FORTIS ONTARIO

September 8, 2009

Ms Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge St., Suite 2700
Toronto, ON
M4P 1E4

Dear Ms Walli:

RE: BOARD FILE NO.: EB-2009-0084
CONSULTATION ON COST OF CAPITAL

FortisOntario is pleased to provide written comments to the Board for its Consultation on Cost of Capital. The written comments were prepared in consultation with industry advisors, DAC Inc.

FortisOntario Inc. (the "Company") is a holding company, which owns and operates regulated electricity transmission and distribution businesses in the province of Ontario through its wholly-owned subsidiaries, Canadian Niagara Power Inc. ("CNPI") and Cornwall Street Railway, Light and Power Company Limited ("CE"). The Company recently announced that it has reached an agreement with Brookfield Renewable Power Inc. to purchase Great Lakes Power Distribution Inc. The Company also owns a 10 per cent strategic interest in Westario Power Holdings Inc., Rideau St. Lawrence Holdings Inc., and Grimsby Power Inc.

Yours truly,

Glen King
Vice President, Finance and
Chief Financial Officer

Enclosure

DAC Inc.
46 Owen Blvd.
Toronto, ON
M2P 1E9

September 8, 2009

Mr. Glen King,
Vice-President, Finance and Chief Financial Officer
FortisOntario Inc.
1130 Bertie Street
PO Box 1218
Fort Erie, Ontario
L2A 5Y2

Dear Mr. King:

Re: The Ontario Energy Board's Review of Cost of Capital EB-2009-0084

DAC Inc. (the "Consultant") understands that the Ontario Energy Board (the "OEB" or the "Board") has initiated a review of its policy regarding the cost of capital. This review follows an earlier review of the financial parameters produced by the Board's cost of capital methodology for 2009. In that review, the OEB requested comments from interested parties regarding the relationship between the proposed return on common equity (the "ROE") derived from the OEB methodology and the expected yield on long term corporate utility debt. In particular, the spread between these two costs was expected to be only 39 basis points in 2009 compared to 247 basis points in 2008.

Since 1997, the Board has primarily relied upon the equity risk premium ("ERP") approach to determine the ROE for rate making purposes for a utility's up coming year. The current formula applied to electric distribution utilities in Ontario is as follows:

$ROE_t = 9.35\% + .75 \times (LTCY_t – 5.50\%)$; where

ROE_t is the utility's return on common equity for year t; and

$LTCY_t$ is the forecast yield on a benchmark 30 year Government of Canada bond in year t.

FortisOntario Inc. (“FortisOntario” or the “Company”) has asked the Consultant to consider the OEB’s methodology, used to determine the ROE and other financial parameters awarded to electric distribution utilities, from the viewpoint of the Company’s ability to attract debt and equity capital and the capital markets’ major issues/concerns regarding the economic regulation of the Ontario electric distribution sector. The Consultant’s qualifications to advise FortisOntario are set out in Appendix A.

Background:

The formulaic approach to the determination of ROEs has been employed by the OEB since 1997 for gas utilities and since 1999 for electric distribution utilities. The British Columbia Utility Commission (the “BCUC”) and the National Energy Board (the “NEB”) had adopted similar formulas in 1994 while the Alberta Energy and Utilities Board (the “AEUB”) adopted a formulaic approach in 2004.

Initially the formulaic approach was viewed as a positive step forward in the regulatory process as the ROE setting process became more timely, more predictable, more transparent and the regulatory burden (both the cost and the amount of management time) associated with annual cost of capital reviews was significantly reduced. The re-regulation of the electricity sector in Ontario by the OEB in 1999 to include more than 250 municipally owned distribution utilities also added support for the use of a formula and generalized set of decision making rules to determine appropriate returns and capital structures for cost of capital purposes.

The use of essentially similar formulas in each of the major regulatory jurisdictions across Canada (the OEB, NEB, BCUC and AEUB) brought a measure of consistency and comparability to rates of return awarded to utilities which had not existed previously and was viewed favourably by participants in the capital markets.

In 2006, the OEB reviewed the application of the formulaic approach and capital structure decision making for electric distribution companies during Technical Conference EB-2006-0088, following Board Staff recommendations to alter the formula and decision making rules with respect to capital structure to assist in streamlining the regulatory process. Upon review, the OEB concluded, among other things, that while there should be no change in the original ROE methodology adopted in 1999; all electric distribution companies should be deemed to have a common equity base of 40%. For the operating subsidiaries of FortisOntario, this decision reduced their common equity base from 50%. The ROE formula was re-based to reflect changes in interest rates between 1999 and 2006.

