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

**Pg. 92, line 2270 - Please explain the rationale for the 50% sensitivity factor applied to this calculation. Please provide your support for this rationale.**

A. The rationale stems from the inverse relationship between utility equity risk premiums and interest rates, which was demonstrated in the DCF-based equity risk premium analysis discussed at pages 82-89 of Ms. McShane's testimony. The need to recognize that relationship in the interpretation of the historical achieved utility equity risk premiums arises from the sizeable gap between the average level of interest rates that prevailed during the period over which the historical utility equity risk premiums were calculated and the forecast level of those rates (7.3% bond income returns historically in Canada versus the 3.5% forecast 30-year Canada bond yield for the test period). The size of the sensitivity factor (50%) applied to the historical equity risk premiums to account for the difference between historical and forecast long-term Government of Canada bond yields was based on the results of the DCF-based equity risk premium analysis. Based on that analysis, as summarized in Table 24, the sensitivity of the utility equity risk premium to long-term government bond yields is no less than 0.50, i.e., equivalent to a sensitivity factor of 50%. As such, the application of a 50% sensitivity factor to the historical average utility equity risk premiums is a conservative recognition of the relationship between utility equity risk premiums and government bond yields.