

Pièce FCBT-UMQ-OC-2

Before the Régie de l'Énergie du Québec

In the matter of:

Hydro Québec Distribution ("HQ DIST")

2003 Distribution Tariff Application (DTA) Demande R-3492-2002

Evidence of
Fédération canadienne de l'entreprise indépendante ("FCEI") /
Union des municipalités du Québec ("UMQ") & Option
consommateurs ("OC")
On Capital Structure and Rate of Return on Common Equity

Updated Economic Forecast

Dr. Lawrence Kryzanowski and Dr. Gordon S. Roberts

Ned Goodman Chair in Investment Finance, John Molson School of
Business, Concordia University, Montreal, Canada; and CIBC
Professor of Financial Services and Area Coordinator, Schulich
School of Business, York University, Toronto, Canada.

March 5, 2003

Régie de l'énergie
DOSSIER: R-3492-2002
DÉPOSÉE EN AUDIENCE
Date: 13 mars 2003
Pièces n°: FCBT-UMQ-OC-2

The economic and interest rate forecasts in our Prepared Testimony filed in January of this year predicted continued growth in the range of 3-4% for real GDP in Canada in 2003. We indicated that this positive outlook was tempered by three, potentially negative factors: the far weaker performance of the U.S. economy, a possible war in Iraq causing higher oil prices and reduced consumer confidence in both the U.S. and Canada and concerns about the impact of the Kyoto Accord. To update our forecast we reviewed the latest economic forecasts available on March 5, 2003 from the same sources employed in our Prepared Testimony: Bank of Montreal, Bank of Nova Scotia and Toronto Dominion Bank.¹

The updated forecasts reinforce the GDP growth forecast for Canada but suggest that growth will be slower during the first half of 2003 because of a weaker than predicted U.S. economy and continuing uncertainty about possible war in Iraq along with higher energy prices driving inflation. The forecasts remain consistent with our view that 2003 will be another good year for Quebec's economy. With higher energy prices, however, it is likely that Quebec will fall behind energy-producing provinces in 2003 economic growth.

Turning to interest rate forecasts, we note a divergence between the U.S. and Canada in central bank policy on short-term rates. While the Fed is not expected to raise short-term rates in the U.S. until late in the year, the Bank of Canada increased short-term rates early this month. In contrast with short-term rates, all of the bank economists have lowered their forecasts for long-term interest rates for 2003 reflecting slower economic

¹ Our updated economic forecast is drawn from BMO Financial Group Economics, *North American Outlook*, February 18, 2003 on www.bmo.com/economic; TD Economics, *The Weekly Bottom Line*, February 28, 2003 and *Provincial Economic Outlook*, February 27, 2003 on www.td.com/economics; and Scotia Economics, *Market Trends*, February 28, 2003, www.scotiabank.com

growth for the rest of this year. Looking further ahead into 2004, forecasts remain at levels at or above those in our Prepared Testimony.

Our update here follows the methodology employed in our prepared Testimony. For rate-making purposes we need to forecast the rate on 30-year Canada's. While there are forecasts of this rate by respected economics groups, others focus exclusively on forecasting 10-year Canada yields. This practice reflects the market trend toward concentrating on the more liquid 10-year bonds. Accordingly, we examine forecasts for both rates. To obtain a second forecast of the rate on 30-year Canada's, we follow the National Energy Board's practice of adding an average spread to the consensus forecast on 10-year Canada's.

As seen in Schedule 1 Revised, we draw on forecasts provided by the economics departments of three Canadian chartered banks. We do not have access to the current forecasts from Consensus Economics. Using 2003 as our "test year", we employ forecasts for June 30, 2003 as representing an "average" for the year.² Beginning with the 10-year forecasts, Bank of Montreal predicts this rate as 5.25%. Scotiabank Group forecasts that the 10-year Canada rate will be 5.10% in the second quarter of 2003. From TD Economics comes a forecast for 5.30%. We average these forecasts to obtain 5.22% as our forecast for the 10-year Canada rate in June 2003.

To transform our 10-year forecast into a prediction for the rate on 30-year Canada's we add the average spread between these two instruments as observed quarterly during 2002. According to BMO Economics this spread averaged 41 basis points. Rounding to 40 basis points and adding to 5.22% gives us 5.62% as our 30-year Canada's forecast for June 2003.

² The forecasts from TD Economics are the average of March 31, 2003 and September 30, 2003 forecasts..

As a check on this forecast, we recalculate the 30-year forecast as the simple average of forecasts from the two banks that predict this rate: 5.55% from Bank of Montreal and 5.60% from TD. This gives us an average of 5.58%, 4 basis points lower than what we obtained earlier.

In summary, our two forecasts suggest an average 30-year Canada rate of 5.60% for June 30, 2003. This represents a decline of 40 basis points in comparison with our original forecast of 6.00%. As noted earlier, this decline results from current economic trends and is expected to be temporary with the 30-year Canada yield predicted to be above 6.00% by the first quarter of 2004. Given that the Regie is setting rates for a period longer than the second half of 2003, we believe it is appropriate to retain our adoption of 6.00% for purposes of our analysis of the fair rate of return on equity for HQ DIST.

Schedule 1 Revised

Forecasts for Interest Rates for June 30, 2003. The table sets out data from Consensus Economics and from three banks: BMO, BNS and TD. Our forecast is simply the average.

<u>Source</u>	<u>10-year Canada's</u>	<u>30-Year Canada's</u>
Bank of Montreal	5.25	5.55%
Bank of Nova Scotia	5.10	--
Toronto Dominion Bank	5.30	5.60
Kryzanowski and Roberts	5.22	5.58

Sources:

www.bmo.com/economic, http://www.scotiacapital.com/English/bns_econ/forecasts.pdf, and <http://www.td.com/economics>.