CAPITALIZATION, RETURN ON EQUITY AND COST OF CAPITAL

1.0 PURPOSE
This evidence provides OPG’s capital structure and its return on common equity for fiscal years ended 2005 - 2009 inclusive.

This evidence also summarizes the capitalization and cost of capital for fiscal years ended 2005 - 2009 inclusive. The summary reflects the capital structure and return on common equity discussed in this evidence, the long-term debt costs described in Ex. C1-T2-S2 and the short-term debt costs described in Ex. C1-T2-S3.

2.0 CAPITAL STRUCTURE
For the 2008 and 2009 fiscal years OPG has applied the capital structure (57.5 percent equity and 42.5 percent debt) recommended by Foster Associates, Inc., as provided in Ex. C2-T1-S1. OPG’s 2008 and 2009 proposed capital structure is determined pursuant to the methodology outlined in Ex. C1-T1-S1.

For the 2005 - 2007 fiscal years OPG has applied the capital structure (45 percent equity and 55 percent debt) that was reflected in information provided by OPG to the Province for the purpose of establishing interim payment amounts.

The debt component of OPG’s capital structure is determined using the methodologies described in Ex. C1-T1-S2 and Ex. C1-T1-S3 for long-term and short-term debt respectively.

3.0 RETURN ON EQUITY
For the 2008 and 2009 fiscal years OPG has applied the 10.5 percent return on equity recommendation of Foster Associates, Inc., as provided in Ex. C2-T1-S1.

OPG has determined a return on equity for its regulated operations for each of 2005, 2006 and 2007 using a reconciliation approach. OPG’s audited financial statements report its accounting earnings before interest and income taxes (“accounting EBIT”) for both OPG’s
regulated hydroelectric business segment and OPG's nuclear business segment. The audited accounting EBIT amounts are amended to include interest, taxes, and other adjustments required to reflect the impact of regulation (discussed below). This approach to determining return on equity effectively addresses the filing guidelines issued by the OEB related to the reconciliation of OPG's evidence to its audited financial statements.

Return on equity information for regulated operations has not been used by OPG for the purpose of operating its business, nor is this information required to support OPG's business or financial planning, financial reporting, or income tax return filings. OPG has determined and presented 2005, 2006 and 2007 return on equity information to provide:

- A general context to assess the adequacy of OPG's interim payment amounts determined prior to regulation by the OEB.
- A level of independent validation of OPG's financial position prior to regulation by the OEB (i.e., the starting point for OPG's return on equity is OPG's audited financial information).

OPG does not expect this information will be necessary to support future payment applications as the regulatory proceeding to establish the initial payment amounts by the OEB will provide:

- Suitable context for assessing the adequacy of payment amounts established by the OEB.
- Sufficient public information to understand OPG's regulated operations and OPG's expected financial position prior to subsequent proceedings.

To determine a return on equity for OPG's regulated operations that is consistent with the return on equity proposed for its test period, the accounting EBIT for OPG's regulated operations reported in OPG's audited financial statements is adjusted to reflect: interest and taxes; certain revenues or expenses included in accounting EBIT that are not included in regulatory income; and differences between the accounting and regulatory methodology used to determine certain revenues or expenses included in both accounting EBIT and regulatory income.
The reconciliation between OPG’s accounting EBIT as reported in OPG’s 2006 and 2007 audited financial statements and the return on equity for OPG’s regulated operations is provided in Ex. C1-T2-S1 Table 1. OPG has provided an explanation for each adjustment to accounting EBIT and the approach OPG has used to determine the adjustment in section 3.1 below. The footnotes to Ex. C1-T2-S1 Table 1b support the derivation of the specific adjustment included in the reconciliation.

The reconciliation is divided into two sections. The first section provides the reconciliation between accounting EBIT and regulatory EBT. OPG uses regulatory EBT as basis for determining the regulatory income tax expense as presented in Exhibit F3-2-1 Table 7 (for 2005 and 2006) and Table 8 (for 2007). The second section provides the reconciliation between regulatory EBT and the return on equity for OPG’s regulated operations.

### 3.1 Adjustment to Accounting 2005/2006/2007 Earnings Before Interest and Taxes to Determine Regulatory Earnings Before Tax

The reconciliation between accounting EBIT and regulatory EBT is based on three adjustments:

- removal of accounting expenses and revenues not included in regulatory EBT
- differences between accounting and regulatory treatment of certain revenues and expenses
- interest expense

#### 3.1.1 Removal of Accounting Expenses and Revenues Not Included in Regulatory EBT

The only revenues or expenses included in accounting EBIT that are not included in regulatory income are accretion expense associated with OPG’s fixed asset removal and nuclear waste management obligations and the revenues earned on OPG’s segregated funds established to finance these same fixed asset removal and nuclear waste management obligations. Together these two items are considered a “closed system”1 that are not included in revenue requirement. Only the period expenses associated with OPG’s

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1 As characterized by the OEB in RP-1999-0001 Decision for Ontario Hydro Services Corporation
nuclear waste management liabilities as described in Ex. H1-T1-S2 are included in regulatory EBIT.

