JANUARY 14, 2013
(9:05 a.m.)
CHAIRMAN:
Q. Good morning everybody. I think we got a change in the lineup this morning. I'm sorry, I don't even know -
KELLY, Q.C.:
Q. It's Newfoundland Power's witness, Mr. Chairman, Ms. Kathleen McShane.
CHAIRMAN:
Q. Yes, of course, yeah.
KELLY, Q.C.:
Q. We have the first cost of capital witness this morning, and then Ms. Perry will be back on to complete her testimony tomorrow.
CHAIRMAN:
Q. Yes. Okay, well, we had quite a bit of storm, so tell Mr. Ludlow that I think the employees of Newfoundland Power provided better than generally good service.
KELLY, Q.C.:
Q. Thank you.
CHAIRMAN:
Q. Pass that on, will you?
KELLY, Q.C.:



Q. Thank you, Mr. Chairman, I will indeed. Our employees worked very diligently to get power back up as quickly as possible. Thank you very much. The witness is ready to be sworn, Mr. Chairman.
MS. KATHLEEN MCSHANE (SWORN) EXAMINATION BY KELLY, Q.C.:
KELLY, Q.C.:
Q. Good morning, Ms. McShane.
MS. MCSHANE:
A. Good morning.
KELLY, Q.C.:
Q. You're the President of Foster Associates Inc.?
MS. MCSHANE:
A. I am.
KELLY, Q.C.:
Q. And if we go to page one of your report at lines 5 through 12, your qualifications are summarized there?
MS. MCSHANE:
A. They are.
KELLY, Q.C.:
Q. And are set in more detail in Appendix G. We won't go there. I understand you've testified in more than 200 proceedings across Canada and



the United States?
MS. MCSHANE:
A. I have.
KELLY, Q.C.:
Q. In relation to cost of capital matters?
MS. MCSHANE:
A. That's correct.
KELLY, Q.C.:
Q. And you've testified before this Board on a number of previous occasions?
MS. MCSHANE:
A. Yes, I have.
KELLY, Q.C.:
Q. Do you adopt your report, the Opinion on Capital Structure and Return on Equity for Newfoundland Power contained in Volume 3 as your evidence in this proceeding?
MS. MCSHANE:
A. I do.
KELLY, Q.C.:
Q. Are there any changes which you wish to make to the report or any of the appendices at this time?
MS. MCSHANE:
A. No, there are not.



KELLY, Q.C.:
Q. Ms. McShane, I'd like to discuss with you three basic areas. The first is capital structure, the second, return on equity, and the third, the automatic adjustment formula. So if we start with capital structure, would you provide the Board with a brief explanation of your recommendations and conclusions with respect to Newfoundland Power's capital structure?
MS. MCSHANE:
A. Certainly. I have concluded that the 45 percent common equity ratio that Newfoundland Power has maintained and is proposing to maintain remains reasonable, based on considerations that's there been no material change in business risk since the Board last reviewed the capital structure, and there's been no evidence filed in this proceeding by any part to suggest otherwise. I note that since August, 2009, when Moody's issued a new debt rating methodology and has tightened its capital structure guidelines, and Newfoundland Power's existing capital structure supports its current ratings. Even at the existing 45

percent common equity ratio, Moody's has noted that Newfoundland Power's credit matrix are somewhat weaker than its similarly rated BAA1 peers in North America. I also note that a review of the trend in allowed capital structures by other regulators in Canada over the past several years shows that the capital structures have been either maintained at current levels or increased.

KELLY, Q.C.:

Q. Okay. Can I get you to comment briefly on the proposals of Mr. McDonald and Dr. Booth with respect to Newfoundland Power's capital structure?

MS. MCSHANE:

A. Well, with respect to Mr. McDonald, his evidence effectively is similar to mine. He supports the 45 percent common equity ratio and notes some of the same considerations that I did. With respect to Dr. Booth, he's recommending that the Board reduce the common equity ratio of Newfoundland Power to 40 percent from 45 percent. With respect to that recommendation, I would note the following; under the Moody's rating methodology which



assigns ratings to nine different factors, if the Board would reduce the common equity ratio to 40 percent, the rating on the capital structure factor itself which is currently BAA, would drop to non-investment grade. The reduction in the common equity ratio would also weaken other credit matrix, which as I noted just a minute ago, are already somewhat weaker than Newfoundland Power's similarly rated peers. As regards the qualitative factors to which Moody's gives weight in coming up with its debt ratings, there are two, both related to the regulatory environment, and in my opinion, if the Board would reduce the common equity ratio from 45 to 40 percent, Moody's would in all likelihood reevaluate its conclusion that Newfoundland Power operates in a supportive regulatory environment, and if Moody's were to reduce Newfoundland Power's rating on one of the regulatory environment or regulatory risk factors, I think that there is a very high likelihood that Newfoundland Power would be downgraded.

(9:15 a.m.)



KELLY, Q.C.:

Q. Okay. Let's go next to the return on equity. If we go to page 104 and look at Table 30, let's start by having you explain your recommendations with respect to return on equity for the Board?

MS. MCSHANE:

A. My recommended return on equity for Newfoundland Power is 10.5 percent, and the recommended ROE is for both 2013 and 2014. The 10.5 percent ROE is based on application of multiple market-based tests, and these include three different equity risk premium tests, and several models of the discounted cashflow test that I have applied to both Canadian and US utilities. The test results themselves are summarized on page 104, as Mr. Kelly pointed us to in Table 30. These tests before any adjustment for financing flexibility together indicate a cost of equity of 9.5 percent. My final recommendation of 10.5 percent incorporates an allowance for financing flexibility of 1 percentage point. This is .5 percent higher than what I recommended in 2009, and .5 percent higher



than what the Board adopted. The higher allowance for financing flexibility is intended to recognize that the Board has in previous decisions decided that it will not give weight to the comparable earnings test, but only to test derived from equity capital market data. In that case there needs, in my view, to be an explicit recognition that the market data in which these market-based test, the equity risk premium, and discounted cashflow test, are based, reflect market value capital structures. In the market value common equity ratios of the companies that are selected to determine or estimate the cost of equity for Newfoundland Power are thicker or incorporate less financial risk than the regulated capital structure to which the market derived cost of equity is applied under the original cost rate based rate of return model that's used in this province and in North America. So I think that the allowance for financing flexibility needs to recognize this disparity as well as allow for recovery of flotation costs. If, however, the Board were to decide that it was appropriate to use

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comparable earnings in conjunction with the market based tests, then I think that it's reasonable to limit the financing flexibility adjustment for the market based test 250 basis points, and in that context if we give weight to comparable earnings, which in isolation supports a return of 11 to 12 percent, incorporate that with the marked based test and a minimum financing flexibility adjustment of 50 basis points, the fair return for Newfoundland Power would still be approximately 10.5 percent.

KELLY, Q.C.:

Q. Okay. Now you indicated in your comments a few moments ago, and demonstrated in your report that you used multiple tests to come up with your cost of capital. Can I get you to elaborate on that and explain to the Board why you use multiple tests?

MS. MCSHANE:

A. In my view, no single test is strong or sufficient enough to ensure that the fair return standard is met. Different tests have different perspectives, different tests have different strengths and weaknesses, different

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tests have more or less reliability under different capital market and economic conditions. This last consideration, in my view, is particularly germane at this point in time, given the relatively or abnormally low level of long term Canada Bond yields. Under current market conditions the application of the capital asset pricing model becomes particularly problematic. The model itself provides no guidance as to how to reconcile the abnormally low level of long term Canada Bond yields, which is the proxy for the risk free rate with estimates of the market risk premium, which have typically been expressed in the nature of a long term average level. As a result, much more judgment is required under current market conditions in the application of that model, and I think less confidence can be placed in the accuracy of the results. In those conditions, it is particularly important to look to multiple tests and particularly important to look to tests such as the discounted cashflow test, which are not benchmarked or anchored to the long term Canada Bond yield. I would also

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note in respect to the discounted cashflow test that we have in the last couple of years, I think, seen other regulators in Canada tend to give more weight to discounted cashflow than they had in earlier proceedings.

KELLY, Q.C.:

Q. Okay. Now in order to use the discounted cashflow model, you have to have a sample of utilities to use it. Can I get you to explain the difficulties with Canadian sample and then what changes you've made in response to the Board's comments in its last rate order with respect to the selection of a sample of US utilities?

MS. MCSHANE:

A. With respect to some general comments, I would say that in order - the fair return standard requires that we consider returns that are available to comparable risk enterprises. In that respect, I don't think you can avoid selecting samples of similar risk to the utility whose return is being set. In Canada, we have a particularly difficult problem because there are only six companies that effectively have regulated operations and are

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publicly traded, and this is a very heterogenous group, both in terms of the size of the companies and in terms of the makeup of their operations, regulated and unregulated. The US public utility equity market is a much broader and deeper universe of companies from which one can select a sample of comparable risk companies. I think it's also important to recognize that when one selects companies that are to be of similar risk, you're never going to find companies that are equivalent in risk on every element, every factor. What you're looking for are companies that overall can be determined to be of similar total risk, business risk, regulatory risk, and financial risk, and in regard to that last point, it is not sufficient to say that the utilities are not of the same business risk or regulatory risk to determine that they are not of similar overall risk. Lower or higher business risk can be offset by a lower or higher equity ratio. That proposition is widely accepted and it, in fact, is at the heart of what the Alberta Utilities Commission does when it sets the cost of capital for Alberta utilities. It

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looks at the different business risks of the utilities that it regulates and sets the capital structures for these sectors and individual companies based on its view of how those utilities compare in terms of business risk. So that at the end of the day you have a group of utilities that the Alberta Utilities Commission believes are comparable total risk, so that it can apply the same return to all those utilities. With respect to the sample of US utilities that I've selected, those utilities have higher common equity ratios than Newfoundland Power. So even if one were to say that they have somewhat higher business risk, they have lower financial risk. Also I would point out that as among the experts in this proceeding, of whom there are four, all of them have been able to select and use to some extent samples of US utilities. With respect to the specific steps that I took to address the Board's concern from the 2009 decision, I did tighten up the selection criteria somewhat to limit the selection of US companies only to those which had Moody's and S & P ratings of BAA1 in

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S & P's framework, BBB+ or better, and I also put a cap on the amount of unregulated operations that any utility in the sample could have. Further, I have set out in an extensive Appendix B, and maybe we could just take a look at Appendix B for a second. I'm not going to go through Appendix B, obviously, but I wanted to just - if we go to Appendix Page B2, and on Page B2 there's a chart for AGL Resources, and there's one for each of the companies in the sample, and what I've done there is to look at and assess the different characteristics, business characteristics, and regulatory risk characteristics of each of the companies, and you can see if you look at AGL Resources, there are the number of customers, operating revenues by type of customer class, what kind of test year is being used, what the allowed returns on equity and the equity ratios are, what deferral mechanisms and other types of regulatory protective mechanisms are available, and as well as looking at what the assessment of the regulatory risk environment by the different debt rating agencies is. Based on that assessment, as well as the

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market data itself, I am comfortable that these are companies that would be viewed as reasonably comparable total risk to Newfoundland Power.