In 2009, electric distribution companies, subject to rate rebasing, are allowed to earn a return on common equity of 8.01% on a 40% common equity base. The gas utilities are allowed to earn a slightly higher ROE on a somewhat smaller common equity base. For example, Enbridge is allowed to earn a return on common equity of 8.39% on a common equity base of 36%.

Problems with the formulaic approach became apparent a few years following its introduction, as ROEs awarded to gas utilities in Ontario began to decline at a faster rate than the ROEs of utilities in the United States having generally similar risk profiles. Compounding this problem, the total regulated return on capital (the “Fair Return”) in the United States provided greater financial integrity to the utility due to the fact that, relative to Canadian utilities, a larger common equity base is usually accepted for rate making purposes. In the United States, the larger common equity base earned a higher return on equity than utilities having similar risk profiles in Canada. The OEB attempted to ascertain the extent of differences in ROEs awarded and the common equity capitalizations for utilities in Canada and United States in 2007 by retaining Concentric Energy Advisors Inc. (“Concentric”) to study the situation. Concentric’s report on their findings is posted on the OEB’s website at:

http://www.oeb.gov.on.ca/documents/industryrelations/keyinitiatives/research/research_ROE_20070614.pdf

The report concludes that since the implementation of a formulaic approach in 1997, ROEs for Ontario gas distribution utilities have been generally lower than those for utilities in the United States by approximately 150 to 200 basis points. Prior to 1997, awarded returns in Ontario were at least at parity and sometimes greater than common equity returns awarded in the U.S. Additionally, the Canadian sample of utilities considered in the Concentric study had been awarded an average common equity percentage within their regulated capital structure of 37.45% while the U.S. sample of utilities had an average common equity ratio of 46.44% within their regulated capital structure. The report also concluded that, taken as a whole, U.S. gas utilities are not demonstrably riskier than Canadian gas utilities implying that the 150 to 200 basis point differential which had developed since 1997 is not appropriate.

Recent Developments:

Recent disruptions in the capital markets and the financial parameters produced by the formulaic model have likely exacerbated the already identified rate differential problem between utilities in Ontario and the U.S. and reduced the fairness of the Board's ROE process further, in the view of financial analysts and capital market participants. Following the major credit crisis experienced in global capital markets during 2008/2009 and a more bearish view for growth in the global economy due to the lack of credit availability and other factors, the yield on federal government debt declined to approximate 65 year lows. This reflected a "flight to quality" by lenders in the face of the credit crisis, as Government of Canada bonds are the most liquid bonds available in the domestic marketplace and have virtually no default risk. Additional demand for Government of Canada bonds due to the credit crisis added impetus to already declining yields throughout the 1995 to 2008 period reflecting the improving financial position of the federal government, which was the result of the federal government paying down debt, achieving annual budget surpluses and supporting new growth in the Canadian economy.

Even with the decline of long term Canada yields, the required yield for 'A' rated utility debt increased by 100 to 150 basis points as the credit spread between utility debt and Government of Canada bonds increased materially. Credit spreads for issuers such as the operating subsidiaries of FortisOntario have increased materially, as well. The cost of attracting additional common equity increased as common and preferred dividend yields increased and the stock market in Canada and elsewhere sold off substantially.

Notwithstanding these increased costs of capital, the rate of return on common equity proposed by the ROE formula for 2009 was 8.01% compared to 8.57% for 2008 while the cost of long term utility debt for 2009 was to be 7.62% versus a forecast cost of 6.10% in 2008. The resulting spread between the yield on long term utility debt and the rate of return on utility common equity declined from 247 basis points in 2008 to a mere 39 basis points in 2009. The proposed reduction of the ROE in an environment of significant increases in the cost of new common equity and the material decline in the spread between the utility ROE and the utility debt rate immediately caused concern in the debt and equity capital markets as the integrity of utility debt and equity capital in Ontario continued its downward decline which had begun in 1997.

OEB Review Process:

On March 16, 2009, the OEB initiated a consultative process to help it determine whether current economic and financial market conditions warranted an adjustment to any of the Cost of Capital parameter values (i.e., the return on common equity, long term debt rate, and/or short term debt rate) set out in the Board's letter of February 24, 2009. On June 18, 2009, the OEB issued its determination that the cost of capital parameter values for 2009 rates should not change from previously announced values and advised stakeholders that it is proceeding with a review of its policy regarding the cost of capital. The OEB anticipated that any changes to the policy made as a result of this review will apply to the setting of rates for the 2010 rate year.