3.1.2 Differences in Accounting and Regulatory Treatment of Certain Revenues and Expenses

To the extent OPG’s accounting treatment and regulatory treatment differ, the accounting numbers are removed (i.e., removing revenue reduces income, removing expenses increases income), and the regulatory amounts are included. OPG has made three adjustments as described below:

- Production in excess of 1900 MW/h: O. Reg. 53/05 provides that OPG earns the difference between the spot market price and the interim payment amount for production in excess of 1900 MW in any hour commencing April 1, 2005. Accounting EBIT reflects these spot market revenues. An adjustment is required to deduct this difference between OPG’s interim payment amount and the spot market price. OPG’s proposed return on equity and revenue requirement did not include incremental revenue associated with the proposed hydroelectric incentive mechanism; therefore its achieved return on equity will be reported on a consistent basis.

- Capital taxes: Capital taxes included in accounting EBIT are based on an allocation of capital taxes determined on a corporate basis. Capital taxes for regulatory purposes are determined by applying the capital tax rate to OPG’s nuclear and regulated hydroelectric rate base

- Unrealized exchange rate adjustments: As a result of a change in Generally Accepted Accounting Principles, OPG is required to include unrealized gains/losses in accounting net income on certain embedded derivative financial instruments commencing January 1, 2007. OPG has a uranium concentrate purchase contract that includes a fixed U.S. dollar rate for these purchases. As a result, this contract is affected by the change in

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2 In December 2006, OPG’s nuclear liabilities increased by $1.386B as described in Ex. H1-T1-S1. As presented in the evidence, certain 2007 expenses related to nuclear liabilities, e.g., capital and income tax, return on equity for Bruce Lease Assets, include the impact of this increase. The 2007 expenses in this Ex. C1-T2-S1 remove the impact of the increase of nuclear liabilities from the calculation of Regulatory EBT as detailed in Ex. C1-T2-S1 Table 1b.
GAAP. Consistent with the regulatory treatment of the other financial derivatives (Ex. C1-2-2), unrealized gains/losses are not included in either the ROE for OPG’s regulated operations or the regulatory EBT for income tax purposes.

3.1.3 Interest Expense

Interest expense is determined using the capital structure, long-term debt, and short-term debt expense and allocation methodologies provided throughout Exhibit C.³

3.2 Adjustments to Regulatory Earnings Before Taxes to Determine ROE

The reconciliation between regulatory EBT and ROE is based on three adjustments:

- income taxes on regulated assets
- approved return on equity for Bruce leased assets
- deferral of 2007 expenses related to the December 31, 2006 increase in ARO

3.2.1 Income Taxes on Regulated Assets

Income taxes are usually determined using the stand-alone utility methodology described in Ex. F3-T2-S1; however OPG has losses for income tax purposes in 2005, 2006 and 2007. OPG’s tax expense for 2005 reflects the last year that the large corporation tax was in effect. As the large corporation tax associated with OPG’s regulated assets is an after tax cost (i.e., not deductible for tax purposes), the large corporation tax has been deducted from regulatory earnings before tax in determining OPG’s 2005 return on equity.

3.2.2 Approved ROE for Bruce Leased Assets⁴

Regulatory EBT includes all earnings associated with Bruce leased assets. The only “cost” not reflected in regulatory EBT is the return on equity OPG is allowed to earn on its Bruce leased Assets. The adjustment is made after the regulatory EBT as OPG’s return on equity is an after tax return. To determine the income tax expense on the ROE associated with the

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³ For 2007, interest expense does not include the portion associated with the December 31, 2006 increase in ARO (see footnote 3)

⁴ The return on equity costs to OPG’s regulated operations does not include the portion associated with the December 31, 2006 increase in ARO (see footnote 3)
Bruce leased assets, OPG has applied the income tax rate as provided in Ex F3-T2-S1, Table 8 for 2005, 2006 and Table 9 for 2007 to the return on equity.

3.2.3 Deferral of 2007 Expenses Related to the December 31, 2006 Increase in ARO

As required by the Regulation, OPG recorded 2007 expenses associated with the December 31, 2006 increase in the Nuclear Liability Deferral Account, Transition as described in Ex J1-1-1. OPG will incur a significantly higher level of expenses as a result of the December 31, 2006 increase in ARO on an on-going basis over the life of its nuclear assets. OPG’s 2007 deferred cost amount of $127M is representative of the increased expenses OPG will incur in the test period. As these are significant on-going costs, they have been included in 2007 ROE to provide a more relevant context within which to assess the adequacy of OPG’s current payment amount.

4.0 SUMMARY OF CAPITALIZATION AND COST OF CAPITAL: 2005 - 2009

OPG’s capitalization and cost of equity reflects the capital structure and return on equity discussed above. The cost of the debt components of OPG’s capital structure is discussed in Ex. C1-T2-S2 for long-term debt and Ex. C1-T2-S3 for its short-term debt. OPG has applied this capitalization to rate base as described in Exhibit B. The resulting capitalization and cost of capital for OPG’s 2005 to 2009 fiscal years is summarized in Ex. C1-T2-S1 Tables 2 - 6 for 2005 - 2009.

OPG recorded expenses of $130.5M in its Nuclear Liability Deferral Account, Transition for 2007. This includes $3.5M in interest expenses related to the deferred recovery of these costs. Interest expense was not included in the adjustment, as it is not an ongoing cost. All other expenses are reflected in OPG’s 2008 revenue requirement.