

**Q. McShane Evidence - Risk Premiums, pages 79-82**

- a. **Please explain why Ms. McShane uses a “normalised treasury Bill return of 2.25% when the US Federal Reserve is committed to keeping the Federal Funds rate at 0.-0.25% through 2014 and she is using a three year time horizon. Please explain why this normalised T Bill return has changed from the 2.75% she used in the summer?**
- b. **Please provide the current Treasury Bill yields in the US and Canada and Ms. McShane’s forecasts for both through 2015.**
- c. **Please provide citations to any current literature that uses a market risk premium over treasury bill yields of 9.25% (page 79)**
- d. **Please indicate whether Ms. McShane is aware of any literature that indicates that the correct adjustment for utility betas is towards their grand mean of about 0.55, rather than 1.0 or alternatively any literature that supports the Blume adjustment towards 1.0 for utilities.**
- e. **Please provide the actual not adjusted betas for the Canadian utilities in the Table on page 81.**
- f. **Please indicate the last time a Canadian utility sample had a beta of 0.64 (without BCE/Nortel).**

- A. a. In the referenced analysis, Ms. McShane used a normalized Treasury bill rate, measured as the forecast long-term Canada bond yield less the typical maturity premium, because the actual short-term rate, having been kept at abnormally low levels for monetary policy purposes, is not representative of the true risk-free rate that would compensate an investor for inflation and postponing consumption.

The normalized Treasury bill rate was estimated as the forecast long-term (30-year) Government of Canada bond yield less the typical maturity premium, as noted above. In the proceeding to which the RFI refers, Ms. McShane was using a forecast 30-year Canada bond yield for 2013-2015, which is higher than the forecast 30-year Canada bond yield she is relying on in this proceeding, which is for 2013-2014 only.

- b. As of October 17, 2012, the Treasury Bill yield in Canada is 0.96% and in the U.S. is 0.11%.

Ms. McShane does not have forecast Treasury Bill yields through 2015. Based on the October 8, 2012 *Consensus Forecasts*, the 3-month Treasury Bill yield for Canada is expected to be 1.0% at the end of January 2013 and 1.2% at the end of October 2013 and the 3-month Treasury Bill yield for the U.S. is expected to be 0.1% at the end of January 2013 and 0.2% at the end of October 2013.

- c. Ms. McShane is not aware of any literature that has used a 9.25% risk premium over Treasury bills. Market risk premiums are frequently expressed as long-term averages, i.e., a long-term average equity market return less a long-term average

bond return. Adjustments that are required to take account of conditions that deviate from “average” are made afterward. For example, in the cost of capital evidence filed with the Nova Scotia Utility and Review Board in August 2012, Dr. Laurence Booth relied on a 5.5% risk premium and a 0.50 beta to develop his CAPM utility ROE, but then made two adjustments to his utility risk premium for higher than normal credit spreads and lower than normal long-term Canada bond yields. Had those adjustments been made directly to the market risk premium, the implied market risk premium over the 30-year Canada bond would have been close to 8% and the implied risk premium over Ms. McShane’s normalized 2.25% short-term rate in excess of 9%.

- d. Ms. McShane does not know to what the grand mean of 0.55 in the question refers. The only utility-specific analysis that Ms. McShane is aware of was a study by Michael J. Gombola and Douglas R. Kahl, “Time-Series Processes of Utility Betas: Implications for Forecasting Systematic Risk”, *Financial Management*, Autumn 1990. The study, which analyzed U.S. utility betas, showed, for the period studied, mean reversion, but suggested that the “raw” (ordinary least squares regression) betas should be adjusted toward a mean lower than the market mean of 1.0, e.g., 0.70, and the adjustment rate should be higher than the Blume rate of adjustment (0.35). This is the only study of which Ms. McShane is aware that addressed solely the adjustment of utility betas. Ms. McShane’s adjustment was not made simply for the purpose of predicting the future “raw” (ordinary least squares regression) beta. Ms. McShane’s adjustment, while consistent with the Blume adjustment, is made for purposes of more accurately estimating the expected return. The adjustment is applied in recognition that the raw beta for utilities does not accurately reflect the empirical risk/return relationship.

- e. The raw betas are as follows:

Company	Bloomberg Raw Beta
Canadian Utilities Ltd.	0.28
Emera Inc.	0.57
Enbridge Inc.	0.45
Fortis Inc.	0.60
TransCanada Corp.	0.37

- f. Ms. McShane is not aware of any Canadian utility samples which have had raw betas of 0.65- 0.70.