KELLY, Q.C.:

Q. Okay. Can I get you next to comment briefly on the ROE recommendations of Mr. McDonald and Dr. Booth?

MS. MCSHANE:

A. With respect to Mr. McDonald, I guess I would say that when I looked at his testimony, I saw that there are what I considered to be a fairly large number of commonalities between our testimony. For example, he and I both consider that Newfoundland Power is an average risk utility at its existing capital structure. Our return recommendations are both premised on that conclusion. He and I agree that cost of equity methods aren't perfect, that they are more or less reliable depending on the capital market conditions, and that it's important to use multiple tests. I think we both agree that Canadian capital markets are challenged at this time. We agree that it is possible to construct and rely on a

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sample of US utilities for the discounted cashflow test. We both give significant weight to discounted cashflow, although we use somewhat different samples and the timing of our estimates is somewhat different, and even the inputs for estimating the investor's expected growth are somewhat different, our base DCF estimates are pretty similar. I think we also agree that it's appropriate to use a test based on historical utility market returns and risk premiums. I think the major area where we part ways is with respect to the capital asset pricing model. Mr. McDonald essentially applies the model by combining this long term average market risk premium that I talked about earlier with what are effectively still abnormally low forecast bond yields. In other words, he really doesn't make any adjustment to address the disconnect between or among the inputs to the model. He appears to recognize that the capital asset pricing model result is not commensurate with a fair return, but he still gives the test result as applied equal weight to his other tests, and in my view, that approach

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underestimates the fair return for Newfoundland Power. With respect to Dr. Booth, his recommendation is effectively based solely on the application of the capital asset pricing model. I don't intend to repeat all of the issues that I consider that the capital asset pricing model faces, but I would point the Board for future reference to pages 51 to 54 of my testimony where I lay out what I believe the important concerns with the capital asset pricing model are. Just as a general comment, I would also note that Dr. Booth's recommended return of 7.5 percent if it were to be accepted, would be the lowest return that's been adopted for an investor owned utility in North America.

KELLY, Q.C.:

Q. Okay. The third point that I'd like to have you discuss is the automatic adjustment formula. You've recommended discontinuance of the automatic adjustment formula at this time. Can I get you to explain why for the Board?

MS. MCSHANE:

A. I think the reliability of any formula is dependent perhaps obviously on the formula's

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ability to produce a fair return, and that is in turn dependent on the predictability and stability of the relationship between the ROE and the variables that are used to adjust the ROE. Since the financial crisis, there really has been very little relationship between long term Canada Bond yields, which is the typical variable to which ROE has been anchored in earlier formulas, and the same is true of the relationship between the utility ROE and utility bond yield. I don't believe that there is any particular efficiency gain from adopting a formula at this juncture that would offset the potential for that formula to mis-specify a fair return.

(9:30 a.m.)

KELLY, Q.C.:

Q. Is there anything else you'd like to add on any of these points that we've talked about or have we pretty much covered it at this stage?

MS. MCSHANE:

A. I think we've pretty much covered it, and I think I'm probably going to have an opportunity to say a few more things in the next day.

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KELLY, Q.C.:

Q. I'm sure Mr. Johnson will have a few questions for you. Thank you, Ms. McShane.

MS. KATHLEEN MCSHANE - EXAMINATION BY MR. JOHNSON:

MR. JOHNSON:

Q. Ms. McShane, good morning.

MS. MCSHANE:

A. Good morning.

MR. JOHNSON:

Q. I always enjoyed kicking off a week at 9 o'clock to talk about some mathematics and numbers and stuff like that, but, anyway, we'll give it a shot. I'll bring you to page 104 of your report, and you referred to this table already, and I just want to confirm the weighting. Obviously, you've indicated already the tests that you have applied and they are set out in Table 30, and we see the risk adjusted equity market gave 8.9 percent, the discounted cashflow method gave significantly higher at 9.5, and the historic utility gave much higher again at 10.25. Now as I understand it, you took the averages of those three, which I would calculate to be 9. 55 percent. Would you take that, subject to

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check?

MS. MCSHANE:

A. Sorry, I averaged three?

MR. JOHNSON:

Q. You averaged the three risk premium tests to come to 9.55 percent. Let's put it this way, Ms. McShane, you gave each of your risk premium tests equal weight?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. And then you also gave the discounted cashflow test, which yielded 9.4 percent equal weight?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. And you ended up - if you took the average of your risk premium tests, it comes to 9.55 percent. You add that to your discounted cashflow test and divide by two.

MS. MCSHANE:

A. That would come to 9.5.

MR. JOHNSON:

Q. Right, 9.475, and then you take - but on top of that we'd need to add a further 1 full

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percent to get you up to the 10.5 percent that you're recommending, right?
MS. MCSHANE:
A. Correct.
MR. JOHNSON:
Q. So in other words, to state the obvious, if the Board was to accept everything that you have to say in Table 30, but they felt that financing flexibility shouldn't really double from 2009 from .50 to 1 percent, all you could get from your recommendation is 10 percent?
MS. MCSHANE:
A. If the Board were to consider that a 50 basis point adjustment was appropriate instead of 1 percent, then the number would be 10 percent.
MR. JOHNSON:
Q. Right, and you speak about the - in your report at page 104, you speak about an alternative approach and that one involves giving weight to the comparable earnings test approach, correct?
MS. MCSHANE:
A. That's right.
MR. JOHNSON:
Q. And under that alternate approach, your report

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states that a fair return on equity based on the comparable earnings test alone is between 11 to 12 percent, correct?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. So 11.5 percent?
MS. MCSHANE:
A. Fair.
MR. JOHNSON:
Q. Right, and then in terms of the weighting under that alternate methodology, you give 75 percent weight to the test up in Table 30?
MS. MCSHANE:
A. Correct.
MR. JOHNSON:
Q. And then you'd give 25 percent weight to your comparable earnings test?
MS. MCSHANE:
A. Correct.
MR. JOHNSON:
Q. And then at that point, though, you wouldn't add the full 1 percent, you'd be back to . 5 percent?
MS. MCSHANE:

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A. Correct.
MR. JOHNSON:
Q. So you feel that alternate methodology backs up your 10.5 percent?
MS. MCSHANE:
A. Correct.
MR. JOHNSON:
Q. Okay, and Ms. McShane, I take it that you would agree with me that your comparable earnings test result of 11.5 percent, that mathematically produces a range that is 60 to 160 basis points beyond the 10.4 percent that Newfoundland Power is even seeking, correct?
MS. MCSHANE:
A. By itself, yes.
MR. JOHNSON:
Q. By itself, that's right, and that test, the comparable earnings test has not been accepted at any time in the past by this Board.
MS. MCSHANE:
A. I don't know about any time, but I would agree with you not recently.
MR. JOHNSON:
Q. Not since you've been putting it forward?
MS. MCSHANE:

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A. I think that's right.
MR. JOHNSON:
Q. And you've put it forward several times?
MS. MCSHANE:
A. I have.
MR. JOHNSON:
Q. And you've put it several times before in your testimony before regulators across the country?
MS. MCSHANE:
A. I have.
MR. JOHNSON:
Q. And you can confirm that there's not been - it's not been generally accepted in the whole of Canada?
MS. MCSHANE:
A. Not in the last few years, except the BCUC has given it some little weight.
MR. JOHNSON:
Q. They said it's not dead yet, it hasn't outlived its usefulness.
MS. MCSHANE:
A. Well, what they said was - they said that, I believe, in 2009 - I'm sorry, in 2006, and they did express one concern particularly at

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that time being whether there needed to be a market to book adjustment to the results. I addressed that issue in 2009, and in 2009, they decided to give it some small weight.

MR. JOHNSON:

Q. Yes, so -

MS. MCSHANE:

A. Without the market to book adjustment.

MR. JOHNSON:

Q. So other than that solitary example, there is no regulatory precedent for accepting or putting weight on comparable earnings test in Canada?

MS. MCSHANE:

A. There haven't been any decisions in, I'd say the last fifteen years, other than the BCUC decision that have given it weight.

MR. JOHNSON:

Q. Pardon me?

MS. MCSHANE:

A. There have not been any decisions, at least in the last fifteen years, other than the BCUC decision that have given it weight.

MR. JOHNSON:

Q. And Dr. Vander Weide is going to give

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testimony. I understand he's testified 400 times, poor fellow, and he does not provide comparable earnings test. So it's not accepted in the United States either, is it?

MS. MCSHANE:

A. I wouldn't say that it's not accepted in the United States. It's less widely used than the discounted cashflow test. Some people use it, some people don't.

MR. JOHNSON:

Q. Most wouldn't?

MS. MCSHANE:

A. Most who? Are you talking about -

MR. JOHNSON:

Q. Most experts wouldn't use it?

MS. MCSHANE:

A. I'm not sure that I would say most.

MR. JOHNSON:

Q. Pardon me?

MS. MCSHANE:

A. I'm not sure I would say most. I know of a number of experts who use it.

MR. JOHNSON:

Q. Okay, but we'll agree predominantly experts don't use it in the United States?

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MS. MCSHANE:

A. I would say there are some that do and some that don't.

MR. JOHNSON:

Q. Okay. Ms. McShane, we provided a cross-examination aid to you where we tried to provide a summary of your recommendations. Basically, a table showing your recommendations in 2009 versus your recommendations for the 2013/2014 test year.

MS. GLYNN:

Q. We'll mark that as Information Item #3.

MR. JOHNSON:

Q. That would have been Item #1 on our letter of January 10th, to Ms. Cheryl Blundon. Ms. McShane, I take it you have it in front of you?

MS. MCSHANE:

A. I do.

MR. JOHNSON:

Q. And just to explain, in this illustration essentially what we did is took - made a summary of your recommendations from the last two - this rate case and the last one, and the column entitled "McShane 2010", we extracted

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that from the reasons of the Board's decisions at page 14, and I believe, in fact, that the Board took that from Newfoundland Power's own submissions in written argument. The 2013/2014 column, that's our summary of your recommendation to the Board in this case. Have you had a chance to look at this chart and see whether we have accurately depicted 2013/2014?

MS. MCSHANE:

A. I think that's correct, yes.

MR. JOHNSON:

Q. Okay, and Ms. McShane, I guess as you can see, the first thing that we are noting is the first thing that jumps out at me to being very obvious is the financing flexibility change that's gone from 50 basis points all the way up to 1 full percentage point, and, I mean, as you indicated to Mr. Kelly, you recognize that last time you proposed .5, and you recognize that in PU 43, this Board approved .5. When did you first start arguing for 1 percent?

MS. MCSHANE:

A. In cases where I've not used the comparable earnings test as an input into my recommended

return. So it would have been since 2009.
MR. JOHNSON:
Q. Since?
MS. MCSHANE:
A. 2009.
MR. JOHNSON:
Q. Since 2009, and you tied that to your not putting reliance on comparable earnings?
MS. MCSHANE:
A. Correct.
MR. JOHNSON:
Q. Okay, and for instance, you recall that you argued for 1 percent allowance for financing flexibility before the Alberta Utilities Commission Generic Cost of Capital Hearing in 2011, correct?
MS. MCSHANE:
A. Correct.
MR. JOHNSON:
Q. And they didn't go with that, did they?
MS. MCSHANE:
A. I don't believe the adopted that, no.
MR. JOHNSON:
Q. And they would have adopted 50 basis points, right?



MS. MCSHANE:
A. I believe that's correct, yes.
MR. JOHNSON:
Q. That's right, and I take it your evidence is that in that case you had jettisoned comparable earnings?
MS. MCSHANE:
A. I had done the same type of approach as here with the - this approach with just market based test, and the alternative with comparable earnings, I believe.
MR. JOHNSON:
Q. And even under your alternative approach whereby you put 25 percent weighting on comparable earnings, why wouldn't you just - why would you need to - you've indicated under your alternate approach you'd put 25 percent weight on comparable earnings, but you'd be satisfied under that scenario of using a 50 basis point financing flexibility?
MS. MCSHANE:
A. Right.
MR. JOHNSON:
Q. And I don't understand the ratio. What's the relationship when you do it that way? Why



would that be advisable?
MS. MCSHANE:
A. I'm not sure what you're asking me.
MR. JOHNSON:
Q. Well, you've indicated that your new approach or your alternative approach is to now we'll give 25 percent weighting to comparable earnings, okay, and 75 percent weight to the test that you've described in Table 30, and you say now when we do that, I'm content actually to go from 1 percent to 50 basis points?
MS. MCSHANE:
A. I mean, that was the approach that I'd taken in the past, so that the two types of tests basically establish a range. One based on - the bottom end of the range based on the market based test, and the upper end of the range based on the returns on book value that are achievable by companies of reasonably comparable risk to a utility.
MR. JOHNSON:
Q. But back before the 2009 case here in Newfoundland, at that point you advocated use of the comparable earnings?



