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

Pg. 67, lines 1659-1663 - Given that Table 11, pg. 66, suggests that when bond income returns are below 4% the average risk premiums are 10.7% and 14.7%, how does this reconcile to your selected 8% equity risk premium?

A. Ms. McShane's conclusion that the risk premium at the forecast 3.5% long-term Canada bond yield is no less than 8%, despite the higher observed historical risk premiums at similar levels of interest rates noted in the question, was intended to balance the following:

(1) The observed higher risk premiums at low levels of interest rates;

(2) The more gradual increase in average achieved risk premiums observed over the preponderance of the data range in Table 11;

(3) The observation that the equity market returns have been in the range of 11.0% to 12.5% (as stated at lines 1650-1652) of Ms. McShane's testimony; and

(4) The recognition that, while a higher expected market equity risk premium at low levels of interest rates is reasonable, a higher equity market return (long-term Canada bond yield plus equity market risk premium) at low levels of interest rates than at higher levels of interest rates is highly unlikely. At an equity market risk premium of 8.0% and a 30-year Canada bond yield of 3.5%, the indicated equity market return is close to the long-term average.