Lehman Bros., has not merely accelerated the decline in Canada bond yields, but has dramatically increased the "credit spread" between government bond yields and the yield of corporate borrowers, even the most highly-rated corporates. The risk premium over government bonds required by global markets for new equity investment has likewise spiked dramatically, far above the levels of the recent past, even far above levels typical of the past few decades. Yet, the formula-based ROE adjustments that Canadian utilities are subject to are, to date, essentially unchanged, leaving the industry in a state of apprehension over what happens next. While we await what may be a partial answer to this question, in a couple of Canadian regulatory proceedings currently underway, we think it is worthwhile surveying the landscape of Canadian utilities, and reviewing where they stand.

Canada Yields

Regulatory ROE adjustment formulas typically reference a consensus forecast for long-term Canada bond yields. "Long-term" is not restricted to the 30-year bond, and often includes reference to the 10-year Canada yield as well. October, November, or December timeframes are typical for most utilities, which have a rate year beginning on January 1st. The adjustment formulas can include actual Canada bond yields, as well as consensus forecasts.

Last November, government bond yields fell dramatically and rapidly, as the magnitude of the challenges faced by global financial institutions became more evident. It became clear that virtually all the major national economies were facing steep recessions, and inflation was disappearing as a concern for the world's central banks. Government bond yields were falling, which has the effect of lowering the result of the automatic adjustment formulae for ROEs.

Credit Spreads and the Cost of Equity

In most normal times, falling inflation expectations and falling government bond yields would occur in tandem with a falling cost of equity capital. In today's markets, however, government bond yields and the cost of new equity capital have moved in opposite directions. In the Treasury bond market, many observers think that the sharp drop in yields reflects not only falling inflation expectations, but extreme risk-aversion in the bond market, and the consequent flight of capital to the safety of Treasury bonds.

As Treasury and Canada bond yields were falling, credit spreads on corporate bonds, including that of the utilities, were rising. At the same time, the expected returns required to attract investors into equity investments were rising very dramatically. However, we think it is clear that the Canadian regulators' traditional ROE adjustment formulas are not incorporating the dramatic increase in the cost of new equity capital in the current environment.

The TQM Application

The **Trans Québec & Maritime Pipeline Inc. (A(low)/ BBB+/ n.r.)** application for an adjustment to its cost of capital for 2007 and 2008 is before the NEB right now. The application was filed by TQM in December, 2007, and the NEB held hearings on the application in Montreal in mid-September. TQM is requesting an increase in its deemed equity capitalization from 30% to 40%, and an increase in its ROE from the NEB's generic Group 1 pipeline rates (which were 8.46% in 2007 and 8.71% in 2008) to 11%. This dramatic rise to "11 on 40" is justified, according to TQM's application filing, due to increased business risk specific to TQM, and the secular erosion in the NEB formula-derived ROE levels, from the low double-digits in the mid 1990s to the mid 8% range we see today.

While TQM's cost of capital application (and a parallel rate application for 2007 and 2008) is specific to TQM, we believe that a material departure by the NEB from the status quo for TQM would likely trigger a subsequent process to amend the cost of capital determination for other Group 1 pipelines, which includes Alliance, Foothills, Westcoast, Maritimes & Northeast, and the TransCanada mainline, and we think will soon include the TransCanada Alberta system. We believe that such a broad-based move by the NEB would, in turn, place pressure on the provincial regulators to amend their formula, in reaction to the same market environment.

We think that TQM's filing, and its testimony in the September hearings, presents compelling evidence that the NEB's ROE formula should be adjusted. (We discussed TQM's application in the June 13th, 2008 edition of Corporate Bond Weekly.) Nonetheless, we never take the outcome of regulatory proceedings for granted. Together with the industry, we believe bondholders will be watching the NEB's TQM decision very closely. While there is no fixed date for the NEB to release its decision, we think it is likely to emerge sometime in February, and perhaps even before the end of January.

In early December, the NEB announced that it had set the formulaic return on equity for Group 1 pipelines at 8.57% for 2009, down 19 bps from 8.71% in 2008. As was said in testimony during the hearings, not only does the formula not reflect the current market cost of new equity capital, it is "not even right directionally."

