Q. McShane Evidence - page 2

a. Ms. McShane refers to the comparable returns standard, please confirm that in Canada the legal requirement is a return on comparable securities as explained in Newfoundland Power's testimony (3-15)

b. Please explain how an investor can purchase the returns of another company without paying the market price to either buy the company or its shares?

c. Please confirm that in the past Ms. McShane has justified "comparable earnings" (that is, the accounting ROEs of other companies) on broad fairness grounds and agreed that it is not an opportunity cost because of b) above.

d. Please explain in detail how a firm that is awarded its opportunity cost cannot attract financing on fair and reasonable terms, when the opportunity cost is by definition fair and reasonable?

e. Please indicate whether Ms. McShane agrees that investors in dividend paying shares, like utilities, do consider fixed income securities as an alternative.

f. Further to (e) above is it Ms. McShane's view that the decline in yields on fixed income securities is an irrelevance for investors in dividend rich utilities. If so please indicate what the closest substitute security to a utility share would be if not a fixed income security.

g. In Ms. McShane's judgment was the 8.80% settlement ROE within the range of fair and reasonable ROEs for 2012?

h. Would it be fair to adjust the 2012 settlement ROE for the difference in Ms. McShane's recommended ROE for 2012 and 2013 on the basis that her recommendation was excessive in 2012 and is similarly so now? If not why?

A. a. Ms. McShane confirms that the *Northwestern* decision refers to securities. While Ms. McShane understands the *Northwestern* decision to be the principal Court case in Canada that defines a fair return, the interpretation of and the enunciation of the fair return standard and its requirements by Canadian regulators rely on additional legal precedents, including the *Hope* and *Bluefield* decisions of the U.S. Supreme Court.

For example, the Ontario Energy Board in its *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities* issued in December 2009 (pages 16-17) stated as follows:

> "The FRS [Fair Return Standard] is a legal concept, and has been articulated in three seminal court determinations as set out below:
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> 1. In *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia* et. al. 262 U.S. 679 (1923), the FRS is expressed to include concepts of comparability, financial soundness and adequacy:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

2. In *Northwestern Utilities Limited v. City of Edmonton*, [1929] S.C.R. 186, the FRS concept was described as follows:

> By a fair return is meant that the company will be allowed as large a return on the capital invested in its enterprise, which will be net to the company, as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise.

3. In *Federal Power Commission v. Hope Natural Gas* 320 U.S. 591 (1944), the Court expresses that "balance" is achieved in the ratemaking process, and outlines three elements of a fair return:

> The rate-making process under the act, i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests…the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock…By that standard, the return to the equity

> owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

The Newfoundland and Labrador Board of Commissioners of Public Utilities in P.U. 7 (1996) similarly cited the *Northwestern* decision and the *Hope* and *Bluefield* "landmark decisions of the United States Supreme Court", as well as the 1960 Supreme Court of Canada decision, which, as cited by the PUB, stated, "in British Columbia Electric Railway vs Public Utilities Commission of British Columbia, et al, [1961] 25 D.L.R. (2d) 689, at pp.697-698, that "earnings must be sufficient ... to enable [the utility] to ... attract capital either by the sale of shares or securities."

While the 1929 *Northwestern* decision defined the fair return by reference to "securities", Canadian regulators have established the fair return on equity on many occasions since that time by considering the returns of comparable risk enterprises, for example, by reference to the comparable earnings test. Ms. McShane is not aware of any subsequent Canadian court decision which has overturned the findings of a Canadian regulator as a result of its having given weight to the returns of comparable risk enterprises, e.g., the comparable earnings test.

b. Investors who buy shares in a utility do so at market prices. The regulator's role is to set the level of earnings that the company will be allowed to earn on the book value of the equity that underpins the assets devoted to public utility service.

c. Not confirmed. The comparable earnings test is compatible with the concept of opportunity cost, and Ms. McShane has consistently recognized that. At page 100 of her testimony, Ms. McShane states:

> The comparable earnings test provides a measure of the fair return based on the concept of opportunity cost. Specifically, the test arises from the notion that capital should not be committed to a venture unless it can earn a return commensurate with that available prospectively in alternative ventures of comparable risk. Since regulation is a surrogate for competition, the opportunity cost principle entails permitting utilities the opportunity to earn a return commensurate with the levels achievable by competitive firms facing similar risk.

According to Dr. Charles Phillips in *Public Utility Regulation: Theory and Practice*, Public Utilities Reports, Inc., 1993, page 397, "The comparable earnings standard recognizes a fundamental economic concept; namely, opportunity cost."

He goes on to say, borrowing part of his definition from Ms. McShane's late colleague, Dr. Stephen Sherwin (Testimony in Tampa Electric, Docket 800011-EU, February 1980) "Stated another way, the opportunity cost of capital concept holds that capital should not be committed to any venture unless it can earn a return commensurate with that prospectively available in alternative employments of similar risk." Further, Dr. Phillips notes (page 398) that "Investors will seek the opportunity that provides the greatest profit, commensurate with the risks involved." He also notes (page 398) that returns on the book value of equity are used because utilities are regulated on the basis of original cost.

d. A utility that is provided the opportunity to earn a return that reflects its opportunity cost of capital should be able to attract financing on reasonable terms and conditions. Please note that this conclusion applies to all forms of capital that the utility requires, not just debt capital.

e. Ms. McShane agrees that investors focused on income producing securities like utility shares, would consider the risk/reward profile of various types of securities, including bonds, as well as other dividend paying stocks.

f. No, it is not irrelevant. Nevertheless, she takes issue with the suggestion that fixed income securities are the closest alternative to utility equity shares. Utility shares are equities, with the attendant risks thereof. The closest alternatives would be other dividend paying stocks, e.g., consumer staple companies. With respect to the relevance of yields on fixed income securities, the issue is the extent to which observed declines in those yields relate to changes in the returns required or expected from utility equities. To put this in perspective, during the 2000s, prior to the financial crisis, the dividend yield (a key component of the expected return) on Canadian utility shares averaged approximately 200 basis points lower than the yield on long-term A-rated utility bonds. On average to date during 2012, the dividend yield on Canadian utility bonds has averaged only 50 basis points below yields on long-term A-rated utility bonds, despite the relatively strong earnings growth expected from those companies.

g. Ms. McShane is of the view that the ROE negotiated for 2012 was lower than the ROE that she found to be fair and reasonable based on her analysis.

h. No. Ms. McShane disagrees with the premise of the question, specifically that her recommended ROE is excessive. As regards how the PUB should approach the requested ROE, in Ms. McShane's view, the Board should always consider the evidence from first principles.