

1 **Q. McShane Evidence – Why doesn't Ms. McShane include an explicit market**  
2 **capitalization criteria in constructing her sample and does Ms. McShane believe that**  
3 **it is a relevant consideration?**  
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5 A. Ms. McShane did not implement a size criterion because it was important to be able to  
6 select a sample of utilities that includes a sufficient number of companies to ensure that  
7 the results of the cost of equity tests are reliable. There are a limited number of small,  
8 publicly traded utilities. Furthermore, smaller companies tend to be traded less  
9 frequently and not followed by as many analysts. Consequently, their market data may  
10 be less reliable than for larger companies which are more frequently traded and they are  
11 less likely to have forecasts of earnings growth, which are required for the application of  
12 the discounted cash flow tests. Ms. McShane does accept that size is a relevant  
13 consideration.  
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15 In the assessment of investment risk, size has two dimensions which are relevant.  
16

- 17 1. A small utility does not have the opportunities to diversify its risks to the same  
18 extent as a larger utility. Negative events are likely to have a greater impact on  
19 the earnings or viability of a small company. For example, assets are typically  
20 more concentrated in a limited geographic area, which limits operational  
21 flexibility. Even for a small utility with the same customer base in terms of  
22 proportions of residential, commercial and industrial customers as a large utility;  
23 the loss of a single customer within a customer class would have a greater impact  
24 on a small utility.  
25
- 26 2. Smaller utilities have fewer financing options, less institutional interest in  
27 acquiring their debt securities, issued debt would be relatively illiquid, and, if  
28 issued to third-parties would likely require stricter covenants than debt issued by  
29 large utilities.  
30

31 Debt rating agencies often take size into account when rating companies and their debt  
32 issues. The impact of smaller size for rated utilities is frequently exhibited in lower debt  
33 ratings for these companies even in cases where their financial parameters are stronger  
34 than their larger peers. As recently as June 2009, DBRS considered size to be a factor in  
35 its ratings of FortisBC Inc., referring to its comparatively small size relative to the  
36 dominant utility in the province, BC Hydro, as a "Challenge". At the time, FortisBC Inc.  
37 had total assets of slightly over \$1 billion and its unsecured debt was rated BBB(high)  
38 (DBRS, *Rating Report: FortisBC Inc.*, June 5, 2009. FortisBC was upgraded by DBRS to  
39 A(low) in October 2010).  
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41 Studies on small size and returns conducted by Ibbotson Associates Inc. have quantified  
42 the impact of a firm's small size on the required return based on an analysis of the  
43 relationship between betas and historic returns for companies of different sizes. The  
44 analyses indicate that small companies tend to exhibit higher betas than larger companies

(Morningstar, Ibbotson SBBI 2012 *Valuation Yearbook: Market Results for Stocks, Bonds, Bills and Inflation*, 1926-2011, pages 85-107).

To illustrate, in the Ibbotson classification of U.S. stocks for 2011, the median utility in the U.S. sample used to estimate the fair return for Newfoundland Power would be a Mid-Cap stock (market value of equity capitalization in the range of approximately \$1.6 billion to \$6.9 billion) as shown in response to CA-NP-320. By comparison, for example, companies with market values of equity between approximately \$425 million and \$1.6 billion would be Low-Cap stocks. The betas of Low-Cap stocks have been approximately 0.15 higher than those of Mid-Cap stocks. In the context of the CAPM, an incremental beta of 0.15, if applied to a market risk premium of 8.0%, indicates an incremental equity risk premium of over 100 basis points ( $8.0\% \times 0.15$ ) for a Low-Cap company relative to a Mid-Cap stock.

While these analyses were performed using all stocks, not utilities specifically, Ibbotson has also performed an industry-by-industry analysis which shows that the conclusions regarding the firm size effect apply to regulated companies as well as unregulated companies. Based on 82 years of data, Ibbotson's analysis demonstrated that the returns for small publicly-traded electric, gas and sanitary utilities have been approximately 1.5 and 3 percentage points higher on a compound and arithmetic average basis respectively than those of large utilities (Morningstar, Ibbotson SBBI, 2008 *Valuation Yearbook: Market Results for Stocks, Bonds, Bills and Inflation*, 1926-2007, pages 154-155).

As regards Newfoundland Power, based on the Ibbotson size categories, it would be considered a Low-Cap stock if it were publicly traded, given its earnings and the typical price/earnings ratios of utility stocks.