MS. MCSHANE:
A. I did.
MR. JOHNSON:
Q. And that was part of your 11 percent overall recommended return on equity, right?
MS. MCSHANE:
A. In 2000 and -
MR. JOHNSON:
Q. 2009 case.
MS. MCSHANE:
A. Yes, it was.
MR. JOHNSON:
Q. And so - there you recommended 50 basis points and you're saying if you're putting any weight on it at all, you can go back to 50; otherwise, stay with the full 1 percent.
MS. MCSHANE:
A. I wouldn't quite say it that way, but if the Board is willing to give significant weight to comparable earnings, then I think it's reasonable to only apply a relatively small financing flexibility adjustment to the market based test.
MR. JOHNSON:
Q. Otherwise, your number really just gets too

big, is that the concern?
MS. MCSHANE:
A. No, I just think that that's a reasonable balance between those different types of tests.
(9:45 a.m.)
MR. JOHNSON:
Q. What's the rationale, though?
MS. MCSHANE:
A. The rationale is -
MR. JOHNSON:
Q. It's easy to say this gives you a balance, but what's the thought behind it?
MS. MCSHANE:
A. The thought behind the difference in the two -
MR. JOHNSON:
Q. You said giving 50 basis points if you're going to put some weight on comparable earnings provides a bit of balance. What are you talking about?
MS. MCSHANE:
A. Well, the idea with - one of the ideas with comparable earnings is that a utility should be allowed to earn a return on its book value that's commensurate with returns on book value



that are achievable by similar risk entities, and in that context there is the premise that utilities values or market to book ratios, should not be constrained to book value. So essentially there is a level of financing flexibility, if you will, already built into the comparable earnings test, so you don't need to include it twice, if you will, in the market based test and in the comparable - when it's to some extent captured by the comparable earnings test.
MR. JOHNSON:
Q. Does financing flexibility have a demonstrable cost?
MS. MCSHANE:
A. Does it have a demonstrable cost?
MR. JOHNSON:
Q. Like, for instance, if someone were to ask, has financing flexibility gone up over the last few years, can you say, yes, it's gone up, yeah?
MS. MCSHANE:
A. Well, there are various elements to it. One of the elements is flotation costs specifically; no, that hasn't gone up. I



wouldn't say that the overall requirement itself has changed, no.
MR. JOHNSON:
Q. No, okay. Now, Ms. McShane, just back to your summary of recommendations, that was the first thing that sort of jumped out at me. The second thing that jumped out at me is obviously the overall recommendation, which was 11 percent now - I'm sorry, 11 percent in 2010, and it's 10.5 percent now, that's even if we took your advice on the 1 percent financing flexibility. So I'm saying, well, I guess cost of equity has gone down for Newfoundland Power, and I guess that would be your professional judgment as well, correct?
MS. MCSHANE:
A. I would say that the cost of equity for a utility today is probably somewhat lower than it was in late 2009.
MR. JOHNSON:
Q. And in terms of somewhat lower, could you put an indication of what somewhat lower would mean to you?
MS. MCSHANE:
A. My recommendation is 50 basis points lower



than it was. I would say that that essentially is the difference, in my view.
MR. JOHNSON:
Q. And could it be greater than 50 percent basis lower?
MS. MCSHANE:
A. It really would depend on at what point in time you were measuring it, but I would say, no, and based on the application of the various tests that are used, it's no more than that.
MR. JOHNSON:
Q. No more than 50?
MS. MCSHANE:
A. I wouldn't say, so, no.
MR. JOHNSON:
Q. And we see - so the cost of equity has come down and we can talk about how much it has come down, but when I look at your market risk - we first see a risk free rate, that's not contentious, 4.25, and you're saying it's 3.5 for the purpose of this case. Your market risk premium, that was in 2010, 6.75 percent, Ms. McShane, correct?
MS. MCSHANE:

A. I think so, yes.

MR. JOHNSON:

Q. And just to be clear on that now, that market risk premium, that would basically be saying that any company that's out there in the market, never mind utilities, any company, that's what the average risk company could expect to return or expect to earn over and above a risk free rate? That's what we're talking about, the premium over the risk free rate?

MS. MCSHANE:

A. That's what that is, yes.

MR. JOHNSON:

Q. Okay, and you're saying that notwithstanding the cost of capital has gone down, the cost of equity has gone down for Newfoundland Power, that the market risk premium is actually elevated from 6.75 percent in 2010 to 8 percent now for 2013 and 2014, right?

MS. MCSHANE:

A. Yes, there is evidence that the market cost of equity is higher today than it was in late 2009.

MR. JOHNSON:



Q. Okay. So that would mean that you're saying that the expected cost of equity for an average risk firm, never mind utilities, is around 11.5 percent?

MS. MCSHANE:

A. Based on the capital asset pricing, yes, it would be.

MR. JOHNSON:

Q. Okay. You mentioned that's the capital asset risk model, but that's not that model, all you're doing there is adding your risk free rate to the market risk premium and coming up with 11.5 percent, correct?

MS. MCSHANE:

A. That would be essentially a capital asset pricing model with a Beta of 1.

MR. JOHNSON:

Q. With a Beta of 1?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. So any company out there?

MS. MCSHANE:

A. Well, it would be for a company with a Beta 1, an average risk company.



MR. JOHNSON:

Q. An average risk company, okay. So in the last case, as you're aware, this Board looked at your 11 percent return on recommendation and ordered 200 basis points less than that, and you're saying that the cost of equity for Newfoundland Power has declined since your opinion in the 2010 GRA, right?

MS. MCSHANE:

A. My estimates are lower than they were.

MR. JOHNSON:

Q. Yes, and your estimates are lower than they were because the cost of equity is declined, obviously?

MS. MCSHANE:

A. Well, I agreed with you that based on my assessment, it looks like the cost of equity is about 50 basis points lower than when I did those estimates in 2009.

MR. JOHNSON:

Q. Right, and, in fact, there was a lot of regulatory activity in 2009. These cases seem to go in cycles, do they not? 2009 was a busy year, and there's more proceedings in Alberta, BC, etc., more recently, is that right?



MS. MCSHANE:

A. Yes, there have been - there were a number of cases in 2009, and there have been several since that time.

MR. JOHNSON:

Q. And, for instance, in Alberta, that Board had a generic cost of capital hearing in 2009, and I believe you participated in that hearing, did you not?

MS. MCSHANE:

A. I participated, yes.

MR. JOHNSON:

Q. And as a matter of fact, that Board in 2009, they issued a decision around late of 2009, around November month, wasn't it?

MS. MCSHANE:

A. I think that's right.

MR. JOHNSON:

Q. And they ordered 9 percent?

MS. MCSHANE:

A. I believe that's right.

MR. JOHNSON:

Q. And they've since - they've revisited that now because the had a 2011 cost of capital generic hearing, right?

MS. MCSHANE:
A. They did.
MR. JOHNSON:
Q. And they reduced it to what, 8.75, is that correct?
MS. MCSHANE:
A. They did, yes.
MR. JOHNSON:
Q. Now in 2009, you indicated you had some involvement before the Alberta regulator, and I'd like to bring you to the Alberta Regulator's case or decision from 2009, and particularly page 15 of that decision.
MS. GLYNN:
Q. We'll enter that as Information Item #4.
MR. JOHNSON:
Q. Now Ms. McShane, as I understand it, in Alberta, they set what's called a generic ROE, and you talked about that a little bit in direct with Mr. Kelly in terms of the approach in Alberta, correct?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And at Table 3 of this decision, it gives the



utility's proposed ROE and equity ratios before the Alberta Board, right, and I understand that you were there - your client was the ATCO Group, is that correct?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And so ATCO Electric TFO, that's ATCO's transmission company, correct?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And they were seeking 10.5 percent on 38 percent equity before the Alberta Board, correct?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And then under the bolded line, Electric and Gas distribution, we have ATCO Electric DISCO, and that would have been the poles and wires company in Alberta?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:



Q. And they were seeking 10.6 percent on a bit thicker common equity of 40 percent as opposed to 38 percent, right?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And then ATCO Gas, they were seeking the highest, they were seeking 11 percent on 40 percent common equity, right?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And in terms - did you support these recommendations that these ATCO companies were making to the Board before Alberta in 2009?
MS. MCSHANE:
A. Do you mean did I do the cost of equity estimates?
MR. JOHNSON:
Q. No, I'm asking you did you support the recommendations that ATCO was making?
MS. MCSHANE:
A. Indirectly.
MR. JOHNSON:
Q. Yes, and your role before the 2009 AUC was



what, Ms. McShane?
MS. MCSHANE:
A. My role was to determine whether or not the individual ATCO Utilities were more or less risky on a business risk basis than sort of benchmark and to determine whether any adjustments to the benchmark ROE were required based on the relative riskiness of the individual ATCO Utilities.
MR. JOHNSON:
Q. So you were the relative risk person for ATCO?
MS. MCSHANE:
A. I think that's probably a good way of saying it.
MR. JOHNSON:
Q. Okay. And I guess it just seems to me that Electric TFO, that being the transmission utility, that would have viewed themselves and you would have viewed them as well, as relatively less risk than the distribution company and the gas company, correct?
MS. MCSHANE:
A. I think that's fair, yes.
MR. JOHNSON:
Q. And that's reflected because they want ten and

a half on 38 percent equity. And I take it you would have concurred that above them in terms of risk would have been electric distribution, right?

MS. MCSHANE:
A. Yes.

MR. JOHNSON:
Q. At 10.6, and highest of those three sectors, you would put gas, ATCO Gas, who were seeking 11 percent, right, on 40 percent common equity?

MS. MCSHANE:
A. Yeah. I would have thought that the ATCO Gas was somewhat riskier than the ATCO Electric, DISCO.

MR. JOHNSON:
Q. Okay. And so would it be fair to say that they obviously, between ATCO Gas and distribution, they saw certainly a 40 percent basis point differential in terms of the overall recommendation as being warranted, correct?

MS. MCSHANE:
A. Based on the samples that were used and the capital structures of the companies in the



sample. I'm not sure that -

MR. JOHNSON:
Q. Well, when I look at ATCO Gas and I look at ATCO Distribution, Electric DISCO, I see 40 percent common equity. So both of them were on the same page when it comes to common equity, but I see a 40 basis point difference between ATCO Gas wanting 11 percent and DISCO wanting 10.6.

MS. MCSHANE:
A. Yeah, and I think that had as much to do with the particular results of the samples that were used than anything. I mean, there was a sample selected for ATCO Electric DISCO as I recall that was an electric sample and there was a sample of utilities selected for ATCO Gas that was gas utilities.

MR. JOHNSON:
Q. But just to be clear, you certainly accept that there is a risk difference, lowest to highest, amongst first transmission being lowest, electric distribution being next and gas being next?

MS. MCSHANE:
A. True. No, I agree with that, yes.



MR. JOHNSON:
Q. And just to confirm, you supported their recommended request or proposed ROE for those, for each of those entities, correct?

MS. MCSHANE:
A. I did. I mean, I did not go into the specifics of the estimates that were made for the sample companies. What I did was to determine whether or not the individual ATCO companies were of similar risk to the samples of companies that the rate -- I'll call them the ROE witness or expert was using.

MR. JOHNSON:
Q. But am I missing you? You were -- I thought that you were opining on or giving your view as well on the relative risk differences between the ATCO companies, were you not?

(10:00 a.m.)

MS. MCSHANE:
A. No, I don't think that that's really what I was doing. I mean, I was determining what the relative riskiness of the ATCO company was versus the sample of companies that the ROE person was using.

MR. JOHNSON:



Q. Did you file a report in the AUC matter?

MS. MCSHANE:
A. I did.

