Q.   Evidence of Ms. McShane Page 5 lines 110-121

(a)   Does Ms. McShane accept Mr. Justice Lamont's definition of a fair rate of return quoted in A1 as a return on other securities of equal attractiveness, stability and certainty to that of the company's enterprise? If not why not?

(b)   Would Ms. McShane accept that Mr Justice Lamont's definition came out of changed conditions in the money market and it is to the money market (now capital) market that we should look to estimate fair rates of return? If not why not?

(c)   Given her answers to a) and b) would Ms McShane accept that the yield on government securities as a default free instrument is an accurate reflection of investor expected returns from holding those securities? If not why not?

(d)   Would Ms. McShane accept that the cornerstone of any discount rate or required rate of return or fair rate of return is the risk free rate from investing in Government of Canada securities? If not why not?

(e)   What other "objective" factors that all expert witnesses can agree on, can Ms. McShane point to that drive equity return requirements or fair rates of return, other than the yields on Government of Canada bonds? Please list them and indicate why she feels that they are both objective and commonly accepted by other expert witnesses? If necessary please provide citations to other expert witness testimony both on the part of companies and interveners.

(f)   Please provide a full list of all ROE adjustment formulae currently in use in Canada, when they were first adopted and when they have been reviewed and/or changed.

(g)   Please indicate whether Ms. McShane judges the reviews indicated in f) above to have been comprehensive and the decisions based on all the evidence put before them by both the company and intervener witnesses; or whether a particular decision was based either on incomplete evidence or faulty analysis.

(h)   Please indicate whether Ms. McShane would judge similar conclusions made by regulatory tribunals faced with the same sorts of analyses to involve circular reasoning or the lack of independent analysis by the regulatory tribunal involved. In particular, which tribunals would Ms. McShane judge to have been negligent in arriving at their decision on their ROE formula?

1   **(i)**   **Please indicate which tribunals Ms. McShane provided expert testimony to**
2   **when their ROE formula were either implemented or changed and which she**
3   **regards as having used circular reasoning rather than basing their decisions**
4   **on the evidence before them.**
5

6   A.   (a)   Ms. McShane accepts that the fair return is, as defined by the Court, as follows:
7

8   "By a fair return is meant that the company will be allowed as large a
9   return on the capital invested in its enterprise (which will be net to the
10   company) as it would receive if it were investing the same amount in other
11   securities possessing an attractiveness, stability and certainty equal to that
12   of the company's enterprise."
13

14   (b)   Ms. McShane agrees that the Court's focus was on changed conditions in what it
15   referred to as the money market; the decision states that "To properly fix a fair
16   return the Board must necessarily be informed of the rate of return which money
17   would yield in other fields of investment." In this context, the reference to the
18   money market can be interpreted as what we refer to as the capital markets.
19

20   (c)   Ms. McShane agrees that the yield on government bond securities reflects the
21   return that investors expect from holding those securities.
22

23   (d)   Ms. McShane agrees that a risk-free rate is the cornerstone of the application of
24   the Capital Asset Pricing Model, and that the long-term Government of Canada
25   bond yield is typically used as a proxy for the risk-free rate. She does not agree,
26   however, that it is necessary to start with the yield on long-term Government of
27   Canada bonds to estimate a fair return. Other models can be used to estimate a
28   fair return which do not require starting with the yield on long-term Government
29   securities, including risk premium tests which use corporate bond yields as the
30   base to which a premium is applied or the discounted cash flow model.
31

32   (e)   While there are factors which cost of capital experts should be able to agree on
33   which are objective indicators of trends, i.e., they can be directly observed, in the
34   cost of capital including the cost of equity, such as corporate bond yields, preferred
35   share yields, and dividend yields, a comparison of the analysis of company and
36   intervenor experts generally indicates that the interpretation or translation of those
37   trends into a fair return is subject to differences of opinion.
38

1   (f)   Automatic adjustment mechanisms which are still in use in Canada include:
2

Province/ Jurisdiction	Status	First Adopted	Dates of Reviews between First Adoption and Last Review	Last Reviewed	Comments
NEB	Under Generic Review as of July 3, 2009	1995	2001 (for TransCanada)	For TQM for 2007 and 2008	Formula not relied upon for TQM Settlement for 2007 rates included ROE based on formula as amended in 2003
Newfoundland and Labrador	Under Review	1998	none	Reviewed in 2003 and amended	
Québec	Currently Under Review for Gaz Metro	1998	Confirmed in 2004 for Gaz Metro at request of Company	Reviewed in 2007 and amended; suspension of formula requested in 2008 denied	
Ontario	Currently under Review for Electricity Distributors	1997	Reviewed in 2003 for Gas Distributors, and confirmed, Reviewed in 2006 for Electricity Distributors and confirmed	Reviewed in OPG rates proceeding in 2007 and confirmed	
Alberta	Currently under Review in Generic Cost of Capital Proceeding	2004		Adopted in 2004	
British Columbia	Currently under Review for Terasen Gas	1994	Reviewed in 1999 and amended	Reviewed in 2006 and amended	

3
4
5   (g)   The reviews referenced in the table above were comprehensive. Ms. McShane
6   has no basis to conclude that the regulators did not consider the full range of
7   information with which they were provided. Given the wide divergence of views
8   of experts, and fact that the preponderance of Canadian utilities have been
9   operating under similar automatic adjustment mechanisms, it is Ms. McShane's
10   view that it becomes increasingly difficult for regulators to abandon the prevailing
11   formula approach.

(h)   Ms. McShane is not suggesting that regulators have been negligent in arriving at their decisions. To the extent that regulators look to other jurisdictions for the confirmation of their decisions, there is an inevitable amount of circularity. The circularity becomes more problematic when virtually all of the ROEs are determined on the basis of automatic adjustment formulas which yield the same result.

(i)   Please see response to (g) above.