Regulated Cost of Capital for Canadian Distribution/Transmission Utilities	Deemed Equity (%)	2008 ROE (%)	2009 ROE (%)
CU Inc.	43/38/33/37 [1]	8.75	TBA[2]
Enbridge Gas Distribution	36	8.39 [3]	8.31 [4]
Gaz Metro Inc. [5]	38.5/7.5 [6]	9.05 [4]	8.76 [4]
Terasen Gas Inc.	35	8.62	8.47
Terasen Gas Vancouver Island Inc.	40	9.32	9.17
Union Gas Ltd.	36	8.54 [3]	8.46 [4]
AltaLink, L.P.	33	8.75	TBA[2]
Borealis Enersource	40	8.57	8.57 [7]
Electricity Distributors Finance Corporation	40	8.57	8.57 [7]
Nova Scotia Power Inc.	40	9.55	9.35
EPCOR Utilities Inc.	39/35 [8]	8.75	TBA[2]
FortisAlberta Inc.	37	8.75	TBA[2]
FortisBC Inc.	40	9.02	8.87
Newfoundland Power Inc.	45	8.95	8.69
Hamilton Utilities	40	8.57	TBA [9]
Hydro One Inc.	40	8.57	8.57[7]/TBA [9,10]
Hydro Ottawa	40	8.57	TBA [9]
Toronto Hydro Corp.	37.5/40 [11]	8.57	8.57 [7]
Veridian Corporation	40	8.57	8.57 [7]

1 ATCO Pipelines/ ATCO Gas/ ATCO Electric Transmission/ ATCO Electric Distribution
2 To be set later this year as part of an AUC Generic Cost of Capital proceeding
3 ROE for rate-setting purposes
4 Incentive regulation earnings sharing referenced to this level of ROE
5 For the Québec regulated gas distribution utility
6 Common Equity/Preferred equity
7 Incentive Rate Mechanism
8 Distribution business /Transmission business
9 New rate year begins May 1st, 2009
10 Distribution / Transmission
11 Deemed equity rises in the 2009 rate year

<u>AltaLink and Alberta-based Utilities</u>

AltaLink, L.P. (A/ A-/ n.r.) is now before its regulator, the Alberta Utilities Commission, with an important rate application that addresses a wide range of issues unique to AltaLink, but by extension also raises the issue of the AUC's cost of capital for the utility sector. As we described in the October 3rd Corporate Bond Weekly, the AltaLink rate application includes a request to increase its deemed equity capitalization. AltaLink's request is running concurrent with a Generic Cost of Capital proceeding by the AUC.

When the AUC (at the time, the EUB) last considered the utility sector's cost of capital, in 2004, a formula-based ROE adjustment was adopted, very similar to the NEB approach. During the proceeding, it was suggested that the AUC's new ROE adjustment formula include some reference to utility bond yields, in place of, or in addition to, Canada bond yields. By directly referencing a close proxy for the financial market's view on utilities' cost of equity, the problem experienced today, the disconnect between government bond yields and the real-world cost of equity, would be mitigated. However, the regulator decided that the suggestion was not appropriate to implement "due to the difficulty of determining and tracking bond yields for a representative sample of corporate bonds."

We note that a great deal of Canadian bond index data, including spread data for both single-A rated corporates and individual utility credits, is available from the TSX. Perhaps this option will be reconsidered by the AUC during the current cost of capital proceeding. In our view, utility bond spreads would track the cost of utility equity capital much more closely than Canada bond yields.

The AUC Generic Cost of Capital proceeding has hearings scheduled for May, and we understand that a decision by the AUC could be anticipated late in Q3, or perhaps even sometime in Q4. Final ROEs for the sector for 2009 will likely only be set as a result of the decision rendered in this proceeding. We think the decision is important not only for AltaLink, but also for the other utilities in the Alberta sector, many of which have a presence in the Canadian bond market.

<u>Ontario LDCs</u>

In Ontario, a formula-based approach to ROE-setting was in place at the Ontario Energy Board for six years to 2008. This OEB formula is similar to the NEB formula. Beginning in May 2008, an incentive regulation mechanism was created that changed the way utility rates will annually reflect changes in Canada bond yields. Under this 3rd generation incentive regulation mechanism (IRM), the revenue requirement for a given LDC is set via a comprehensive, evidence-based forward test year rate application in year one of its IRM period, using the existing OEB formula-derived ROE as an component of the revenue requirement. In successive years, the revenue requirement will be adjusted by an inflation factor, less a productivity factor. Hence, in years after the subject utility's rate application, the traditional ROE formula is not used to adjust that utility's revenue requirement.

Because Ontario has roughly 90 LDCs, and the regulator did not have the resources to review 90 such rate applications all at once, some utilities began the process for the rate year beginning May 2008, others will begin for the May 2009 rate year, and still others, not until 2010.