MR. JOHNSON:
Q. Would you undertake to file a copy of that report, Ms. McShane?

MS. MCSHANE:
A. Certainly.

MR. JOHNSON:
Q. Ms. McShane, and I understand that you have similarly testified recently and provided evidence regarding electrical or utility sectors, whether they be gas, transmission or electric distribution. Would that be correct?

MS. MCSHANE:
A. Yes, in the BC generic proceeding, one of the minimum filing requirements of the BCUC was risk ranking for sectors that -- utility sectors that it had specified it wanted to look at.

MR. JOHNSON:
Q. So the BCUC, they go about it in a generic fashion and to them it was important to know how this different sectors added up in terms of risk and where they were relative to each

other?
MS. MCSHANE:
A. They do it in a generic fashion. They obviously allow returns for various utilities and what they do is they determine -- well, they have in the past, at least, determined an ROE that they believe is applicable to what they call the benchmark BC utility and in this proceeding in 2012, they were looking at a somewhat broader, I guess, set of issues and they did want to consider how the different sectors ranked.
MR. JOHNSON:
Q. And not only did they want to consider it, but they have a minimum filing requirement that mandates that what be filed regarding the sector rankings, Ms. McShane?
MS. MCSHANE:
A. I have no idea.
MR. JOHNSON:
Q. Well, didn't you provide testimony in BC that satisfied British Columbia's minimum filing requirement as regards -
MS. MCSHANE:
A. Oh, that was something that was specific to



that proceeding. It's not like a minimum filing requirement that's required in every cost of capital proceeding.
MR. JOHNSON:
Q. Well, in the generic cost of capital proceeding that you testified in in December of 2012 in British Columbia, there was a minimum filing requirement?
MS. MCSHANE:
A. Right.
MR. JOHNSON:
Q. And that minimum filing requirement had to do with ranking of the companies -
MS. MCSHANE:
A. Right.
MR. JOHNSON:
Q. - by businesses, right?
MS. MCSHANE:
A. Sectors.
MR. JOHNSON:
Q. And you provided that evidence?
MS. MCSHANE:
A. Sectors, yes.
MR. JOHNSON:
Q. And were you the only expert to provide that



evidence?
MS. MCSHANE:
A. I believe so.
MR. JOHNSON:
Q. Yes. And could we turn you to your cost of capital testimony for the Fortis BC utilities dated August 2012? I'm looking at page 45 in particular.
MS. GLYNN:
Q. Sorry, Mr. Johnson, we'll mark that as Information Item No. 5
MR. JOHNSON:
Q. Okay. Page 45, Ms. McShane.
MS. MCSHANE:
A. I have that.
MR. JOHNSON:
Q. Okay. And in this report, this is dated August, but you've just testified as to this in December, you've set out the sector rankings, lowest to highest business risk and the rationale, and you put electricity transmission at the lowest, correct?
MS. MCSHANE:
A. Generically, yes.
MR. JOHNSON:



Q. Generically, yeah. And in a nutshell, why would you put them at the lowest?
MS. MCSHANE:
A. I think all of the reasons are set out right here. There are six of them.
MR. JOHNSON:
Q. Okay.
MS. MCSHANE:
A. I mean, I can repeat them, but they're -
MR. JOHNSON:
Q. No, I don't want you to repeat them, but you just confirmed them. And then with electricity distribution, there's six reasons why you put that just above electricity transmission, right?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. Okay. And then natural gas distribution, you would say that that has more business risk than electricity distribution, right?
MS. MCSHANE:
A. Generally, generically I should say.
MR. JOHNSON:
Q. Yeah. And because there's more limited end

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uses for natural gas than for electricity. "The heating load is generally a significant portion of throughput for which there are substitutes including solutions that are more technologically and economically feasible than were available historically. Throughput is generally more weather sensitive than for electricity distribution utilities. Industrial processes that use natural gas can frequently switch to other sources of energy." And number five is "heating load oriented utilities more exposure to declining throughput due to factors such as smaller and more efficient energy efficient homes and more energy efficient equipment than electricity distributors. Six, with some exceptions, example ATCO Gas, gas distributors retain responsibility for acquiring a gas supply portfolio. Gas purchases are subject to prudence review." And you go on in seven saying "as sellers and transporters of fossil fuel may have more exposure than electricity distributors, particularly where electricity is produced by green energy sources, to impacts of environmental policies and

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regulations directed at reducing emissions and favouring clean and renewable energies." And then at the highest, you would put vertically integrated electric utilities, and then you provide the reasons why you would put them in that pecking order, right?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. So let's try to put some names to some of these sector categories. Ms. McShane, for electric transmission, would you include in there companies like Hydro 1?

MS. MCSHANE:

A. They are electricity transmission, yes.

MR. JOHNSON:

Q. And Alta Link?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. ATCO Transmission?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. Any more that you can name that would fit

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under that sector?

MS. MCSHANE:

A. Well, there are a couple of other transmission utilities in Alberta, but those are the major ones.

MR. JOHNSON:

Q. What are the other couple in Alberta?

MS. MCSHANE:

A. ENMAR Transmission. EPCOR Transmission.

MR. JOHNSON:

Q. And in terms of examples of electric distribution, you would include Fortis Alberta?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. Toronto Hydro?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. Hydro Ottawa?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. Newfoundland Power?

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MS. MCSHANE:

A. It's distribution, but it also has some generation.

MR. JOHNSON:

Q. But you -- when you testified in British Columbia, you put that under the examples of electric distribution, correct?

MS. MCSHANE:

A. I'm not sure. Do you have a reference for that? I don't remember putting it in a particular -

MR. JOHNSON:

Q. I think that I can get you a reference and I'll see if I can get one at the break for that.

MS. MCSHANE:

A. Okay.

MR. JOHNSON:

Q. But certainly, you're aware that Moody's, for instance, says they have such small amount of generation that they're basically T&D in their books?

MS. MCSHANE:

A. I'm aware that Moody's considers -- describe them as a transmission and distribution

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utility.
MR. JOHNSON:
Q. And fundamentally, you assess them as being a transmission and distribution utility, correct?
MS. MCSHANE:
A. I would say they're closer to a pure transmission and distribution utility than they are to a vertically integrated utility like Nova Scotia Power.
MR. JOHNSON:
Q. Maritime Electric, that would be electric distribution?
MS. MCSHANE:
A. It's -- again, I mean, it's got some generation, but it's more distribution than vertically integrated.
MR. JOHNSON:
Q. Yeah. And again, I understand that when you testified in BC, you also put that under the electric distribution group.
MS. MCSHANE:
A. I don't remember that, but so if you have -
MR. JOHNSON:
Q. Okay. We can work that out.

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MS. MCSHANE:
A. Okay.
MR. JOHNSON:
Q. And in terms of examples of gas distribution, again this would be usually in the sector, the higher business risk, but the companies would be companies like Fortis Energy BC, that would -- that's a -
MS. MCSHANE:
A. Fortis BC Energy.
MR. JOHNSON:
Q. Fortis BC Energy, they're also known as FEI?
MS. MCSHANE:
A. That's what their acronym is, yes.
MR. JOHNSON:
Q. And as a matter of fact, that was the company that you were testifying for before the BCUC recently in December, right?
MS. MCSHANE:
A. It was the Fortis BC Utilities.
MR. JOHNSON:
Q. Okay. One of which is FEI?
MS. MCSHANE:
A. Correct.
MR. JOHNSON:

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Q. Okay. And you put under that category ATCO Gas?
MS. MCSHANE:
A. That's a gas distribution utility, yes.
MR. JOHNSON:
Q. Union Gas?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. Enbridge Gas?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. Gas Metro?
MS. MCSHANE:
A. That's a distribution utility, yes.
MR. JOHNSON:
Q. Any further gas distribution companies that fall under the rubric?
MS. MCSHANE:
A. There are other gas distribution utilities. I'm not sure -
MR. JOHNSON:
Q. That's a fair number. In terms of vertically integrated, again, they would be higher

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according to your -- higher business risk. Vertically integrated, Nova Scotia Power?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. Fortis British Columbia?
MS. MCSHANE:
A. Fortis BC Inc., yes.
MR. JOHNSON:
Q. Fortis BC Inc.
MS. MCSHANE:
A. Not as vertically integrated as Nova Scotia Power, but it's not a pure distribution and transmission utility either.
MR. JOHNSON:
Q. You consider it a vertically integrated obviously?
MS. MCSHANE:
A. I mean, yeah, they're -- I mean, there are obviously lines, but yes, I would consider them more vertically integrated than Newfoundland Power but less vertically integrated than Nova Scotia Power.
MR. JOHNSON:
Q. As between Nova Scotia Power and Fortis BC

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Inc., you would put Nova Scotia Power at higher business risk?

MS. MCSHANE:

A. Yes, I would.

MR. JOHNSON:

Q. Yeah. And so they would be the riskiest in the country, would they, in terms of business risk?

MS. MCSHANE:

A. The riskiest in the country?

MR. JOHNSON:

Q. Because if they're in the highest sector.

MS. MCSHANE:

A. Well, I think I'd like to make the point that if you come back to pages 43 to 44 of this testimony where I put a fair number of caveats on this discussion and particularly at line 1106 and onward on page 44 where I said specifically that "the rankings provided below from lowest business risk to highest business risk are intended to be generic based on fundamental characteristics that are generally common to utilities in each category. They should not be interpreted to mean, for example, that every utility categorized as an

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electric distribution utility is of lower business risk than every gas distribution utility or that every gas distribution utility is of lower business risk than every vertically integrated utility." So the specific answer to your question is no, I wouldn't consider Nova Scotia Power the highest risk utility in Canada and I would still think that Pacific Northern Gas, for example, which is a gas distribution utility is a higher risk utility or has been a higher risk utility than Nova Scotia Power.

MR. JOHNSON:

Q. As between Nova Scotia Power and Fortis BC Inc., you would put Nova Scotia Power at higher business risk?

MS. MCSHANE:

A. I would.

MR. JOHNSON:

Q. And are you aware what Nova Scotia Power's common equity ratio is in their capital structure?

MS. MCSHANE:

A. For rate setting purposes, its allowed common equity ratio is 37 and a half percent and it's

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allowed to earn on equity of up to 40 percent.

MR. JOHNSON:

Q. Pardon me?

MS. MCSHANE:

A. It's allowed to earn a return on an equity ratio of up to 40 percent.

MR. JOHNSON:

Q. And they just settled on an ROE in Nova Scotia. Are you aware of that, Ms. McShane?

MS. MCSHANE:

A. I am, yes.

MR. JOHNSON:

Q. And September 14th, 2012, do you know what the settlement was?

MS. MCSHANE:

A. Nine percent.

MR. JOHNSON:

Q. Yeah. Now Ms. McShane, you indicated your caveats, et cetera, but in terms of the business risk, those would be the indicia of the risk characteristics that you think should be taken into account? There's no doubt about that. You said that in black and white in your report at page 45 and 46.

(10:15 a.m.)

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MS. MCSHANE:

A. Those are the generic types of factors that differentiate the sectors.

MR. JOHNSON:

Q. Okay. And just to confirm now, you're here obviously for this electric distribution company, Newfoundland Power, and recommending 45 percent common equity in its capital structure and your recommendation is for 10 and a half percent, and you testified just last month, prior to Christmas, in British Columbia for FEI which is the gas distributorship which has 40 percent of common equity in its capital structure and so you must have suggested that they get a higher return on equity because of their lower common equity structure, right?

MS. MCSHANE:

A. No, I didn't.

MR. JOHNSON:

Q. I bet you you didn't. I bet you you suggested the same return as Newfoundland Power, didn't you, 10 and a half percent?

