COST OF CAPITAL

1.0 INTRODUCTION

The purpose of this evidence is to summarize the method and cost of financing Hydro One Transmission's capital requirements for the 2011 and 2012 test years.

2.0 CAPITAL STRUCTURE

Hydro One Transmission's deemed capital structure for rate making purposes is 60% debt and 40% common equity. This capital structure was approved by the Board as part of its May 28, 2009 Decision on Hydro One's Transmission Rate Application (EB-2008-0272). This is consistent with the Board's report on the cost of capital: see the Report of the Board on the Cost of Capital for Ontario's Regulated Utilities dated December 11, 2009 (EB-2009-0084). The 60% debt component is comprised of 4% deemed short term debt and 56% long term debt.

3.0 RETURN ON COMMON EQUITY

Hydro One Transmission's evidence reflects a return of 10.16% for the test year 2011 and 10.41% for the test year 2012. This is based on the Board's formulaic approach in the Report of the Board (EB-2009-0084), using the Long Canada Bond Forecast for 2011 and 2012, based on the September Consensus Forecast and Bank of Canada data which was available in October 2009 and the change in the spread of A-rated Utility Bond Yield. Hydro One assumes that the return on equity for each test year will be updated in accordance with the December 11, 2009 Cost of Capital Report, upon the final decision in this case. For rates effective January 1, 2011, the Board would determine the ROE for Hydro One Transmission based on the September 2010 Consensus Forecasts and Bank of

Canada data which would be available in October 2010 and the change in the spread of the A-rated Utility Bond Yield which is available on Bloomberg. For rates effective January 1, 2012, the Board would determine the ROE based upon the September 2011 Consensus Forecasts and Bank of Canada data which would be available in October 2011 and the change in the spread of the A-rated Utility Bond Yield which is available on Bloomberg.

4.0 DEEMED SHORT-TERM DEBT

The Board has determined that the deemed amount of short-term debt that should be factored into rate setting be fixed at 4% of rate base. The Board has indicated in Appendix D of the December 11, 2009 Cost of Capital Report, once a year, in January, Board staff will obtain real market quotes from major banks, for issuing spreads over Bankers Acceptance rates to calculate an average spread. The short term rate will be calculated as the average Bankers' Acceptance for the 3 months in advance of the effective date for the rates, plus the average spread calculated above. Variable rate debt which pays interest based on the bankers' acceptance rate, has been included as part of the deemed short term debt amount of 4%. For Hydro One Transmission the deemed short-term rate is 3.99% for 2011 using the November 2009 Global Insight Forecast plus a spread of 150 bps, which is an estimate of the spread that would be charged to Hydro One to obtain a short-term loan in the bank market. The deemed short term rate is 5.00% for 2012 using the November 2009 Global Insight forecast plus a spread of 150 bps, which is an estimate of the spread that would be charged to Hydro One to obtain a short term loan in the bank market.

Hydro One assumes that the deemed short term debt rate for each test year will be updated in accordance with the December 11, 2009 Cost of Capital Report, upon the final decision in this case. Specifically, for rates effective January 1, 2011, the Board would determine the deemed short term debt rate for Hydro One Transmission based on the September 2010 Bank of Canada data which would be available in October 2010 plus the average spread. For rates effective January 1, 2012, the Board would determine the deemed short term debt rate based upon the September 2011 Bank of Canada data which would be available in October 2011 plus the average spread calculated in 2011.

5.0 LONG-TERM DEBT

The Board has determined that the deemed amount of long-term debt that should be factored into rate setting be fixed at 56% of rate base. The long term debt rate is calculated to be 5.67% for 2011 and 5.64% for 2012. The long term debt rate is calculated as the weighted average rate on embedded debt, new debt and forecast debt planned to be issued in 2010, 2011 and 2012 as discussed in Exhibit B1, Tab 2, Schedule 1. Details of Hydro One Transmission’s long term debt rate calculation for the 2011 and 2012 test years are identified at Exhibit B2, Tab 1, Schedule 2, pages 5 and 6. A detailed discussion of Hydro One Transmission's debt and forecast interest rate support is provided at Exhibit B1, Tab 2, Schedule 1. Historical long-term debt cost information is filed at Exhibit B2, Tab 1, Schedule 2, pages 1 to 3.