As has been observed in the Treasury and Canada bond markets, in addition to reflecting falling inflation expectations, the sharp drop in yields reflects the extreme risk-aversion of the bond market, and the consequent flight of capital to the safety of Treasury or Canada bonds. We think it is clear that neither the traditional ROE adjustment formula, or the inflation-less-productivity factor rate adjustment of the OEB's IRM, will reflect the dramatic increase in the cost of new equity capital in the current financial market environment.

Of further interest, we note that in its Generic Cost of Capital decision of December 2006, the OEB considered and rejected a proposal to add a premium to the ROE, to provide an incentive for new infrastructure investment. The OEB was not convinced that such an incentive for new equity investment was "warranted at this time." At present, however, the Canadian federal and provincial governments (as well as national and regional governments worldwide) are considering a broad array of incentives to stimulate infrastructure spending. We do not expect that the OEB will reconsider this idea anytime soon. However, we think some might argue that such an incentive for new capital spending would not only ease the capital-raising difficulty of utilities that have large capital programs, but could arguably dovetail with a renewed public policy emphasis to stimulate public and private infrastructure spending.

<u>What will Regulators Do?</u>
While on one hand, the level of regulated ROEs primarily affects utility shareholders, interest coverage ratios, and certain other key credit ratios are also directly affected by ROEs. So, corporate bond investors also have a keen interest in regulatory rate-setting, and the level of utility ROEs. Rating agencies clearly follow utilities' financial performance and prospects very closely, and can be expected to respond favourably to rising ROEs- and conversely, can and often do respond negatively to falling ROEs.

We think the ROE question now before several regulators will be challenging, as it will implicitly involve a difficult arbitration between utility shareholders and ratepayers. We expect counter-arguments to be presented from energy user groups wishing to forestall any rate increase arising from recognition of a rising cost of capital. For example, in the typical cost of capital proceeding or rate application, academic analyses presented by interveners' expert witnesses tend to focus on average investment returns, for data purporting to represent the medium or long-term. It's conceivable that, under this line of thinking, it could be argued that the present financial turmoil is more or less a blip, that does not require any regulatory reaction. Indeed, it might be argued that there is an annual adjustment to ROEs that takes place, and that this has been designed to adjust everything that needs adjusting: the risk-free cost of borrowing. According to this line of thinking, the fixed equity premium component of the CAPM-derived formulas are already based on long-term averages, that, by definition, accommodate even extreme annual fluctuations in the magnitude of the equity premium.

Will regulators thus view the elevated cost of capital as a temporary phenomenon, not requiring any changes to the return on equity? While we think this viewpoint would ignore the evidence of today's capital markets, and could place some utilities at risk of downgrades, we can't rule out such a response.

On the other hand, we note that the cost of utility debt is not absorbed by utility shareholders, but is borne by ratepayers. As AltaLink demonstrated in its rate application, the cost of a downgrade, even of a single notch, can be greater than the rate impact of measures (such as higher equity thickness and higher allowed ROEs) aimed at maintaining the financial integrity of the utility, as measured by the credit rating. Hence, we think it can reasonably be argued that by allowing ROEs to rise to reflect the current cost of capital, the long-run all-in cost of capital for the utilities can be influenced to an optimal level, not merely for the sake of shareholder returns, but for utility customers as well. We think this logic makes the case for higher ROEs somewhat more likely to be accepted by at least some Canadian regulators. Naturally, the fairness principle of regulation (allowing a fair opportunity to earn a return on equity comparable to investments with similar risk characteristics) also argues for some relief from the rigidity of the current ROE formulas.

<u>Effect on Spreads</u>
Quite simply, in our view, a series of adverse regulatory decisions on ROEs and the cost of capital from the NEB, the AUC, and other provincial regulators would likely lead (all else being equal) to wider utility bond spreads. A series of positive decisions by regulators could aid a recovery in utility spreads.

In past recoveries from credit events that widened corporate bond spreads across all sectors, we note that the utility sector has often been among the first sectors to recover. We think it is quite possible that utilities will again lead any recovery from the current turmoil in credit markets. However, we think that the Canadian bond market will be sensitive to these upcoming regulatory decisions, and we are concerned these decisions have the potential to either reinforce, or retard, the recovery of utility sector spreads.

