

- 1 **Q. Vander Weide Evidence - CAPM Estimates**
2
3 **a. Please confirm that the Value Line beta estimates are adjusted toward 1.0**
4 **using the Blume adjustment.**
5 **b. Please indicate whether Dr. Vander Weide is aware of any published**
6 **academic research that indicates that utility betas “regress” toward their**
7 **grand mean rather than 1.0 as assumed by the Blume adjustment.**
8 **c. Please provide a graph of the utility betas in Dr. Vander Weide’s sample of**
9 **US firms since 1990 and indicate whether they have regressed or moved**
10 **toward 1.0.**
11 **d. Please indicate why Dr. Vander Weide has used a US market risk premium**
12 **estimate rather than a Canadian one since the fair return estimate is for a**
13 **Canadian company.**
14 **e. Please provide a copy of the 2011 Year book.**
15 **f. Please confirm that the CAPM studies referenced by Dr. Vander Weide to**
16 **justify the graph on page 42 used short term Treasury Bill yield as the risk**
17 **free rate and did not adjust betas the way that Value Line does.**
18 **g. Please provide the CAPM estimates similar to those on page 43 using**
19 **Treasury bill yields and actual betas.**
20
21 **A. a. Confirm.**
22
23 **b. Dr. Vander Weide is aware that utility betas have not regressed to 1.0. However,**
24 **whether utility betas regress toward 1.0 or toward a “grand mean” is irrelevant to**
25 **Dr. Vander Weide’s conclusion that the CAPM underestimates the cost of equity**
26 **for companies with betas less than 1.0. Dr. Vander Weide bases his conclusion**
27 **primarily on his study of the referenced articles, which report results of studies**
28 **that do not adjust betas for their tendency to move toward 1.0.**
29
30 **c. Please see the response to CA-NP 270 (b.). Such a graph would be irrelevant to**
31 **Dr. Vander Weide’s conclusion that the CAPM underestimates the cost of equity**
32 **for companies with betas less than 1.0. Dr. Vander Weide bases his conclusion**
33 **primarily on his study of the referenced articles, which report results of studies**
34 **that do not adjust betas for their tendency to move toward 1.0.**
35
36 **d. Dr. Vander Weide uses the U.S. market risk premium data because the U.S.**
37 **market risk premium data are based on a more broadly diversified stock market**
38 **index than is available for use in Canadian risk premium data. The CAPM model**
39 **requires estimates of the risk premium on a broadly diversified market because**
40 **the CAPM assumes that the market index includes all risky securities in the**
41 **economy.**
42
43 **e. Dr. Vander Weide purchases the SBBI[®] Yearbook for a fee from Morningstar.**
44 **The book may be purchased at**
45 **<http://corporate.morningstar.com/US/asp/home2.aspx?xmlfile=7083.xml>. In**

1 addition, Dr. Vander Weide notes that he obtained the Ibbotson market risk
2 premium data in his evidence from the 2012 SBBI[®] Yearbook.

3
4 f. Confirm.

5
6 g. The requested study would not provide useful information regarding
7 Newfoundland Power's cost of equity. In his CAPM studies, Dr. Vander Weide
8 uses adjusted betas equal to approximately 0.7. The unadjusted beta for a
9 company with an adjusted beta of 0.7 would be approximately 0.55. The studies
10 in the articles referenced by Dr. Vander Weide demonstrate that, for companies
11 with unadjusted beats less than 1.0: (1) the CAPM underestimates the cost of
12 equity; and (2) the difference between the required market return and the CAPM-
13 estimated return is greater, the further the unadjusted beta estimate is from 1.0.
14 These studies strongly support the conclusion that the CAPM-estimated cost of
15 equity for a company with an unadjusted beta equal to 0.55 would significantly
16 underestimate the company's cost of equity. Thus, the requested CAPM
17 calculations would also significantly underestimate Newfoundland Power's cost
18 of equity. To illustrate the irrelevance of the requested study, consider the CAPM-
19 estimated cost of equity using a Treasury bill yield of approximately 0.1 percent,
20 a beta of 0.55, and a market risk premium of 6.6 percent. The CAPM-estimated
21 cost of equity would be 3.7 percent. Given that the average allowed ROE for
22 natural gas and electric utilities is approximately 10 percent, a 3.7 percent cost of
23 equity estimate is not credible.