As Hydro One Transmission has a market determined cost of debt, the weighted average long term debt rate is also applied to any notional debt that is required to match the actual amount of long term debt to the deemed amount of long term debt. This is consistent with the treatment in EB-2008-0272.

6.0 COST OF CAPITAL SUMMARY

Hydro One Transmission's 2011 rate base is $8,378.5 million which results in an after-tax required return of 7.40%. The 2012 rate base is $9,134.6 million, which results in an after-tax required return of 7.52%, as shown in Table 1, below:

Table 1
2011 and 2012 Cost of Capital

	2011				2012			
Amount of Deemed	**($M)**	**%**	**Cost Rate (%)**	**Return ($M)**	**($M)**	**%**	**Cost Rate (%)**	**Return ($M)**
Long-term debt	4,692.0	56.0%	5.67%	265.9	5,115.3	56.0%	5.64%	288.3
Short-term debt	335.1	4.0%	3.99%	13.4	365.4	4.0%	5.00%	18.3
Common equity	3,351.4	40.0%	10.16%	340.5	3,653.8	40.0%	10.41%	380.4
Total	8,378.5	100.0%	7.40%	619.7	9,134.6	100.0%	7.52%	687.0

Historical, bridge and test year debt and equity summary schedules have been provided at Exhibit B2, Tab 1, Schedule 1.

COST OF THIRD PARTY LONG-TERM DEBT

1.0 HYDRO ONE TRANSMISSION LONG-TERM DEBT

The debt portfolio for Hydro One Transmission, as set out in Exhibit B2, Tab 1, Schedule 2, is based on debt issued by Hydro One Networks Inc. to Hydro One Inc., of which the Transmission business is mapped a portion. Hydro One Networks Inc. issues debt to Hydro One Inc., reflecting debt issues by Hydro One Inc. to third party public debt investors.

Third party public debt investors hold all of the long term debt issued by Hydro One Inc. Hydro One Inc.'s debt financing strategy takes into consideration the objectives of cost effectiveness, distributing debt maturities evenly over time, and ensuring the term of the debt portfolio is compatible with the long life of the Company's assets.

Hydro One Inc. has a Medium Term Note ("MTN") Program that provides ready access to issue debt with a term greater than one year into the Canadian debt capital markets. The standard maturity terms of five, ten and 30 years are preferred by investors and represent the main financing which Hydro One Inc. utilizes to execute its financing strategy and raise the required funds. The short form base shelf prospectus for the current $3.0 billion MTN Program is provided in Exhibit A, Tab 10, Schedule 2. Hydro One Inc. also maintains $1.5 billion in liquidity facilities which would be drawn in the event it cannot access the long term debt markets for financing.

2.0 CREDIT RATINGS

As Hydro One Inc. issues medium term notes in the Canadian public debt markets, credit ratings are a requirement. The credit ratings of Hydro One Inc.'s debt obligations by

Dominion Bond Rating Service, Moody's Investors Service and Standard & Poor's Rating Services are as follows:

Table 1
Credit Ratings for Hydro One Inc.

Rating Agency	Short-term Debt	Debt
Standard & Poor's Rating Services (S&P)	A-1	A+
Dominion Bond Rating Service (DBRS)	R-1(middle)	A(high)
Moody's Investors Service (Moody's)	Prime-1	Aa3

The most recent rating agency reports are provided in Exhibit A, Tab 10, Schedule 1.

3.0 COST OF LONG-TERM DEBT

The long term debt rate is calculated as the weighted average rate on embedded debt, new debt and forecast debt planned to be issued in 2010, 2011 and 2012. The weighted average rate on long term debt rate is 5.67% for 2011 and 5.64% for 2012. Details of Hydro One Transmission's long term debt rate calculation for the 2010 bridge year and 2011 and 2012 test years are identified at Exhibit B2, Tab 1, Schedule 2, pages 4 to 6.