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For much of this decade, the bonds of **Gaz Metro Inc. (GMi, A/ A/ n.r.)**, 71% owner of the utility operator Gaz Metro LP (GZM), traded at slightly tighter spreads than most of its peers within the natural gas distribution sector. Over the past roughly six months, its bonds have settled into the thick of the pack, trading more in line with (and briefly, somewhat wider than) the sector average. We attribute the shift mainly to GMi and GZM being temporarily overleveraged, compared to their historic norms. The Green Mountain Power acquisition (in April, 2007) has to date been financed with debt. GZM's intention to issue units, to restore leverage to a target range "in the low 60's", has been delayed by weak equity market conditions, which has pushed GZM's cost of capital well above the deemed ROEs of GZM's regulated utility operations. We note, though, that both DBRS and S&P have stable outlooks on the ratings, and appear to be patient as GZM waits for improving markets prior to issuing units. As well, S&P, and we think the bond market, has at times expressed concern with GZM's strategy to diversify beyond its core gas distribution business. However, the proposed Rabaska project is seemingly on hold, and the wind power joint venture with Boralex has a fairly long time line, moderating immediate capital financing requirements. Given management's strong commitment to reduce leverage with a units issue, we are becoming more comfortable with GZM's diversification strategy, risk profile, and leverage. We think it's unlikely that the leverage of GZM (guarantor of GMi's first mortgage bonds) will be stretched further than the roughly 65.5% debt to capitalization as of the most recent quarter-end. We now see GMi bonds as fairly to attractively valued at current spreads. We see potential upside to spreads if Canadian regulators review their ROE adjustment formulas to allow equity returns more in line with the prevailing cost of equity capital.

Québec Distribution

The Québec distribution operation's earnings performance, and credit metrics, are largely driven by the regulation of the Régie de l'énergie. In line with most Canadian utility regulation, we have historically viewed the Régie as benign for credit quality, thanks to the generally timely commodity price recapture in customer rates, and the reasonable assurance of full recovery of prudently incurred capital and operating costs. Taking this strong assurance of cost recovery into account, we have in the past viewed Canadian deemed leverage levels as manageable, and allowed ROEs as thin but more of an issue for equity holders than creditors. In the past two years, however, and especially in 2009, we have come to view the formulaic ROE adjustments common in Canadian regulation as producing inadequate returns from an equity perspective, and a material concern from a creditor standpoint as well.

In GZM's most recent rate case, GZM requested that the application of the formulaic ROE adjustment be stayed, as credit spreads, and the cost of equity, have dramatically risen, to levels that were unforeseeable just 12 months ago. The formulaic adjustment changes the base authorized ROE annually, according to Canada 30-year bond yield forecasts, and assumes a nearly static "equity risk premium." The request to deviate from the formula was denied, on the basis of a lack of "expert evidence" introduced in the application. As a result, despite the obviously dramatic increase in credit spreads, and the cost of equity, the formula produced a decline in the base authorized ROE, to 8.76% in fiscal 2009, from 9.05% in fiscal 2008. (GZM's fiscal year end on Sept 30th.)

We anticipate that GZM will take the cue of the Régie and introduce even more "expert evidence" in its next rate application. There is clearly no shortage of such evidence in the capital markets today. Perhaps the NEB's pending decision in the TQM rate case (discussed below) will offer insight into the possible outcome of the next GZM rate application.

Apart from regulatory mechanics, GZM performance has been reasonably stable. While temperature and wind-normalized residential and commercial volumes rose 1.8% in fiscal 2008, industrial volumes declined a material 14%, due to the shut-down of TransCanada Energie's Bécancour natural gas-fired electricity generation plant. In November 2007, GZM requested a rate adjustment to take into account this loss of industrial load. After hearings in July 2008, the Régie granted GZM's request, though the rate adjustment only took effect as of October 1, 2008. We believe this constituted somewhat of a headwind in 2008 results, that should be relieved in 2009.

While the allowed "base rate" ROE is only 8.76% for 2009, the Régie's performance incentive mechanism allows for earnings above this threshold under certain conditions. GZM expects an additional 18 bps of earnings from this mechanism for 2009. As well, an energy efficiency incentive mechanism could generate an additional 40 bps of ROE, bringing the total expected ROE for 2009 to 9.34%. In 2008, the realized ROE was an impressive 10.37%, attributable to GZM's attainment of 47 bps of productivity gains, 41 bps from the energy efficiency incentive, and 44 bps from an overearnings-sharing mechanism. The Quebec distribution activities has a deemed capitalization of 38.5% common equity, 7.5% preferred equity, and 54% debt.

