

1 Q. Reference: CA-NP-090 and Page 27 of Coyne Evidence

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3 Mr. Coyne uses 2.97% as the risk-free rate in his CAPM analysis, which is
4 determined by taking the three-year average of the “expected” Canadian
5 government bond yields for 2016, 2017 and 2018 respectively.

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7 a) Does Mr. Coyne agree that in the CAPM, the risk-free rate is used in the
8 model to measure the return that an investor could earn by investing in an
9 asset with no risk (i.e., a beta of zero)?
- 10 b) Can Mr. Coyne find one example during the fall of 2015 or the first two
11 weeks of January, 2016, of a Canadian federal government bond that would
12 have been available that would have provided investors with a 2.97%
13 return?
- 14 c) Assuming the answer to part b) is no, please justify the logic of using the
15 average of future expected rates (that may never materialize as expected) in
16 the CAPM to measure an investment return that is “available” to investors
17 today.

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19 A. a) Mr. Coyne agrees that the risk-free rate is intended to be the return on a riskless
20 asset.
- 21
22 b) No.
- 23
24 c) As explained on page 10 of Concentric’s report, interest rates in Canada remain
25 near all-time lows due to the highly accommodative monetary policy of the Bank
26 of Canada. However, yields on corporate bonds and credit spreads have
27 increased, as explained on page 11, which suggests higher risk aversion among
28 investors. Use of bond yield forecasts, as opposed to the current risk free rate,
29 reflects the current market reality that while bond yields remain near all-time
30 lows, investors are factoring higher interest rates into their longer-term
31 expectations and required returns. Absent the use of forecasted bond yields, the
32 Company’s actual cost of capital would be underestimated. The BCUC
33 recognized this distinction in its most recent Generic Cost of Capital decision
34 where it found:

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36 *“Evidence submitted to the Panel indicates that, at the time of filing,*
37 *returns available to Canadian investors on long-term Government of*
38 *Canada default free bonds were in the 2.6 to 3 percent range. (Exhibit*
39 *B1-9-6, Appendix F, page 77; Exhibit C6-12, pages 53-71) Although*
40 *this return was available to investors and therefore seems to meet the*
41 *requirement of an opportunity cost, all of the experts submit that the*
42 *appropriate opportunity cost is better measured by the forecasted yield*
43 *on a long-term risk free instrument and that in some cases even this*
44 *estimate should be adjusted.”¹*

¹ BCUC, Generic Cost of Capital Proceeding (Stage 1), Decision, May 10, 2013, page 59.