Request for Information

Q. The risk premiums Dr. Booth utilizes in Schedule 4 of Appendix C include negative risk premiums. Please explain if it is logical that the expected risk premium for utilities" returns on Equity can ever be negative.

A. Statistically you have to include negative values otherwise by definition you bias the estimates. Suppose for example you look at 2000 for the electrics in Schedule 5. They had a bad year and as a result their retention rate was -5% and their ROE decreased to 7.04. As a result, their growth rate was -0.35% and their estimated fair return of 4% implied a negative risk premium. However, in the following year their ROE jumped to 13.63% in part because their book equity had been reduced in 2000. Combined with a retention rate of 48.77%, well above average this produced a fair return of 10.28% at a time that their dividend yield fell dramatically.

Looking at the estimates and then dropping ones you don't like is not acceptable. What is acceptable is recognizing that there are problems and using techniques to try and get around them by, for example, using say the Treasury bill yield plus 5.0% as the expected ROE or the median retention rate in place of the actual one. In this case URP3 gives more reasonable values.

On a general point it is logical for utility risk premiums to be negative. In the early 1980s the Ontario Energy Board awarded Consumers Gas (as EGDI then was) an allowed ROE less than the Government of Canada bond yield. This recognized that the LTC bond yield contained a significant risk premium not evident in utility shares.