Trans Québec & Maritimes Pipeline

The TQM Pipeline has been a fairly steady, though mediocre, performer over the past several years. GZM is a 50% co-owner of TQM, together with TransCanada. TQM forms the transmission backbone of the province's natural gas system, and is effectively an extension of the TransCanada mainline. Together with PNGTS, TQM forms GZM's transmission segment, which earned 13% of GZM EBIT in 2008, in line with prior years. TQM is thinly capitalized, with only 30% common equity, and 70% debt, as per NEB's capitalization decision dating to 1994. TQM applied for a material increase in capitalization to 40%, and a higher ROE of 11% in its 2007-2008 rate application. We are cautiously optimistic that the NEB will award the requested 40% equity capitalization, and vary its formulaic approach to ROEs in TQM's case, based on what we view was convincing evidence in the rate application, and the obvious facts on the ground that today's cost of equity for such assets is much higher than the NEB's allowed ROEs of 8.46% in 2007, 8.71% in 2008, and 8.57% for 2009. NEB hearings on the rate application concluded last autumn, and the NEB has just announced that its Decision will be released on Thursday, March 19th. This decision is anticipated by many as a potential trend-setter, and will be closely read by the industry.

Portland Natural Gas Transmission System
GZM owns 38.29% of PNGTS, with TransCanada Pipelines owning the 61.71% controlling stake. Operating since 1999, the line ships natural gas from the TQM system at the Québec border to Portland ME, and on to the Boston area, via a line jointly owned with Maritimes & Northeast Pipelines. Since losing its single largest industrial client (a Calpine subsidiary gas-fired generation plant) in March 2006, PNGTS has underperformed expectations, though it remains fairly consistently profitable. Throughput on PNGTS was 50 Bcf in 2008, down from 58 Bcf in 2007, which was in turn down from the peak of 62 Bcf in 2005. PNGTS filed a rate case with the FERC in April, 2008, requesting a roughly 6% increase, as well as other changes to its tariffs. The proposed tariffs are being charged on an interim basis beginning September, 2008, and a rate hearing will commence in July, 2009. Along with Vermont Gas Systems and Green Mountain Power, GZM's share of PNGTS earnings have improved recently due to the decline in the Canadian dollar versus the US dollar.

Vermont Gas Systems
GZM has owned Vermont Gas Systems for over 20 years, and has generally allowed local management to run the company's operations and regulatory affairs, much as Fortis Inc. has successfully favoured local management of its subsidiaries. VGS is the sole natural gas distributor in Vermont, and is regulated by the Vermont Public Services Board on a cost-of-service basis, with a price adjustment mechanism for the gas commodity cost. Unlike GZM's Québec distribution subsidiary, VGS does not have a temperature normalization mechanism in its rate design. Hence, with its customers' usage concentrated in heating, volumes, revenues, and earnings are sensitive to temperature. Q1 2009 was colder than normal, increasing deliveries 4.2% over 2008. VGS's authorized ROE for 2009 is 10.50%, unchanged from 2008. Regulatory deemed capitalization is more favourable for credit quality than Canadian regulation, at 45% debt, 55% equity.

Green Mountain Power Corp. (senior secured n.r./ A-/ A3)
Since April, 2007, GZM has owned 100% of GMP through wholly-owned Northern New England Energy Corp. GMP is the second-largest electricity distributor in Vermont. Together with VGS, the Vermont utilities accounted for roughly 10% of GZM's EBIT in 2008. Roughly 75% of GMP electricity supply is purchased under contracts from Hydro Québec and Vermont Yankee (owned by Entergy), which expire in 2015 and 2012, respectively. GMP is already negotiating to replace these power contracts, which are favourably priced. GMP has said that it favours increasing its purchases from Hydro Québec, and decreasing its reliance on nuclear generation from Vermont Yankee. The target allowed ROE for 2008 was 10.21%, and will be 9.81% in 2009, with an earnings sharing mechanism for earnings (or earnings shortfalls) more than 75 bps above (or more than 125 bps below) the target ROE. Capitalization is a conservative 48.6% debt, and 51.4% equity. Consumption declined 3.7% in Q1 2009, despite colder temperatures, which the company attributed to the slowing U.S. economy. The most recent rate application requested and received a modest 1.58% rate increase, due mainly to rising regional transmission charges. In its most recent research on GMP, S&P characterises the regulatory environment in Vermont as "restrictive", and "challenging, but improving", though S&P adds that GMP has effectively managed its regulatory relationships.

GMP owns 33% of Vermont Transco LLC, the owner of Vermont's main high-voltage transmission facilities. Gaz Metro's most recent investor presentation mentions that the Vermont electricity distribution sector, with 20 companies serving only 600,000 customers, is "poised for consolidation." We infer that GZM would be interested in opportunities to be an acquirer, as they arise. We don't see this as especially concerning for GZM credit quality, depending, of course on the cost, and the financing, of any such acquisitions.