The amount of each Hydro One Networks Inc. debt issue that is mapped to the Transmission business is based on its most recent forecast of borrowing requirements. Borrowing requirements are driven mainly by debt retirement, capital expenditures net of internally generated funds, and the maintenance of its capital structure. For example, in November 2009, Hydro One Inc. issued $250 million of five-year notes with a coupon rate of 3.13%, of which $175 million was mapped to Hydro One Transmission as shown on line 29 of Exhibit B2, Tab 1, Schedule 2, page 3. The interest rates of debt issues mapped to the Transmission business, as shown in Exhibit B2, Tab 1, Schedule 2, are equal to the actual interest rates on debt issued by Hydro One Networks Inc. to Hydro One Inc., and by Hydro One Inc. to third party public debt investors.

3.1 Embedded Debt

The Board has determined in its December 11, 2009 Cost of Capital Report that for embedded debt, the rate approved in prior Board decisions shall be maintained for the life of each active instrument, unless a new rate is negotiated, in which case it will be treated as new debt. Hydro One Transmission's embedded long term debt, which was issued during the period from 2000 to 2008, is shown on lines 1 to 24 of Exhibit B2, Tab 1, Schedule 2, page 3. The rates on these embedded debt issues were approved by the Board as part of EB-2008-0272.

3.2 New Debt

The Board has determined in its Cost of Capital Report that the rate for new debt that is held by a third party will be the prudently negotiated contract rate. This would include recognition of premiums and discounts. The following discusses new debt issued during 2009 and 2010, which are shown on lines 23 to 29 of Exhibit B2, Tab 1, Schedule 2, page 4.

In January of 2009, Hydro One Inc. issued \$100 million of notes, of which \$65 million was mapped to Hydro One Transmission, as shown on line 23 of Exhibit B2, Tab 1, Schedule 2, page 4. The issue was a re-opening of the 3.89% coupon note originally issued in November, 2008, bringing the total amount in that series to \$200 million.

In January of 2009, Hydro One Inc. issued \$200 million of notes, of which \$130 million was mapped to Hydro One Transmission as shown on line 24 of Exhibit B2, Tab 1, Schedule 2, page 4. The issue was a re-opening of the 5.00% coupon note originally issued in November, 2008, bringing the total amount in that series to $600 million.

In March of 2009, Hydro One Inc. issued a $300 million thirty-year note with a coupon rate of 6.03%, of which $195 million was mapped to Hydro One Transmission as shown on line 25 of Exhibit B2, Tab 1, Schedule 2, page 4.

In July of 2009, Hydro One Inc. issued $300 million of thirty-one-year notes with a 5.49% coupon rate, of which $210 million was mapped to Hydro One Transmission, as shown on line 26 of Exhibit B2, Tab 1, Schedule 2, page 4.

In November of 2009, Hydro One Inc. issued $250 million of five-year notes with a 3.13% coupon rate, of which $175 million was mapped to Hydro One Transmission, as shown on line 27 of Exhibit B2, Tab 1, Schedule 2, page 4.

In January of 2010, Hydro One Inc. issued $500 million of notes maturing in November 2014, of which $150 million was mapped to Hydro One Transmission. At the time of the issue Hydro One entered into a $500 million notional principal amount fixed to floating interest rate swap to convert this note into variable or floating rate debt paying an effective interest rate of three-month bankers' acceptance rate plus 40 basis points. This variable rate debt has been included as part of the deemed short-term debt amount equal to 4% of rate base.

In March of 2010, Hydro One Inc. issued $200 million of thirty-year notes with a 5.49% coupon rate, of which $120 million was mapped to Hydro One Transmission, as shown on line 28 of Exhibit B2, Tab 1, Schedule 2, page 4. The issue was a re-opening of the 5.00% coupon note originally issued in July 2009, bringing the total amount in that series to $500 million.

In March of 2010, Hydro One Inc. issued $300 million of ten-year notes with a 4.40% coupon rate, of which $180 million was mapped to Hydro One Transmission, as shown on line 29 of Exhibit B2, Tab 1, Schedule 2, page 4.

3.3 Forecast Debt

Hydro One Transmission’s forecast borrowing requirements are $200 million remaining for 2010, $900 million for 2011 and $675 million for 2012. For 2011 and 2012 planning purposes it is assumed that debt issuance will be evenly distributed over the standard five, ten and 30 year terms, which are preferred by investors.