The OEB's review of its policy regarding the cost of capital is entirely consistent with the actions of other regulatory boards using a formula to adjust ROEs. For example, the NEB waived the use of its ROE formula derived in Decision RH-2-94 for Trans Quebec and Maritimes Pipeline Inc. to derive rates for 2007 and 2008 and based its determination on an after tax weighted average cost of capital ("ATWACC") approach which gave rise to higher ROEs for the two years than the RH-2-94 formula would have provided. The Alberta Public Utilities Commission is currently reaching the end of a generic ROE hearing process which has essentially become a review of the reasonableness of its formula. The BCUC is reviewing the capital structure and ROE of Terasen Gas, the "benchmark low risk utility" in British Columbia and this review is focused on the reasonableness of the formula in use in that jurisdiction.

The review of the Board's policy regarding the cost of capital, the Fair Return Standard and the current ROE formula and adjustment mechanism is very timely given economic and capital markets developments since the adoption by the OEB of the equity risk premium approach in 1997. The Board's objective is to consistently meet the Fair Return standard with respect to the return on common equity, long and short term debt costs and capital structures awarded to gas and electric distribution utilities operating in Ontario. In addition, the level of activity in the annual regulatory calendar in Ontario demands that all stakeholders in the process must be on the lookout for new approaches that are more streamlined, more transparent and more reasonable in light of long term economic and capital markets developments.

Lenders and equity investors in Canada view the Board's proceeding and other similar proceedings before the NEB, BCUC and the AEUB as potentially watershed events which could define their investment programs in the future.

Competition for Utility Investment Funds:

Currently and for the foreseeable future, there will be an ample supply of investment opportunities for lenders and equity investors in domestic and international utility-like infrastructure projects. These projects offer lenders strong credit metrics, utility-like credit ratings, indirect government support and equivalent or higher returns than utility bonds. The same projects offer equity investors a diverse portfolio of long term "necessary" assets, indirectly supported by governments, synergistic business partnerships with domestic and international private sector developers and operators and returns which exceed those available in the Ontario utility sector.

Tax changes in 2005 and continuing market integration have allowed Canadian lenders and equity investors to participate, to a much greater extent, in the financing of utility and infrastructure assets in foreign jurisdictions. It is anticipated that this investment trend will continue as Canadian investors become more comfortable operating in such jurisdictions.

The implications of these developments are that Ontario based gas and electric distribution utilities face a much more competitive environment in which to attract debt and equity funds to finance capital expenditures. To attract funds on reasonable terms, Ontario based utilities should have internationally competitive credit metrics, such as earnings and cash flow coverage of interest obligations and cash flow to total debt obligations, adequate equity bases and competitive rates of return on common equity. The Board's ROE setting methodology impacts the foregoing financial results directly.

Mechanics of the ERP Formula:

With regard to the determination of an appropriate ROE for utility purposes, the perception of the long Canada bond yield has changed significantly since the equity risk premium approach was derived in the 1990s. At that time, the yield on such bonds was not a pure "risk free rate" but included additional compensation required by foreign investors for Canada's somewhat more tenuous financial position and weaker currency. Fortunately, due to strong economic growth and prudent financial management in the intervening period, Canada is now viewed more positively in international capital markets. This change in perception as well as an effective debt management program have removed, for the most part, the historic yield premium and brought 30 year Canada bond yields to approximate 65 year lows. In 2006, the ROE formula was re-calibrated when yields on long Canada bonds were expected to be 5.50%. Such yields are now less that 4.00%.

Achieved investor returns have been driven down by so-called “exuberant” market conditions. According to central bankers and other market participants, investors have been willing to accept too much investment risk, for too little return. The market correction in the last year represents the end of this anomaly. Unfortunately investors’ willingness to accept inadequate returns in the past may have been considered in the re-calibration of the equity risk premium in 2006.

The reliability of the year-to-year adjustment mechanism, based solely on expected changes in long term Canada bond yields, has also been called into question by the Concentric study, commissioned by this Board, of Canada and U.S. awarded utility returns. The recent decision by the National Energy Board (RH-1-2008), one of the first jurisdictions to adopt the ERP methodology and formulaic approach to setting the ROE in which, the NEB set aside the use of only Government of Canada bond yields to determine pipeline ROEs, chose a different methodology which provided higher ROEs and also endorsed the review and consideration of the financial performance of U.S. based pipelines and utilities as they represent comparable risk opportunities for Canadian investors.

