Q. Reference: Dr. Booth's Evidence, Page 40, Lines 4-5

Does Dr. Booth believe that the market risk premium varies with the level of interest rates, or is it static regardless of the LTC yield? Please provide any evidence or rationale used to support your response.

A. Dr. Booth would judge the market risk premium as varying with the underlying risk in the equity and bond markets. In the 1990s when Canada was running very large deficits the LTC bond included significant inflation risk, that is, the risk the government would inflate its way out of its debt problems (similar to the US now given President Trump's statements). At that time Dr. Booth used a "low" market risk premium and pointed out that the risk of a Canadian regulated utility was essentially the same as investing in Government of Canada bonds, since their betas were both about 0.50. With a 5% "normal" market risk premium this implied that the actual market risk premium might have decreased by 2.5% due to the increased risk in the long Canada bond. As this risk disappeared with the Federal Government's commitment to reducing the deficit the market risk premium reverted to normal. Dr. Booth published some of this thinking with the empirical support in the Journal of Applied Corporate Finance (1998), "A new model for estimating risk premiums along with some evidence of their decline." This paper is available for download from his web page.