Q. Mr. Coyne uses a medium term forecast of the ten year government bond rate from 2016-2018 (page 27). Please explain why Mr. Coyne judges the market to be inefficient in determining the current long Canada yield in the sense that the market takes these forecasts into account in setting the current yield. Is Mr. Coyne, in effect, double counting the expected increase in interest rates?

A. Mr. Coyne's use of a medium term forecast of ten year government bond yield, to which he adds the average historical spread between ten and 30-year government bonds yields, is consistent with the Board's previous decisions. As stated by the Board in the Decision and Order in P.U. 13(2013) at page 22: "It is regulatory practice in Canada to use the forecast yield for the long-term Canada bond as a proxy for the risk free rate in equity risk premium models."

Use of a forecast does not imply Mr. Coyne believes the market is inefficient. Investors, and specifically utility investors, take a long term view of their returns, and a forecast of the risk free rate helps capture these expectations. Furthermore, use of the forecasted bond yield to determine the risk free rate has not resulted in double-counting the expected increase in interest rates. It merely reflects market expectations for the evolution of future long-term bond yields.