Wind Power Joint Venture
GZM and Boralex have signed 20 year electricity supply agreements with Hydro Québec Distribution for a proposed 272 MW wind farm, to be located in the Seigneurie de Beaupré, on property owned by the Séminaire de Québec. The roughly $800 million investment still requires regulatory authorizations, and the partners are still considering financing options. A turbine supplier has been chosen, and the project is expected to be generating earnings in 2014. We understand that the equity portion of GZM's investment in the joint venture will be considered an unregulated operation, for purposes of covenant restrictions on GZM's unregulated assets. GZM believes there is potential for higher ROEs than the allowed ROEs from its Québec natural gas distribution business. We consider this project as moderately riskier than the core regulated operations, but not a threat to the ratings, given the 20-year contracts with Hydro Québec.

Rabaska LNG Development
GZM's partnership with Enbridge Inc. and GDF Suez (Gaz de France) to construct an LNG regasification and storage terminal at Rabaska appears to us to have lost momentum. The partners have received all the key approvals required to begin construction, and in May 2008 signed a letter of intent with Gazprom's North American subsidiary, which would take an equity stake in the terminal, and subscribe for 100% of capacity. However, the Gazprom agreement has yet to be finalized. Partners have cited external factors and uncertainties in financial, commodity and construction markets as slowing progress towards finalization. Like the wind project, the LNG terminal would be considered unregulated for covenant purposes. We believe that both equity stakes will be comfortably within GZM's 10% of non-consolidated assets covenant ceiling. We would consider the project modestly positive from a credit perspective. It would require a new pipeline to connect it to the TQM system, and thus lead to an increase in TQM's rate base, and

materially increase throughput on the existing, underutilized TQM pipeline. However, we do not see construction beginning in the near future, given the current dynamics for the North American natural gas market, with expected demand growth waning, and potential North American supply increasing.

Liquidity
GMi has entered into a $400 million credit agreement, guaranteed by GZM. In February 2008, the credit agreement was extended to December 21, 2012. The credit agreement provides backing for GMi's $400 million CP program. Short term debt was a modest $54 million as at September 30th, the beginning of the winter heating season, while natural gas inventories were $235 million, attesting to very strong liquidity, in our view.

SIFT Rules Taxation
GZM has not yet detailed if it will convert to a corporation, once it becomes taxable under federal SIFT rules in its fiscal 2011 (beginning Oct 1st, 2010). GZM continues to study its options. We note that Scotia Capital equity research expects GZM to reduce its cash distributions by roughly 30%, the expected tax rate. However, we believe that this should be close to neutral for taxable holders of the units.

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The National Energy Board released its Decision on the Trans-Québec & Maritimes Pipeline Inc. (A(low)/ BBB+/ n.r.) 2007 and 2008 rate application on March 17th, and it appears that the industry and investors are still engaged in carefully assessing not only the Decision itself, but its wider implications. We are favourably impressed with many of the NEB's stated reasons for its Decision, which acknowledge that "significant changes have occurred in financial markets and economic conditions since 1994, … that cast doubt on some of the fundamentals underlying the RH-2-94 Formula as it relates to TQM." We think most of the NEB's stated reasons to vary from its standard formulaic adjustment to TQM's 2007 and 2008 target ROEs apply not only to TQM, and not only to 2007 and 2008, but to most of the Canadian regulated sector, for 2009 and for the foreseeable future. As a result, we are optimistic that at least some of the NEB's reasoning in this Decision will be applied more broadly. Despite the narrow scope of this NEB Decision to TQM, we think it may represent a turning point in the Canadian regulatory climate vis-à-vis the level of allowed ROEs. If this is so, the credit ratios of regulated companies have some upside potential, which has not been the case for quite some time. We think this is positive for all utility bond spreads, and could mildly augment the tentative recovery in credit spreads the Canadian bond market has experienced so far this year. More immediately, we think the NEB's decision should very materially improve TQM's secondary market bond spreads.

Outcome of the Decision for TQM ROEs

Cutting straight to p 82 of the NEB's densely-worded 86-page Decision, the NEB allowed TQM an after-tax weighted average cost of capital (ATWACC) of 6.4% for both 2007 and 2008. In the press release announcing its receipt of the NEB Decision, TQM said that, assuming 40% deemed equity capitalization, the 6.4% ATWACC was equal to a 9.85% ROE in 2007, and a 9.75% ROE in 2008. This is higher than what the RH-2-94 Formula result would have been, an 8.46% ROE on 30% deemed equity in 2007, and 8.71% on 30% deemed equity in 2008.

In its application, TQM requested an 11% ROE on a 40% deemed equity capitalization. Expressing TQM's requested "11% on 40%" as an ATWAAC (assuming TQM's embedded cost of debt) would represent a requested ATWACC of 6.9%.