Table 2 lists the fixed rate MTN's which Hydro One Networks Inc. plans to issue in 2010, and will be mapped to the Transmission business, as shown on lines 30 and 31 of Exhibit B2, Tab 1, Schedule 2, page 4.

Table 2
Forecast Debt Issues for remainder of 2010

2010		
Principal Amount ($Millions)	**Term (Years)**	**Coupon**
100.0	5	3.56%
100.0	10	4.68%

Table 3 lists the fixed rate MTN's which Hydro One Networks Inc. plans to issue in 2011, and 2012 will be mapped to the Transmission business, as shown on lines 28 and 33 of Exhibit B2, Tab 1, Schedule 2, page 6.

Table 3
Forecast Debt Issues for 2011 and 2012

2011			2012		
Principal Amount ($Millions)	**Term (Years)**	**Coupon**	**Principal Amount ($Millions)**	**Term (Years)**	**Coupon**
300.0	5	4.26%	225.0	5	4.76%
300.0	10	5.38%	225.0	10	5.88%
300.0	30	6.41%	225.0	30	6.91%

3.4 Interest Rates for 2010, 2011 and 2012 Forecast Debt Issues

Transmission business borrowing will be financed at market rates applicable to Hydro One Inc. Table 3 summarizes the derivation of the forecast Hydro One Inc. yield for each of the planned issuance terms for 2010, 2011 and 2012.

Table 4
Forecast Yield for 2010-2012 Issuance Terms

	2010		
	5-year	**10-year**	**30-year**
Government of Canada	3.00%	3.80%	4.35%
Hydro One Spread	0.56%	0.88%	1.36%
Forecast Hydro One Yield	3.56%	4.68%	5.71%
	2011		
	5-year	**10-year**	**30-year**
Government of Canada	3.70%	4.50%	5.05%
Hydro One Spread	0.56%	0.88%	1.36%
Forecast Hydro One Yield	4.26%	5.38%	6.41%
	2012		
	5-year	**10-year**	**30-year**
Government of Canada	4.20%	5.00%	5.55%
Hydro One Spread	0.56%	0.88%	1.36%
Forecast Hydro One Yield	4.76%	5.88%	6.91%

Each rate is comprised of the forecast Canada bond yield plus the Hydro One Inc. credit spread applicable to that term. The ten year Government of Canada bond yield forecast for 2010 is based on the average of the three month out (February 2010) and 12 month out (November 2010) forecasts from November 2009 Consensus Forecasts, and for 2011 and 2012 is based on the October 2009 Consensus Forecasts. The five and 30 year Government of Canada bond yield forecasts are derived by adding the November 2010 average spreads (five to ten year for the five year forecast and 30 to ten year for the 30 year forecast) to the ten year Government of Canada bond yield forecast. Hydro One's credit spreads over the Government of Canada bonds are based on the average of indicative new issue spreads for November 2009 obtained from the Company's MTN dealer group for each planned issuance term.

3.5 Treasury OM&A Costs

Treasury OM&A costs are incurred to:

- execute borrowing plans and issue commercial paper and long term debt;
- ensure compliance with securities regulations, bank and debt covenants;
- manage the company's daily liquidity position, control cash and manage the company's bank accounts;
- settle all transactions and manage the relationship with creditors; and
- communicate with debt investors, banks and credit rating agencies.

These costs are $2.1 million for 2011 and 2012 as shown on line 33, page 5 and line 35, page 6 of Exhibit B2, Tab 1, Schedule 2.

3.6 Other Financing-Related Fees

Column (e) of Exhibit B2, Tab 1, Schedule 2 ("Premium, Discount and Expenses") represents the costs of issuing debt. These costs are specific to each debt issue and include commissions, legal fees, debt discounts or premiums on issues or re-openings of issues relative to par, and hedge gains or losses.

Other financing related fees, $5.7 million in 2011 and $5.7 million 2012, identified on line 34 page 5 and line 36 page 6 of Exhibit B2, Tab 1, Schedule 2, include the Transmission allocation of Hydro One Inc.'s standby credit facility, annual credit rating agency, banking, custodial and trustee fees.