MS. MCSHANE:

A. I did, yes.

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MR. JOHNSON:
Q. Yeah. And why is it that FEI, which would fall into a sector which would be considered to have, generally speaking, subject to caveats or whatever, less business risk, why would that company be given 10 and a half percent and Newfoundland Power investor be given 10 and a half percent on higher common equity?
MS. MCSHANE:
A. Well, if you look at how FEI and Newfoundland Power are valuated by the debt rating agencies. At 40 percent common equity, FEI has higher debt ratings than Newfoundland Power. So from an overall risk perspective, at least from the debt rating agencies' perspective, at 40 percent equity, FEI is an average risk utility. With 45 percent equity, Newfoundland Power is a weaker credit.
MR. JOHNSON:
Q. But Ms. McShane, you're here giving professional evidence, opinion evidence about the cost of equity of Newfoundland Power, right?
MS. MCSHANE:

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A. I am.
MR. JOHNSON:
Q. And I thought the record was replete -- I can't go there now off my fingertips, but the record is pretty full to the extent that credit rating reports and bond rating reports are not necessarily -- or never mind necessarily, they're not indicative of what the return should be for an equity investor. You haven't departed from that judgment?
MS. MCSHANE:
A. When you say they're not indicative of the -- they don't tell you what the return is, no.
MR. JOHNSON:
Q. Yeah. I mean, so the bond rating, it doesn't give an indicator to the Board of what the common equity return should be for the utility on review?
MS. MCSHANE:
A. No, the bond rating doesn't tell the Board what the common equity return should be, but you can -- one thing that the bond rating does do is give you an assessment, at least an independent assessment, of how -- at least from a debt rating perspective, how investors

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view the relative overall risk of a Newfoundland Power versus an FEI.
MR. JOHNSON:
Q. In terms of FEI, so they've had 40 percent common equity in their capital structure for how long?
MS. MCSHANE:
A. Three years.
MR. JOHNSON:
Q. So just three years. What were they at before that?
MS. MCSHANE:
A. 35.
MR. JOHNSON:
Q. So they were ten basis points away from where Newfoundland Power was, and even at -
MS. MCSHANE:
A. Sorry, they were what?
MR. JOHNSON:
Q. Ten percent, I'm sorry.
MS. MCSHANE:
A. Oh, ten percentage points.
MR. JOHNSON:
Q. Yes. And in terms of the financial risk, you spoke in your opening about differences in

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financial risk between firms, FEI would have less financial risk than Newfoundland Power, I take it?
MS. MCSHANE:
A. No, I don't believe it has less financial risk than Newfoundland Power. In terms of common equity ratio and credit metrics, it doesn't. It has better credit ratings. It's a much bigger utility.
MR. JOHNSON:
Q. Right.
MS. MCSHANE:
A. So, I mean, to some extent investors do take into account utility size.
MR. JOHNSON:
Q. Ms. McShane, can I ask you, as between a company that has 45 percent common equity in its capital structure and a company that has 40 percent common equity in its capital structure, would it not be accepted by yourself that the company with 45 has less financial risk than the company with 40 percent?
MS. MCSHANE:
A. Well, if you're comparing the same company

with itself, then yes, but when you're comparing a Newfoundland Power with an FEI, I think you need to look at all of the factors, including the fact that Newfoundland Power is a much smaller utility than FEI.

MR. JOHNSON:

Q. Well, Ms. McShane, let's put it this way, I thought part of your thesis, for instance, in using your US comparables is that -- and correct me where I'm wrong in terms of premise, but that the business risks and the utility -- the business risk, regulatory risks of your sample and Newfoundland Power, in your books, they're approximately the same. Would that be about right?

MS. MCSHANE:

A. The what, please?

MR. JOHNSON:

Q. They'd be approximately the same?

MS. MCSHANE:

A. No, I need the first part of the sentence.

MR. JOHNSON:

Q. In terms of your US utility sample, your 13 or 14 companies, that your premise is that their US companies, your US companies, business risk



and regulatory risk is sort of on a par with Newfoundland Power's, that's basically your -

MS. MCSHANE:

A. My premise is that the overall risk is sort of on the -- is on par with that of Newfoundland Power.

MR. JOHNSON:

Q. Okay. But in terms of -- I'm focusing now on the business risk and the regulatory risk. Do you say that they are on a par with Newfoundland Power?

MS. MCSHANE:

A. They are relatively similar, but my ultimate focus is on the total risk and whether the total risk is similar.

MR. JOHNSON:

Q. And the reason that you say that the total risk is similar is because you take into account financial risk, correct?

MS. MCSHANE:

A. I do.

MR. JOHNSON:

Q. And the financial risk you take into account has to do with their capital structure, does it not?



MS. MCSHANE:

A. And their credit metrics.

MR. JOHNSON:

Q. Their capital -- but their capital structure would be their percentage of common equity?

MS. MCSHANE:

A. Correct.

MR. JOHNSON:

Q. Because your reports and Dr. Vander Weide's, I believe, says "oh, you got to really pay attention now because these US parents have higher common equity, so less financial risk." So you throw it all together and they're more or all less equal than Newfoundland Power. Would that be about right?

MS. MCSHANE:

A. That's the end result, yes, that they have lower financial risk and so they have similar debt ratings to Newfoundland Power.

MR. JOHNSON:

Q. So if that applies between these US companies and Newfoundland Power, why can't we conclude that Newfoundland Power has less financial risk than say FEI because of the differences in corporate structure?



MS. MCSHANE:

A. Sorry, I don't understand "because of the differences in corporate structure" part.

MR. JOHNSON:

Q. I'm sorry, because of the differences in the thickness of the common equity ratio.

MS. MCSHANE:

A. Because it's clear to me that a 40 percent equity ratio for Newfoundland Power would not give it the same overall risk when all of the factors including size are considered as FEI.

MR. JOHNSON:

Q. Ms. McShane, if I could bring you to the FD -- or the MD&A which I filed I think it was last week, the Fortis MD&A? That came with a letter dated January 9.

MS. GLYNN:

Q. We'll mark that as Information Item No. 6

MR. JOHNSON:

Q. I'm referring, Ms. McShane, to page -

MR. HAYES:

Q. Can I get the reference again, Mr. Johnson?

MR. JOHNSON:

Q. It's -- I'm sorry, Mr. Hayes. It's the Interim Management Discussion and Analysis of

-

MR. HAYES:
Q. Okay. We do have it.
MR. JOHNSON:
Q. Okay. And it's page 22 and this is the Interim Management Discussion and Analysis of Fortis Inc. for the three and nine months ended September 30, 2012 and the document is dated November 1st, 2012, and I'm referring to page 22.
MS. MCSHANE:
A. I have that.
MR. JOHNSON:
Q. Okay. Now Ms. McShane, in terms of under regulatory highlights, and I'm sorry, under that nature of regulation, Fortis lists each of its regulated utilities. FEI is the one we were talking about and FEVI, what's that? Are you familiar with that one?
MS. MCSHANE:
A. Yes, that's Fortis Energy Vancouver Island.
MR. JOHNSON:
Q. What are they?
MS. MCSHANE:
A. They are a natural gas distribution utility



that serves Vancouver Island.
MR. JOHNSON:
Q. Okay. And F-E-W-I?
MS. MCSHANE:
A. That's Fortis BC Energy Whistler.
MR. JOHNSON:
Q. And what are they?
MS. MCSHANE:
A. They're a gas distribution utility that serves the municipality of Whistler.
MR. JOHNSON:
Q. And Fortis BC Electric, that's the vertically integrated one you spoke of?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And Fortis Alberta, that's the T&D?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And they have 41 percent common equity?
MS. MCSHANE:
A. Correct, yes.
MR. JOHNSON:
Q. And they're presently getting 8.75 percent on



that common equity?
MS. MCSHANE:
A. They are.
MR. JOHNSON:
Q. Yeah. And you would put them obviously in the same sector as Newfoundland Power in terms of T&D?
MS. MCSHANE:
A. They're in the same -- basically in the same sector, different characteristics, different size. Fortis Alberta is a much bigger utility than Newfoundland Power, operates in a much more growth oriented province, doesn't have any generation.
MR. JOHNSON:
Q. No generation. And in terms of Maritime Electric, they're 40 percent and their 2012 allowed return is a 9.75 percent. Then we have the Fortis Ontario, some of those -- Canadian Niagra Power that falls under Fortis Ontario, they're eight percent, is it?
MS. MCSHANE:
A. I'm not familiar with them. I mean, I know that they've -- that the way it works in Ontario is they have multiple year performance



based regulation plans and under those plans, the ROE doesn't change until the utility rebases its rates. 8.01 looks like an ROE that was determined under the old formula of the Ontario Energy Board before it was revised in 2009.
MR. JOHNSON:
Q. And Algoma Power, do you know anything about them?
MS. MCSHANE:
A. No, I don't.
MR. JOHNSON:
Q. Okay. And so would you -- so is it your evidence that you regard Newfoundland Power as being more or less risky than FEI say?
MS. MCSHANE:
A. I'd say on a fundamental risk basis, it's probably a bit less risky, but it's a much smaller utility which tends to have offsetting implications as far as what's an appropriate capital structure.
MR. JOHNSON:
Q. And so would it be the small size of Newfoundland Power, that -- where does that figure into it?

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MS. MCSHANE:
A. It figures into whether or not it should have a 45 versus 40 percent capital structure, common equity ratio.
MR. JOHNSON:
Q. So to -- the total difference between the 40 and 45 is justified by the relative size difference in Newfoundland Power? Is that what you're saying?
MS. MCSHANE:
A. I would say in large part it would -- the difference is justified and it's also justified by the fact that even at 45 percent common equity, Newfoundland Power still has lower debt ratings than FEI.
MR. JOHNSON:
Q. And what's the debt ratings of FEI?
MS. MCSHANE:
A. Moody's A3 on unsecured debt. I think they're A1 on secured debt. I have it in my testimony here. I can double check here so we know for sure. The ratings are set out on Schedule 4 and shows that Fortis BC Energy Inc.'s debt ratings which are listed under the Gas Distributors Group are A1 for senior secured

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and A3 for senior unsecured.
MR. JOHNSON:
Q. And who provides those?
MS. MCSHANE:
A. Sorry, did I say that correctly? A3 for senior unsecured. A1 for senior secured from Moody's.
MR. JOHNSON:
Q. And that compares to Newfoundland Power's as how?
MS. MCSHANE:
A. Newfoundland Power's first mortgage bonds which are -- which would be -
MR. JOHNSON:
Q. Secured.
MS. MCSHANE:
A. - analogous to the secured are A2 and it's issue a rating which would be analogous to the unsecured debt rating would be AA1.
MR. JOHNSON:
Q. Now in terms of the business risks of FEI, for instance, how big a utility is FEI?
MS. MCSHANE:
A. How big a utility?
MR. JOHNSON:

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Q. Yeah.
MS. MCSHANE:
A. It's about a three billion dollar rate base.
MR. JOHNSON:
Q. Okay. But they have risks that Newfoundland Power don't have, I would take it you'd agree with that?
MS. MCSHANE:
A. They have their own risks, yes, that are not the same as Newfoundland Power's risks.
MR. JOHNSON:
Q. And in your evidence before the BC proceeding, you talked about the primary categories of utility business risk, correct? You remember that?
(10:30 a.m.)
MS. MCSHANE:
A. I do.
MR. JOHNSON:
Q. Pardon me?
MS. MCSHANE:
A. I do.
MR. JOHNSON:
Q. You do. And the primary categories of utility business risk are set out in your report from

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page 39 to 41?
MS. MCSHANE:
A. They are.
MR. JOHNSON:
Q. And the first risk that you talk about is market demand risk. "Market demand risk relate to the size of the market for the utility services and the ability of the utility to capture market share" and you indicate it reflects the demographics of a service area, diversity of economy, economic growth potential, geography, weather, et cetera.
MR. KIRBY:
Q. I'm not sure we're all with you on the same page, Mr. Johnson.
MR. JOHNSON:
Q. Oh, I'm sorry. We're at the BCUC evidence. The BCUC that we had up previously.
MS. GLYNN:
Q. I think it's Information Item No. 5.
MR. JOHNSON:
Q. So here you list the primary categories of utility business risk, so market demand risk, and you talk about competitive risk, supply

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risk, operating risk, political risk, regulatory risk, and those are the categories that would apply equally to Newfoundland Power, I take it?

