

**Q. Opinion on Capital Structure and Return on Equity**  
**Kathleen McShane – Volume 3**

**Pg. 4, #6f - Please explain why the financing flexibility allowance would differ for this alternative method, 50 bps vs. 100 bps.**

A. As discussed with respect to Ms. McShane's principal approach, which relies solely on the market-based tests, a reasonable adjustment to the bare bones cost of equity falls within a range. The minimum adjustment (0.50%) is the adjustment for financing flexibility that is sufficient for a utility to maintain its financial integrity. In this context, financial integrity means that it is in a position to raise new equity without impairment of the existing shareholders' investment. The market-based costs of equity (risk premium and discounted cash flow) represent values which, if applied to, and earned on, the book value of equity, would result in the market value of the utility's equity equating to its book value. The 0.50% financial flexibility allowance represents the adjustment to the bare bones cost of equity compatible with maintaining a market to book ratio in the range of 1.05 to 1.10. The upper end of the range recognizes that the cost of equity is estimated by reference to market values, including market value capital structures. The original cost rate base model applies the market-based cost of equity to the book value capital structure. The upper end of the range of the adjustment to the bare bones cost of equity recognizes the higher financial risk in the book value capital structure to which the market-based cost of equity is applied than reflected in the market value capital structures underpinning the market-based cost of equity. With the alternative approach, which gives weight to both the market-based tests and the comparable earnings test, the comparable earnings test separately captures the discrepancy between the return on market value and the corresponding fair return on book value. As a result, under this approach, adding the minimum allowance for financing flexibility only to the market-based tests is reasonable.