We understand that, based on a deemed 30% equity capitalization and TQM's embedded (actual) cost of debt, the NEB's Decision translates to an ROE in the range of 11.6% to 11.8%. We think this is the closest "apples to apples" comparison with the status quo 8.46% and 8.71% that the NEB's formula yielded for these rate years. Thus, while the NEB's decision of a 6.4% ATWACC is less than the 6.9% requested, we still view the result as materially better than the status quo.

TQM has had a 30% deemed equity capitalization since 1995, when the RH-2-94 Decision first took effect. Its actual capitalization has very closely tracked this deemed level since 1995. We calculate its actual debt to capitalization as 70.2% in 2007, and 69.9% as of Q3, 2008. TQM has not yet filed its year-end 2008 financial statements on SEDAR.

ATWACC

In TQM's application, it presented two ways of assessing the cost of capital. The traditional method, widely used, starts with a deemed capitalization, and applies an ROE to the equity component of capitalization. The deemed capitalization is intended to be the most appropriate mix of debt and equity for the firm, given its business risk. The ROE represents an appropriate return for shareholders, again, given business risk and the financial risk implied by the capital structure.

Alternately, the cost of capital can be represented by an after-tax weighted average cost of capital, or ATWACC, which makes no assumption about capital structure, but rather reflects the required total cost of debt and equity financing of the enterprise as a whole. TQM submitted that the ATWACC approach is used by TQM's two owners, Gaz Metro and TransCanada, in their investment and capital budgeting decisions. The NEB noted that ATWACC comparisons are "consistent with the way decisions are usually made in the business world."

Fundamentally, TQM's application requested a higher return on investment because financial market conditions, and TQM's own business risk, had changed since 1994. To determine precisely how much higher a return was appropriate required the introduction of recent evidence from financial markets. The NEB agreed with TQM's assessment that an ATWACC methodology "enables comparisons of returns on an equal footing between companies of comparable risk by neutralizing the effect of financial risk attributable to different capital structures." The NEB Decision utilized evidence put forth by both TQM and the Intervenors in the rate case, on the market cost of equity, and the market cost of debt, for companies of comparable risk, for a period we believe ends in 2007. These averages were combined with market-value capital structure to produce an aggregate observed cost of capital of the sample companies.

While such a use of ATWACC brings the virtue of greater comparability, it represents a significant departure from the widespread (though not universal) regulatory tradition of an ROE based on a specified deemed capitalization that fixed-income investors are most used to. As well, the financial market data of comparable companies the NEB used is not published in the Decision. Rather, the NEB "used judgement to reach an overall conclusion", and presented a single, complex chart (Figure 7-1 on p 79 of the Decision) that outlined some of its judgement and reasoning, with non-specific indications of the degree of influence of various factors on the final outcome. We think that this limited transparency makes the Decision, on its own, more complex for the debt investor to assess.

Because the ATWACC approach does not specify a deemed capital structure, we think it may be viewed by some debt investors as implying that a greater degree of flexibility for management is being conferred by the regulator to determine, and change, company leverage. We think that, if similar ATWACC methodologies were to be more widely adopted by the NEB, or by other Canadian regulators, regular guidance from management to the debt markets on corporate financing policy and intentions would be desirable.

In TQM's case, we note that its application to the NEB specifically requested 40% equity capitalization. As well, in testimony at the NEB hearings last September and October, TQM management noted that the rating agencies have criticized the NEB's deemed 30% equity as leaving the company too aggressively leveraged. Management also indicated that its tendency would be to have TQM move to a capital structure closer to that of its owners, which is 60/40. We view this as clear guidance on management's intentions for TQM's leverage. We hope the rating agencies note this approvingly. The NEB directed TQM to report its leverage as of year-end 2008 in its filing for final tolls, by April 30th.

We expect TQM to make gradual, though not necessarily rapid progress, to increasing its equity capitalization, perhaps by reducing the withdrawals by the partners to allow retention of earnings over time. TQM also has additional capital structure flexibility, due to upcoming debt maturities in August, 2009 and September, 2010.

Finally, we note more generally that, should a utility increase leverage beyond the bond market's expectations, it risks increasing its cost of debt capital past the "sweet spot" which optimizes risk and returns, which we believe broadly coincides with typical regulatory deemed capitalization. We think that a material move in this direction would ultimately prove self-defeating.

<u>TQM 2009 Tolls</u>
We understand that TQM has a negotiated toll settlement with shippers for 2007, 2008, and 2009, for all matters except the cost of capital. Hence, a determination of the cost of capital for 2009 is still required.