MS. MCSHANE:

A. They're generic categories of business risk that apply to all utilities.

MR. JOHNSON:

Q. Yeah. And then you expand a bit more over on page 49 and the pages that follow on the different categories or the different categories of utility business risk. So you talk about market demand and competitive risk in FEI's case. Ms. McShane, I understand that there's significant risk, as outlined in your report, in your view, based by FEI, for instance, when it comes to market and demand risk and competitive risk.

MS. MCSHANE:

A. They do face material competitive risk vis-a-vis electricity in BC.

MR. JOHNSON:

Q. And when you say material, could you put that in some sort of context for us, quantify it?

MS. MCSHANE:

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A. No.

MR. JOHNSON:

Q. They compete with electricity for heating?

MS. MCSHANE:

A. For heating and for -

MR. JOHNSON:

Q. Cooking?

MS. MCSHANE:

A. Cooking, yes.

MR. JOHNSON:

Q. Right.

MS. MCSHANE:

A. And for water heating.

MR. JOHNSON:

Q. Right. And in their service territory, what percentage of the market do they have, in terms of customers versus electricity?

MS. MCSHANE:

A. I don't see the overall market share numbers. I see the -

MR. JOHNSON:

Q. I see over at page -

MS. MCSHANE:

A. - residential sector.

MR. JOHNSON:

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Q. I see over on page 50, for instance -

MS. MCSHANE:

A. Right.

MR. JOHNSON:

Q. - at line 1280, it talks about -- first of all, this is just provincial now, "although BC is the second largest natural gas producing province in the country, natural gas has just under 50 percent share of the residential market compared to over 60 percent in Ontario, which produces relatively little gas" and then it goes on "market share of natural gas in the residential sector in Alberta is over 80 percent." So first of all, relative to gas distributors in other, Alberta and Ontario, there's more competition for other fuel sources or power sources in BC first of all, right?

MS. MCSHANE:

A. There's more competition in BC than in Alberta for natural gas.

MR. JOHNSON:

Q. And in terms of the share of the customers in BC for FEI, that has been going down, has it not?

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MS. MCSHANE:

A. In the residential market, that's true.

MR. JOHNSON:

Q. Yes. And what's the reason it's been going down?

MS. MCSHANE:

A. Well, there are a number of factors. There's been the relative price of natural gas, the volatility of natural gas prices, and government energy policy which is supportive of green energy sources which natural gas in BC has not been viewed as such.

MR. JOHNSON:

Q. And in terms, how does multi-residential buildings fit into the issues of market share in British Columbia for FEI?

MS. MCSHANE:

A. There is a shift toward multi-family dwellings away from single family homes. Multi-family dwellings tend to be smaller, so they use less of whatever energy source than the larger single family homes, and because -

MR. JOHNSON:

Q. Not only -- go ahead, sorry.

MS. MCSHANE:

A. - because it's easier to install electric equipment in multi-family homes, there's been a tendency to use electricity rather than natural gas.
MR. JOHNSON:
Q. Right. And as I understand it, the bottom of page 49, line 1263, "FEI's capture rate in new multi-unit dwellings has been and continues to be materially lower than in single family housing, approximately 30 percent versus 70 percent." So that, I take it, means that in single family houses, they had about 70, but in the new multis, they're getting about 30?
MS. MCSHANE:
A. That's right.
MR. JOHNSON:
Q. And the market is moving heavily towards multis?
MS. MCSHANE:
A. In?
MR. JOHNSON:
Q. In their service area?
MS. MCSHANE:
A. In their service territory, yes.
MR. JOHNSON:



Q. Yeah. And in addition to that, over on page 50, at 1271, it talks about per customer usage rates continue to fall as well.
MS. MCSHANE:
A. Right, and that is partly a function of -
MR. JOHNSON:
Q. Of the shift?
MS. MCSHANE:
A. - the shift.
MR. JOHNSON:
Q. Right, okay. And then in BC, there is mention at page 52 of competitor pressures. This is at line 1315. "Competitive pressures on natural gas in BC that stem from the abundance of low cost hydro resources and the evolving housing competition are amplified by energy policies. Designed to fight climate change, provincial energy policies and associated regulations promote reduced and more efficient energy use, discourage the use of fossil fuels and promote development of use of clean energy." So this is a big concern in the market as well?
MS. MCSHANE:
A. Where?



MR. JOHNSON:
Q. This is a big concern in FEI's territory?
MS. MCSHANE:
A. Yes. There is an energy policy that has discouraged the use of fossil fuels.
MR. JOHNSON:
Q. And legislation passed in that province as well is referred to at the bottom of page 52?
MS. MCSHANE:
A. Correct.
MR. JOHNSON:
Q. And that's the legislation that discourages the use of fossil fuels?
MS. MCSHANE:
A. Yes, and the one that's listed at the bottom are new legislation that was passed since the last time the cost of capital was considered in BC.
MR. JOHNSON:
Q. And the Greenhouse Gas Reduction Clean Energy Regulation that put an extra charge on natural gas, I take it?
MS. MCSHANE:
A. I don't think so. The extra charge on natural gas was before 2012. There was a carbon tax



that was applied earlier than that and I think it reached its maximum level in 2012, but the regulation was before that.
MR. JOHNSON:
Q. Yes, but the regulation is before that, but the amount of the extra cost or premium, I don't know if I'm putting it properly, has escalated since the legislation was passed from I think 50 cents a unit up to $1.50 per unit.
MS. MCSHANE:
A. Yeah, the additional cost per gigajoule, called the carbon tax, in 2012 was $1.50.
MR. JOHNSON:
Q. And then over on supply risk at page 53, there's concerns over there about supply risk. In a nutshell, what are those, Ms. McShane?
MS. MCSHANE:
A. I don't know that there's a huge concern over supply risk. It says at the top of page 54 the supply risk, which was already low, is somewhat lower than in 2009.
MR. JOHNSON:
Q. And then we have operating risk and "FEI's operating risk relate to factors that can

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cause outages or leaks on the distribution system, third party damages, accidental and intentional equipment failure, severe weather and natural disasters which could result in material service disruptions or environmental liability." Where would the environmental liability come into play?

MS. MCSHANE:

A. The environmental liability would come into play if -

MR. JOHNSON:

Q. Natural gas leaks?

MS. MCSHANE:

A. - if there were leaks that damaged the environment.

MR. JOHNSON:

Q. And you indicate "in contrast, the utilities that operate systems in more benign geographic regions, FEI operates facilities in remote and rugged terrain which are subject to damage from a variety of natural events, example avalanches, landslides, forest fires." So in terms of the remote and rugged terrain, where are we talking about?

MS. MCSHANE:

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A. Obviously not downtown Vancouver.

MR. JOHNSON:

Q. So in rural areas of British Columbia, up in the country?

MS. MCSHANE:

A. Yeah.

MR. JOHNSON:

Q. Up in the back country.

MS. MCSHANE:

A. It covers, you know, a significant part of the province.

MR. JOHNSON:

Q. Yeah, okay. And there's mention of political risk. This has to do with legislation, policies and decisions, which we've already touched on. And then finally, we have regulatory risks. In a nutshell, what are those for FEI?

MS. MCSHANE:

A. The regulatory risks?

MR. JOHNSON:

Q. Yes.

MS. MCSHANE:

A. You can describe the regulatory risk generally as the risk that the regulatory environment

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will change so that there's a higher risk of not recovering utilities cost.

MR. JOHNSON:

Q. And in particular, your report points out that a principal change that has occurred -- and I'm reading it from page 55, line 1425, that "the principal change that has occurred since the '09 application relates to increased regulatory lag and uncertainty that stem largely from the changing environment, particularly for natural gas. More of its activities are subject to regulatory oversight, entailing more frequent, protracted and contentious proceedings." So it's your evidence that FEI regulatory risk has gone up from 2009 levels?

MS. MCSHANE:

A. Well, you can see what the conclusion was. It says on balance, it's no lower and is some ways higher than in 2009.

MR. JOHNSON:

Q. So in terms of comparing the regulatory risk which is, as some have put it, generally supportive in Newfoundland Power's instance, how would you compare the two risks, between

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FEI regulatory risk and Newfoundland Power?

MS. MCSHANE:

A. I would say that on balance the regulatory environment is supportive in both provinces. I mean, if you look at the ratings on regulatory support from Moody's, they're the same for Newfoundland Power and for FEI.

(10:45 a.m.)

MR. JOHNSON:

Q. And I think DBRS actually uses the words in relation to Newfoundland Power market share that they have market dominance on the island of Newfoundland. Would you agree with that characterization?

MS. MCSHANE:

A. I mean, they have -- they're the only distribution utility on the island.

MR. JOHNSON:

Q. Makes them pretty dominant.

MS. MCSHANE:

A. Well, most electric distribution utilities are dominant in their service area and for the main, you know, basic services that they provide and can't be provided by anybody else.

MR. JOHNSON:

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Q. And that would be one of the reasons why you would rank them as having less business risk generally than gas distribution?
MS. MCSHANE:
A. As a generic proposition, that's true.
MR. JOHNSON:
Q. Yes. Ms. McShane, in spite of these risks that are outlined for FEI recently in your report and I'm looking at business risk of FEI relative to 2009 at page 56, you say "despite the shale gas boom and lower commodity prices of natural gas, the principal trends in FEI's business risk that were identified in the 2009 application have persisted. The level of business risk in the aggregate to which FEI is exposed is at least as high as when it was last assessed in 2009 and consequently, in the context of the trend in business risk, FEI has deemed 40 percent common equity ratio remains at the lower end of a reasonable range." But you didn't recommend that they get a higher, obviously, common equity ratio in the case of FEI?
MS. MCSHANE:
A. I did not recommend and the company did not request a higher common equity ratio.

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MR. JOHNSON:
Q. Mr. Chairman, I wonder -- it is about 10 to 11 -- if we could have a little break and then I'll just gather myself a Bit.
CHAIRMAN:
Q. Sure. We're back again at say 20 after? Is that -- we agreed for a half hour break at 11:00, so 20 after we shall reconvene.
(BREAK - 10:47 a.m.)
(RESUME - 11:24 a.m.)
MR. JOHNSON:
Q. Ms. McShane -- want me to proceed, Chairman?
CHAIRMAN:
Q. Oh yes, I'm sorry. Sure, absolutely.
MR. JOHNSON:
Q. Ms. McShane, just to finish off the discussion we're having, Ms. McShane, we have obviously discussed before the break the specific business risks of FEI relative to the categories of business risk that you've outlined and my question would be: how would you judge Newfoundland Power's business risks relative -- or business risk relative to FEI? You have stated, as you know, that generically gas distribution has more business risk than electric distribution. But specifically, is FEI more or less risky than Newfoundland Power, in terms of business risk?

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MS. MCSHANE:
A. I would say if you put aside the issue of size, where FEI is a much larger utility, FEI is of somewhat higher fundamental business risk than Newfoundland Power. On the other hand, Newfoundland Power does have issues with being a small utility operating in a province that's -- you know, has relatively low growth prospects, has worse demographic prospects than other provinces. So fundamentally, I guess, I would say FEI is of somewhat higher business risk, but Newfoundland Power does have its own issues which to me warrant it having the common equity ratio that it proposes, including its relatively small size.
MR. JOHNSON:
Q. So just to be clearer on this, taking Newfoundland Power as it is, small size, market dominance, regulatory supportiveness, all of those things, on a business risk basis, would FEI have less risk or more risk than Newfoundland Power?

