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

Are there any changes to the current automatic adjustment formula, in your view, that could make it more reliable in determining a future return on equity for Newfoundland Power?

A. If long-term Government bond yields were within a normal range, i.e., long-term Canada bond yields at or above 4.0%, Ms. McShane is of the view that a formula which incorporates the change in both forecast long-term Government of Canada bond yields and the spread between A-rated utility bonds, both with a sensitivity factor of 50%, would likely broadly capture both secular and cyclical changes in the utility cost of equity. There are two principal caveats, however. First, those relationships do not appear to have held since the dramatic decline in the yield on long-term Government bonds which commenced in mid-2010. Second, if such a formula were to be implemented when interest rates return to more normal levels, the formula and the initial ROE need to be internally consistent. Specifically, it would not be reasonable to apply the formula outlined above to an initial ROE that was established on the premise that, over the past 15 years (since the initial adoption of a formula by the PUB in 1998), as long-term Canada bond yields have experienced a broad secular decline, the utility cost of equity has fallen by 75% to 80% of the change.