Q. Reference: the fair return standard on page 6: In terms of the impact of debt on the cost of equity, would Mr. MacDonald agree that if through the use of deferral accounts there is minimal variability in the earned ROE then by definition the use of debt is not magnifying equity returns? If not please explain why not?

A. Mr. MacDonald does not confirm. Utility assets are financed using both debt and equity. Debt holders have a senior claim over a utility's earnings/assets. Equity bears more risk therefore investors require a higher rate of return on equity than on debt. Capital structure affects the utility's estimated cost of equity. It would not be appropriate to conclude on a fair return on equity without also considering capital structure. In other words, if we conclude on a fair return on equity at one capital structure we should not necessarily apply the same fair return on equity to another capital structure with more or less debt (all else equal). An allowed ROE must consider both the level of business risk and the level of financial risk.