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MS. MCSHANE:
A. FEI has more risk with the size issue aside. I think that they're relatively similar if you consider the size issue.
MR. JOHNSON:
Q. Ms. McShane, if you could turn up the overview again of the summary of your recommendations, that was the Cross-Ex aide that we referred to earlier.
KELLY, Q.C.:
Q. The recommendations?
MS. GLYNN:
Q. Information Item No. 3
MR. JOHNSON:
Q. Info No. 3. Just to circle back for a second and then we're going to talk about the market risk premium in more particulars, but as we've noted, your overall recommendation has come down 50 basis points from 11 to 10.5 percent for Newfoundland Power and certainly if we took out the larger floatation and compared like to like from last time, we'd go from 11 percent to 10 percent in terms of the floatation allowance being the like to like

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and Ms. McShane, what I do notice is that the market -- the overall expected market return, which would be the risk free rate in 2010 plus the market risk premium, if we added the 425 and the 6.75, we'd come to about 11 percent and then if we go over to the 2013- 2014 column, we see a 3.5 risk free on an 8 percent risk premium, so 11 and a half percent. So whilst the cost of equity is falling for Newfoundland Power, it's evidently going up for the market and just like to have an explanation for why that would be the case.

MS. MCSHANE:

A. Well, it's partly a function of the application of different tests and the different test results, but with respect to the return for the market, as you pointed out these estimates, I mean I think if you look at page -- sorry, I'm back in my BC testimony. If you look at page 47 of the testimony and Table 8 where there's a comparison of the conditions affecting the overall market in mid 2012 when I prepared this evidence versus October 2009, you can see that if I look at the bottom three lines of the table where

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there is a estimate of the forward earnings yield on the S&P 60 and what this is intended to show, these last three lines, is to show what the trend, general trend in the cost of equity in the market has been since that time and it indicates that, you know, based on the forward earnings yield that the cost of equity for the market was higher and because Canada Bond Yields were lower, there's a higher market risk premium today or in mid-2012 when this was done than there was the last time we were here before the Board.

As regard the utility specifically, I mean, there are other tests that are used to estimate the cost of equity, not just this test. So overall, using the discounted cash flow test, for example, that indicates -- that test indicates a lower utility cost of equity today than in 2009.

(11:30 a.m.)

MR. JOHNSON:

Q. So there would be nothing consistent, in your view, with what a regular company, an average company could expect its cost of capital going up but the utility's cost of capital coming

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down?

MS. MCSHANE:

A. I don't think that there's necessarily any inconsistency. Not all cost of capital move exactly together all the time.

MR. JOHNSON:

Q. And in terms of the October 2009 column, that was the date of the actual hearing when you were in testifying?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. July 2012 column, that's when you were preparing this particular testimony?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. And would you be able to provide by undertaking an update to date of the column, so that we could have January of 2013?

MS. MCSHANE:

A. I should be able to do that, yes.

MR. JOHNSON:

Q. That TSX figure, I take it, would have gone up a fair bit since July of 2012?

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MS. MCSHANE:

A. The TSX -

MR. JOHNSON:

Q. Price index.

MS. MCSHANE:

A. - the composite?

MR. JOHNSON:

Q. Yes.

MS. MCSHANE:

A. I think it's -- right now, it's around 12,500.

MR. JOHNSON:

Q. And in terms of your present overall market return estimate of 11 and a half percent, which falls out of your report, I'd like to put some context around that estimate and seeing you have been comparing October '09 to 2012 in Table 8, I'd like to just bring you to the Board's decision, just for ease of reference, at page 22 of the Board's decision and Order in P.U. 43 (2009), in particular page 22.

KELLY, Q.C.:

Q. Apparently it's not on the electronic version, Mr. Chairman.

MS. GLYNN:

Q. We could locate it on the website.
KELLY, Q.C.:
Q. We're not connected on this system.
MS. GLYNN:
Q. Okay.
MR. JOHNSON:
Q. Well, I can -- I think we can get by without a big delay on it. At page 22 of the Board's decision, they had set out a table, because Dr. Booth had commented on the Mercer Report in the last case and the Board set out Table 1 which gave the long term expected returns by asset class as estimated by Mercer.
KELLY, Q.C.:
Q. I will give my copy to the witness so she has it in front of her.
MR. JOHNSON:
Q. Now Ms. McShane -- Jackie, it's not going to come up on this anyway, is it?
MS. GLYNN:
Q. No.
MR. HAYES:
Q. Should be able to get it in a couple of minutes.
MR. JOHNSON:



Q. Okay.
MS. GLYNN:
Q. P.U. 43 (2009).
MR. JOHNSON:
Q. Yes.
MS. GLYNN:
Q. If you just click on Reasons for Decision.
MR. JOHNSON:
Q. Table 1 and it shows what Mercer had been saying in relation to the long term expected returns. Now I know these are not arithmetic returns. These are geometric returns. But it says Canadian equity is eight and a half. US equity is eight and a half. Fixed income, that would be basically bonds at 4.4 percent. Now Ms. McShane, as you're no doubt aware, we don't look at the arith -- the geometric returns. We look at arithmetic. And my understanding, Dr. Booth tells me that we add half the variance of the annual rate of return to arrive at the expected arithmetic rate of return. You're familiar with that type of adjustment?
MS. MCSHANE:
A. I am.



MR. JOHNSON:
Q. And Dr. Booth advises me that for equities in the current context, we'd add about two percent to get to the arithmetic return. Would you accept that type of adjustment in the context of an 8.5 percent geometric return?
MS. MCSHANE:
A. I think that's fair.
MR. JOHNSON:
Q. Okay. And so in 2009, the expectation -- this would be for the entire market now -- would be about 10.5 percent on an arithmetic return basis in both Canada and United States equities, okay. Do you accept that?
MS. MCSHANE:
A. Well, that's what Mercer is indicating.
MR. JOHNSON:
Q. That's what Mercer says. And the fixed income of 4.4 percent, so if we were looking at trying to derive a premium, just to get a sense of a premium at that time, would we say 10.5 percent less the 4.4 and come up with what the premium would be?
MS. MCSHANE:



A. No, because fixed income would include more than just -
MR. JOHNSON:
Q. More than just long Canada's?
MS. MCSHANE:
A. Right.
MR. JOHNSON:
Q. Right. So it would be perhaps a little more than six basis points for long Canada's?
MS. MCSHANE:
A. I don't know what the six basis points is.
MR. JOHNSON:
Q. That would be the spread between the arithmetic 10.5 and the 4.4, because you're saying long Canada's would be a little less than 4.4. Would that be right?
MS. MCSHANE:
A. Well, I don't know what the fixed income breakdown is that they're assuming, so I don't -- I can't really tell you what adjustment you'd need to make until I knew what the portfolio of fixed income security means.
MR. JOHNSON:
Q. Okay. For present purposes, let's just stick to equities then, and we have 10 and a half

percent, and I take it that's sort of a long
term expected return, like a 10-year type of
analysis. Is that what Mercers usually
provides?

MS. MCSHANE:

A. I don't know what the Mercer numbers represent
here.

MR. JOHNSON:

Q. Okay.

KELLY, Q.C.:

Q. I'm not sure it's really fair to ask this
witness to interpret information from another
report which she doesn't have the report.

MR. JOHNSON:

Q. Well, we're merely looking at a table that's
in the Board's decision and I could go to
another reference.

KELLY, Q.C.:

Q. But the questions go to what are the
underlying assets within -- that make up that
portfolio. That's the concern. Asking this
witness to speculate on what is in that
portfolio is not terribly helpful, I wouldn't
think, Mr. Chairman.

CHAIRMAN:



Q. Your concern is that she's been asked to
interpret information provided by another
source.

KELLY, Q.C.:

Q. Without the makeup of the portfolio that makes
up that data.

CHAIRMAN:

Q. Without the context, yeah.

KELLY, Q.C.:

Q. That's the concern I have.

MR. JOHNSON:

Q. Actually we could just focus on the equities.
I mean, the witness has agreed that if you
look at those equity returns on an arithmetic
basis, you're up around ten and a half percent
and that's sufficient for my discussion with
the witness. And in connection with Mercer,
Ms. McShane, if we could turn up CA-NP-382?
And in connection with that, I'd like you to
go to Table 1. And as I understand it, in
this response, Newfoundland Power provides, in
Table 1, pension plan assets, equities and
bonds and it says expected rate of return for
equities is 9.9 percent. This is -- and they
say at the bottom, in the footnote, I believe,



that -- in footnote 3 that the arithmetic
rates of return were provided by the company's
actuaries, Mercer Canada Limited. So that
would be the full arithmetic return of 9.9,
according to at least Mercer, and that
assessment would obviously be somewhat less
than what you would put forward at 11 and a
half percent, would it not?

MS. MCSHANE:

A. It is less, yes.

MR. JOHNSON:

Q. Yeah, and have you seen anything more recent
from Mercer in terms of what the arithmetic
return would be on a go-forward basis in any
regulatory proceedings?

MS. MCSHANE:

A. I'm sure I saw something in the BC proceeding,
but it was confidential and I don't remember
what the specifics of it were.

MR. JOHNSON:

Q. So you had to sign a confidentiality agreement
in relation to that?

MS. MCSHANE:

A. I must have, because I was asked some
questions in camera about it.



MR. JOHNSON:

Q. And who commissioned the report?

MS. MCSHANE:

A. Excuse me?

MR. JOHNSON:

Q. Do you know who commissioned the report or who
got the report from Mercers?

(11:45 a.m.)

MS. MCSHANE:

A. Well, it was filed -- my recollection is it
was a document that was filed in response to
one of the minimum filing requirements, so it
would have been a document that was obtained
by FEI.

MR. JOHNSON:

Q. Okay. And anyway, so the Board in BC actually
went in camera and you had to sign a
confidentiality as Dr. Booth did?

MS. MCSHANE:

A. I must have. I don't recall having done so,
but I did see the document and I was asked
questions about it.

MR. JOHNSON:

Q. Would you be able to check and see whether or
not you in fact did have to sign a

confidentiality agreement in relation to that document?

MS. MCSHANE:

A. I can, yes.

MR. JOHNSON:

Q. Okay, and just -

KELLY, Q.C.:

Q. I don't know where this goes, Mr. Chairman, because as the witness has already explained, apparently that's an in-camera hearing before the BC Public Utilities Board. It's not information that Newfoundland Power has. It's information that was conducted in a privileged, confidential hearing in camera before the British Columbia Utilities Board. So I don't think it is appropriate to ask this witness questions in a public forum that go to that -- go to whatever was conducted.

Secondly, this report, I gather, has to do with another utility and its pension assets. The information with respect to Newfoundland Power's pension assets is already in the RFI response, which is before the Board.

MR. JOHNSON:



Q. First of all, I don't know what Mr. Kelly's basis for saying that it was particular to FEI's pension assets were, as opposed to something more generic. I think there is a -

KELLY, Q.C.:

Q. Well, I -

MR. JOHNSON:

Q. He must know something about it.

KELLY, Q.C.:

Q. I stand corrected. I don't know precisely what -- whose pension assets it was. That was not the point I was trying to make. The point I was trying to make is insofar as this hearing is in relation to Newfoundland Power, 382, whatever the number is, gives you the information with respect to those assets within Newfoundland Power's pension plan. This hearing is about Newfoundland Power. We spent a lot of time this morning trolling around about other utilities' operating characteristics, et cetera. I'm not sure frankly where all that gets us, but there comes a point where we have to focus on what relates to Newfoundland Power.

MR. JOHNSON:



Q. Well, as I recall, you thought I was spending a lot of time trolling around US data at one point. But Mr. Chairman, here's the point from my perspective, if this witness is not under a confidentiality in relation to a document that bears upon an assessment of equity returns over a period of time, a document that a brother or sister regulator is going to be taking on board in terms of its determining of fair return on equity for cost of capital in British Columbia, if there is no impediment to the witness providing it, why wouldn't she -- why wouldn't we provide it and then it'll probably go to weight as to what we do with it.

