**Q. Evidence of Ms. McShane Appendix E**

**(a) Ms. McShane's financing flexibility adjustment on page E-4 is explicitly based on targeting a market to book ratio of 1.05-1.1 so that the utility can issue stock at above book value. In her judgment is such an adjustment still needed if the market to book is say 2.0 such that there is no chance of selling stock below book value even before a financing flexibility adjustment. Please explain in full.**

A. (a) Yes. As explained in Appendix E, "An adjustment to the equity risk premium and discounted cash flow test results for financing flexibility is required because the measurement of the return requirement based on market data results in a "bare-bones" cost. It is "bare-bones" in the sense that, theoretically, if this return is applied to (and earned on) the book equity of the rate base (assuming the expected return corresponds to the approved return), the market value of the utility would be kept close to book value." The actual market to book ratio reflects, among other things, expected earnings. For the sample of U.S. utilities, whose average market to book ratio in 2008 was approximately 1.6 times, the average *Value Line* forecast ROE was approximately 12.25% for the period 2012-2014. (See Schedule 15) By comparison, Ms. McShane's three market-based tests for estimating the cost of equity (before the financing flexibility allowance) averaged 10.25%.