Q. Evidence of Ms. McShane, Two factor model, Pages 60-67: With reference to CA-NP-109 above would Ms. McShane agree that one reason for the higher returns could be the improved regulatory environment as represented by the adoption of forward test years, the removal of the commodity function, fuel pass throughs, the increased use of deferral accounts, the adoption of ROE formulae etc. If not please explain how these risk reduction changes would show up in her regression model when she uses fixed coefficients, that is, the risk factors (betas) are constant throughout the time period.

A. The market returns that have been achieved by utilities over the longer term would reflect various factors, both positive and negative, including the rate of expansion of the utility industries, the evolution of the regulatory regime over time, the trends in allowed returns compared to trends in the cost of equity, as well as the reaction of utility shares to macroeconomic factors (e.g., increases in inflation and interest rates, followed by decreases in inflation and interest rates). Ms. McShane has no evidentiary basis to conclude that the higher returns achieved than explained by the regression are a function of declining risk. An analysis of the relative total volatility of the S&P/TSX Utilities index, measured by the ratio of five-year monthly standard deviations of the total market returns of the Utilities Index to the Composite from 1970 to 2011, although the relative volatility has changed throughout the period, show that there has not been a statistically significant trend up or down in the relative risk of the Utilities Index compared to the Composite.

Further, the conclusion that utility stocks earn higher returns than the CAPM predicts is an empirical observation that is not solely related to utility stocks, but to low beta stocks generally (with the converse observed for high beta stocks). As applied specifically to utilities, it is not an empirical observation limited to Canadian utilities, but has been identified as an issue for U.S. utilities as well. Nor is it simply a recent phenomenon. Studies which have identified and attempted to account for the underestimation date back to the late 1970s and early 1980s. If the issue were simply that the failure of the model to explain returns was due to the factors suggested in the question, it is unlikely that academics would have devoted considerable time and effort to attempting to specify models which more closely capture the risk/return relationships. Indeed, various factors have been identified which may account for the empirically observed relationships, including the preferential tax treatment of dividends versus capital gains, the misspecification of the market portfolio (which should in theory include all investable assets), and skewness or asymmetry in returns potential.