<u>Capital Markets’ Issues/Concerns:</u>

There have been significant concerns and commentary in the capital markets that the Board’s current formula and methodology does not meet the Fair Return standard and does not preserve the financial integrity of Ontario based utilities. For electric distribution companies such as the operating subsidiaries of FortisOntario, the financial parameters derived from the OEB’s methodology raise the following issues:

- The short term debt rate of 1.33% is not reflective of the cost of short term debt. For a high grade utility, the spread over the Bankers Acceptance rate would approximate 175 basis points, for a utility such as the operating subsidiaries of FortisOntario; the spread would be in the range of 250 to 275 basis points. If this incremental cost is not included in customer rates, the financial integrity of distribution utility will be eroded as earnings and cash flow coverage of interest obligations and the earned return on common equity will be reduced;

- The operating subsidiaries of FortisOntario, given their size, requirement for funds, recently reduced common equity ratio, the relatively low rate of return on common equity and resulting weaker credit metrics would require a spread of approximately 250 to 300 basis points over long term Canada bonds to arrange a longer term financing (10 to 15 years) in the market. The subsidiaries are limited to the private placement market which generally requires somewhat higher yields to compensate lenders for the lack of liquidity and more stringent covenants which limit the Company's financial flexibility; and
- The return on common equity of 8.01% does not represent a fair return for the Company's utility operations and may be inadequate to attract new equity capital into the Ontario electricity sector.

Conclusions:

Capital market participants believe the OEB methodology should be re-examined with particular focus on the appropriateness of the currently assumed equity risk premium, the use of Government of Canada bond yields as the base of the ROE formula and a sensitivity factor of .75 to adjust the base ROE with changes in the credit markets.

Yours very truly

Donald A. Carmichael

Appendix A

Qualifications of
Donald A. Carmichael

My name is Donald A. Carmichael. I live in Toronto, Ontario where I am a financial consultant and advisor. Prior to becoming a financial consultant, I worked in the investment banking industry for more than 30 years with Scotia Capital Inc., Richardson Greenshields Limited and McLeod Young Weir Limited. My work was principally focused on natural gas transmission and distribution companies as well as electricity generation, transmission and distribution companies in both the public and private sectors. I was responsible for advising investment banking clients on the appropriate terms and pricing of debt and equity securities, providing strategic advice regarding mergers and acquisitions and executing business on behalf of some of the firms' most significant clients. This included advising both governments and corporations on strategic, regulatory and financing issues. I frequently participated in the marketing of debt and equity transactions to institutional investors, on behalf of my clients. I had extensive interaction with representatives of such lenders and investors in respect of the business profile of the issuer and the pricing of the issue. My activities in Ontario include debt, preferred and/or common equity financing for The Consumers Gas Company Ltd., Union Gas Limited, Hydro One Inc. Toronto Hydro Corporation and the valuation of Consumers Gas and Union Gas for acquisition purposes.

Since forming my consulting and advisory business, I have advised the following clients:

- In 2006, I appeared on behalf of the Coalition of Large Electricity Distributors (a group consisting of Toronto Hydro, Mississauga Hydro, Horizon Utilities, PowerStream Utilities, Ottawa Hydro and Veridian Corporation) before a Technical conference organized by the Ontario Energy Board (the "OEB") to discuss new processes to regulate Ontario's 90 local electricity distribution companies in a more streamlined fashion. I commented on the potential capital markets reaction to the OEB's proposals to streamline the determination of the ROE as well as necessary levels of equity capital to finance utility investment.
- In 2007, I co-authored an expert report to the Nuclear Waste Management Organization regarding its long term funding program for the storage of nuclear waste produced by nuclear power reactors operating in Canada. In addition, I assisted Ontario Power Generation Inc. ("OPG") in negotiating the financial parameters of a long term power purchase agreement between OPG and the Ontario Power Authority. I advised Toronto Hydro Corporation regarding the financing of certain non-regulated activities through subsidiary companies on a limited or non-recourse basis.
- During 2008, I advised OPG on various regulatory strategies relating to its initial application to the OEB regarding the company's regulated nuclear and hydraulic generating assets. I provided an opinion to OPG's senior management team as to whether the applied for rate increase was reasonable

in light of the risks which the regulated operations of the Company face and to provide on-going strategic and tactical input.

- In 2009, I have submitted testimony to the British Columbia Utility Commission regarding the reasonableness of its ROE formula on behalf of Terasen Gas Inc.

I received my education at The University of Waterloo where I obtained an Honours Bachelor of Mathematics degree and at the Rotman School of Business at the University of Toronto where I achieved a Master of Business Administration with specializations in Finance and Operations Research.

Over the course of my career, I have appeared before the National Energy Board (Interprovincial Pipe Lines Limited and Trans Mountain Pipe Line Inc.), the Canadian Radio-television and Telecommunications Commission (the BC Telephone Company Limited, Telesat and Teleglobe), the Alberta Energy and Utilities Board (AltaLink LLP), the OEB (Union Gas Inc., Ontario Hydro, Coalition of Large Distributors), the New Brunswick Public Utilities Board (New Brunswick Power Corporation) and the Board of Commissioners of Public Utilities of Newfoundland (Newfoundland and Labrador Hydro).