It is possible that TQM and shippers will reach an agreement that largely mirrors the NEB's 2007 and 2008 Decision. However, we understand that Intervenors in the rate case (and especially shippers, as represented by the Canadian Association of Petroleum Producers, known as CAPP) have a 30-day time limit to request permission to appeal the Decision. This period runs until April 17th or 18th. An appeal could make a negotiation awkward, in our view. As well, if the NEB were to initiate a Generic Cost of Capital review (which is typically a roughly two-year process), or even an abbreviated process to review its RH-2-94 Decision, a negotiation over TQM's 2009 cost of capital could be viewed as a redundant exercise. We will observe developments on this matter over the next few weeks.

<u>The NEB's Reasoning</u>
We are favourably impressed with many of the NEB's stated reasons for its Decision.

In describing its application of the regulatory principle of setting tolls that yield "fair and reasonable" returns to shareholders, the NEB refers to the Federal Court of Appeal's analysis in *TransCanada v NEB (2004)*: "It (fair and reasonable) does not mean that investor and consumer interests are balanced. In the Board's view, the Federal Court of Appeal was clear that the overall return on equity must be determined solely on the basis of a company's cost of equity capital, and that the impact of any resulting toll increase is an irrelevant consideration in that determination."

Then, the NEB goes on to make what we view as crucial acknowledgments, that: 1) Canadian financial markets have experienced greater globalization since the RH-2-94 Decision; and, 2) The decline in the ratio of Canadian government debt to GDP has put downward pressure on Canada bond yields.

Elaborating on this, the NEB states :

> "The RH-2-94 Formula relies on a single variable … the long Canada bond yield. In the Board's view, changes that could potentially affect TQM's cost of capital may not be captured by long Canada bond yields, and hence, may not be accounted for by the results of the RH-2-94 Formula. Further, changes regarding (TQM's) business environment … may not have been captured by the Formula. Over time, these omissions have the potential to grow and raise further doubts as to the applicability of the Formula result for TQM for 2007 and 2008."

We think that this reasoning applies to all regulated Canadian utilities whose ROEs are now being set by formulaic adjustment. We observe that most provincial regulators have, since RH-2-94 took effect in 1995, adopted very similar formulas which use Canada bond yields as the key variable in their periodic ROE adjustments.

In our view, the single largest factor in the NEB's TQM Decision was the gradual decline in Canada yields from 1995 to 2007. However, in addition to this long and gradual decline, since the failure of Lehman Bros. in September, 2008, global sovereign yields have plunged precipitously, while credit spreads, and the cost of equity, have ballooned. Clearly, this mismatch between Canadian regulators' formulaic ROE resets and the real-world cost of debt and equity capital is very material.

The Decision also refers to a number of factors specific to TQM, and acknowledge that its business risk has increased since 1994, due to increased supply and market risk, the competitive threat of fuel switching by Québec industrial users, and rising competition among pipelines in the U.S. Northeast. As well, the NEB acknowledged TQM's significant investments required to maintain throughput. In our view these are material contributing factors to the NEB's Decision, but not the most important factors driving the magnitude of the change on ROE.

Implications for the Canadian Utility Sector

We infer that, if the gradual decline in Canada yields from 1994 to 2007 was sufficient cause for the NEB to vary its RH-2-94 Decision for TQM, the dramatic fall in Canada yields since mid-2008, while the real world cost of credit and equity was rising, is clearly sufficient cause for more of these formulaic ROE adjustments to be reviewed.

A few days after the NEB released the TQM Decision, it issued a request for submissions on whether it should review its RH-2-94 Decision. We think that, after nearly 15 years of unchanged application, it has become appropriate to at minimum adjust the RH-2-94 Formula to yield results more in line with the current market cost of equity capital.

As well, days before the TQM Decision, the Ontario Energy Board initiated "a consultative process to help it determine whether current economic and financial market conditions warrant an adjustment to any of the Cost of Capital parameter values set out in the letter of February 24th." In the February 24th letter, the Board announced its formula-based ROE of 8.01% for the rate year beginning May 1st. This is only 39 bps higher than the deemed long-term borrowing rate, which is derived from observation of more recent market data.

We are cautiously optimistic that the NEB and OEB requests will result in timely upward adjustments of their allowed return targets.

More broadly, we think that the reasoning within the NEB's TQM Decision is applicable across all the Canadian regulators that currently rely on similar ROE adjustment formulas. If this occurs, then the outlook for utility credit ratios will become more positive than it has been for many years. We see this as mildly bullish for sector spreads, not in the short term, but in the medium term, should it become apparent that Canadian regulators are taking appropriate actions to reflect the obvious other-than-temporary changes in financial market conditions.

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