

1 **Q. Evidence of Ms. McShane, Historic returns, Page 74-77: Please discuss any**  
2 **differences and why such estimates are not circular in reflecting pervious regulatory**  
3 **ROE and business risk reduction decisions.**  
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5 A. The most significant differences between the two periods are: (1) the differences in bond  
6 total returns and (2) the levels of equity returns achieved by the U.S. electric utility  
7 sector. All of the market-based tests as applied to utilities entail some circularity because  
8 the inputs (e.g. prices and changes in prices, growth, expectations, actual returns) reflect  
9 some reaction on the part of investors to what returns regulators have set or what returns  
10 they expect regulators to set. The advantage of this test is that it provides a direct  
11 estimate of the utility expected return. In general, achieved market returns may differ  
12 from what investors had expected *a priori*. However, it is reasonable to expect that more  
13 stable sectors of the market will have actual returns that are closer to what investors had  
14 expected. As utilities are relatively low risk equity investments, the expected and actual  
15 returns are more likely to converge over the long-run than those of more volatile sectors.  
16 As a result, use of achieved utility returns provides a better estimate of the expected  
17 utility risk premium than a CAPM or CAPM-like risk premium test, which requires that  
18 utility specific expected returns be inferred from those of the overall market.