CHAIRMAN:

Q. But I thought I understood that the report itself was presented in a privileged context and cloaked in privilege. Is that correct?

KELLY, Q.C.:

Q. That's my understanding, and it was proprietary information of Mercers.

CHAIRMAN:

Q. So it wouldn't be available to us, would it?

KELLY, Q.C.:



Q. Not -

CHAIRMAN:

Q. I mean, the report, if it's privileged, obviously it's confidential presented in an in-camera proceeding, it's not available for us in substance, so I don't know what -

MR. JOHNSON:

Q. I think that's the very issue, I think, Mr. Chairman. The issue is if Ms. McShane is not impeded, by virtue of having signed a confidentiality agreement, to provide the document, then it would be for this Board to determine whether it needs to do something in camera or confidential or whatever, which you'd have to assess. But I'm at the threshold question as to whether this witness is impeded from providing the document by way of having signed a confidentiality.

KELLY, Q.C.:

Q. My friend provided the undertaking that Dr. Booth signed and that document indicated that it was imposed as a condition of an order of the British Columbia Utilities Commission. So it appears, from what -- we have no direct knowledge, but it appears from what the

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Consumer Advocate has provided to us, that this is: a. proprietary information belonging to Mercers and I gather some other entity; b. imposed as a condition by the British Columbia Utilities Commission; and c., as Ms. McShane has indicated, conducted in a closed hearing. So we -

MR. JOHNSON:
Q. The only difficulty with Mr. Kelly is he's under the supposition that Ms. McShane has in fact signed such a confidentiality and -

CHAIRMAN:
Q. Dr. Booth has, hasn't he? Did you say that?

MR. JOHNSON:
Q. He has. He has, but Ms. McShane was an advisor of FEI, the very people who commissioned the report, and she doesn't know whether she signed one. And all I've asked her is to determine whether she has in fact signed one, and then we'll have to do what we do.

CHAIRMAN:
Q. I mean, is it not very difficult for you to find out whether you in fact have signed this?

MS. MCSHANE:

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A. That's true. It wouldn't be very difficult to find out.

CHAIRMAN:
Q. So let's just pass on and we'll find out and -

KELLY, Q.C.:
Q. I just want to make it clear, whether the witness has in fact signed an undertaking or not does not solve the other problems associated with the production of that report in this forum.

CHAIRMAN:
Q. Okay.

KELLY, Q.C.:
Q. And just -

CHAIRMAN:
Q. Yeah, that's -- yeah, okay.

MR. JOHNSON:
Q. Now in relation then, let's go to another cross aide, having to do with TD Economics. That one's publicly available, so we can look at that one, dated November 13, 2012.

CHAIRMAN:
Q. Just to go back quickly. If it's a privileged document, then a copy is not publicly available anyway.

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KELLY, Q.C.:
Q. Exactly. It's apparently -- from what I understand, largely from information provided by my friend, it is proprietary information to Mercers and some other entity. It's not even information that Newfoundland Power, the applicant before this Board, has.

CHAIRMAN:
Q. Okay. Lawyers.

MR. JOHNSON:
Q. Can't live with them. Can't live with them.

MR. HAYES:
Q. Mr. Johnson, is that the correct document on the screen?

MR. JOHNSON:
Q. No, November 13th, 2012.

MS. GLYNN:
Q. And this will be marked as Information Item No. 7.

MR. JOHNSON:
Q. This document is a fairly recent observation from TD Economics and I'd like to refer you specifically, Ms. McShane, to page three and particular Table 1. And this document, this box again gives the expected returns by asset

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class over bonds and equities and at the bottom, it says "the returns are expressed as geometric annual averages over the next ten years" and you observe what they're saying about equities in the United States and Canada, the geometric return, right, seven percent.

MS. MCSHANE:
A. That's the US S&P 500.

MR. JOHNSON:
Q. That would be the whole of the market?

MS. MCSHANE:
A. The S&P 500 would, which is the largest companies in the US.

MR. JOHNSON:
Q. Right, and then other developed countries, including Canada, they're saying seven percent for their equities as well?

MS. MCSHANE:
A. That's what their estimate is for ten years.

MR. JOHNSON:
Q. Yes, and that would be about nine percent, if we converted it to an arithmetic basis?

MS. MCSHANE:
A. That would be their estimate based on an

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arithmetic translation, yeah.

MR. JOHNSON:
Q. Right. And you accept the arithmetic translation. But in terms of the bonds, they're a total of 3.75 percent, including treasuries, corporates and municipal bonds, and in terms of the risk premium that that would imply, could you give us a sense of what the risk premium would be implied over bonds if we're talking about arithmetic equity returns of about nine percent?

MS. MCSHANE:
A. Well, you would need to do some adjustment to the bonds for arithmetic averages, I guess, and again, it's not too clear what the 3.75, what the breakdown is, but I mean, I suppose you could look at it being, you know, approximately nine minus 3.75.

MR. JOHNSON:
Q. So that would be 5.25?

MS. MCSHANE:
A. That would be, you know, what they're looking at in terms of next ten years.

MR. JOHNSON:
Q. And this, again just putting it all in

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perspective, in terms of these risk premiums or the going forward, and so if they -- if we just look at that and say we'll take that on board and say that's about five and a quarter, that is a fair bit lower than your market risk premium that we're talking about of eight percent, right, because your market risk premium has actually gone up from the last hearing and now it's up around eight percent. Whereas if we look at TD, they're saying if you look on a go-forward basis, as you said, the risk premium is about five and a quarter percent essentially, and do you not accept that that's a big spread between what a big group like TD is saying and you're saying?

MS. MCSHANE:
A. It's a big difference. I do have an analysis set out in my testimony which explains why I have the risk premium where it is and it does have a lot to do with, you know, the difference between where we are in terms of long Canada bond yields today versus what the long term average was in the past.

MR. JOHNSON:
Q. Okay. Well, if you're up at eight percent,

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and we'll come to some of the tests in your evidence, et cetera, but you know where Dr. Booth is in terms of what he's saying the market risk premium is?

MS. MCSHANE:
A. I do.

MR. JOHNSON:
Q. What is he saying it is?

MS. MCSHANE:
A. Well, it's not as simple as a number. His market risk premium is in the range of five to six before he makes other adjustments, which would result in a higher market risk premium than the base five to six percent.

MR. JOHNSON:
Q. You're familiar with the Fernandez survey that Dr. Booth refers to in his evidence?

MS. MCSHANE:
A. I am.

MR. JOHNSON:
Q. And if I could turn you to Dr. Booth's report, particularly Appendix B at page 11?

MS. MCSHANE:
A. Talking about Table 2?

MR. JOHNSON:

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Q. This is a report that is actually referenced or the Fernandez survey is actually referenced in the Board's decision from last time, and at that time, before the Board there was just evidence of what the market risk premium was used in 2008 and at that time, the survey was 884 finance professors. Do you recall that?

MS. MCSHANE:
A. No, not specifically, but I'll take that subject to check.

MR. JOHNSON:
Q. Okay. You are aware, as Dr. Booth sets out at the bottom of page 11, that Professor Fernandez has followed up on this survey and has extended the survey in each of the years 2009 up to 2012. You're familiar with that?

MS. MCSHANE:
A. Yes.

MR. JOHNSON:
Q. From the BC testimony, for instance?

MS. MCSHANE:
A. Yes.

MR. JOHNSON:
Q. And you're aware that it's been extended to include financial analysts and companies as

well as professors of finance?

MS. MCSHANE:

A. Yes.

(12:00 p.m.)

MR. JOHNSON:

Q. And he goes on to say, at page 12, that this Fernandez survey was answered by 7192 respondents out of about 21 and a half thousand e-mails sent out, and he notes only 47 said the CAPM was not very useful, but then he notes that of the 2,223 US responses, the average market risk premium estimate was five and a half percent and the median was 5. 4 percent, and he reports that for Canada, the results were reversed with a median market risk premium of five and a half percent and an average of 5.4 percent. He notes that the maximum estimate of the market risk premium by the 94 Canadian respondents was ten and a half. That's the maximum. The minimum, 3.4. But he notes 75 percent were at six or less, Ms. McShane, and in terms of that, I mean, you would be substantially higher at eight percent than the median in the United States, the median in Canada, the average in the United



States, the average in Canada, by a big margin.

MS. MCSHANE:

A. I agree that my estimated risk premium is higher than these surveys indicate.

MR. JOHNSON:

Q. And he goes on to say that "Fernandez surveys have discovered that professors of finance have traditionally been high in their market risk premium estimates, which was in part due to their use of historic estimates. This is still true in the United States where the average market risk premium estimate of professors of finance was 5.6 percent versus five percent for analysts and 5.5 percent for companies. However, in Canada this is no longer true as professors of finance are at 5.4 percent, the same as companies, while analysts are at 5.9." And this is interesting, at line 12, "Professor Fernandez reports the trend over time and the estimate of the market risk premium for the United States where are the most responses as follows:" and do you see how it trends over time, Ms. McShane?



MS. MCSHANE:

A. I see that it's lower in 2012 than it was in 2008.

MR. JOHNSON:

Q. And it's lower in 2012. At 2012, it's five and a half and it's lower than 2009. It's lower than 2010 and it's slightly lower than 2011, correct?

MS. MCSHANE:

A. Yes, that's what the numbers show.

MR. JOHNSON:

Q. So this extensive survey not only shows that your market risk premium is high, but it shows that you are going in the opposite direction because in 2010, your market risk premium was 6.75 percent. These guys and gals are coming down and you're going up. Do you find that at all striking?

MS. MCSHANE:

A. Well, I understand that it's different and I explain in my testimony why I believe that based on the analysis I've done that the equity risk premium is higher at lower bond yield than it is at higher bond yields.

MR. JOHNSON:



Q. So your evidence is that it's directionally gone up?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. Let's talk about 2009. The financial markets in 2009, Ms. McShane, what were they like?

MS. MCSHANE:

A. Well, it depends on when you're talking about in 2009. 2009 conditions changed considerably over the course of that year.

MR. JOHNSON:

Q. When were they the worst?

MS. MCSHANE:

A. Probably March.

MR. JOHNSON:

Q. And was it all fixed up by April?

MS. MCSHANE:

A. No, wasn't -- it's not all fixed up now.

MR. JOHNSON:

Q. But they -- and so -

MS. MCSHANE:

A. But by the time the hearing took place, there had been considerable improvement in market conditions.

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MR. JOHNSON:
Q. And the GRA of Newfoundland Power was filed May 10th, 2009. Would you take that?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And you filed your report in May of 2009, right?
MS. MCSHANE:
A. I did, and addressed at the hearing the changes in the capital market conditions that had occurred since the evidence was filed.
MR. JOHNSON:
Q. Yes, and as I recall, the slight change that made a difference to one of your tests that had no bearing or impact upon your return on equity for Newfoundland Power for 2010, correct?
MS. MCSHANE:
A. I don't believe that I changed the recommendation, no. I think you're right.
MR. JOHNSON:
Q. That's right. And in point of fact, your written evidence that was filed May 10th, obviously you didn't start work on that, you

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know, the week before. You had been at that -
MS. MCSHANE:
A. You don't think so? No, that's true. I mean, I had spent a while doing that. I mean, made sure that by the time it was filed we had the most recent data that was reasonably available in time to have it filed.
MR. JOHNSON:
Q. Your report, you were working on your report through April month and you were probably at your report in March month?
MS. MCSHANE:
A. True.
MR. JOHNSON:
Q. Yeah. And March of 2009, I mean, that had to be the lowest part of the equity market. I mean, that's when she really troughed out. Is that right?
MS. MCSHANE:
A. I think it was March 9th, if I recall correctly, that the market hit its trough.
MR. JOHNSON:
Q. Yeah. And so, would you agree with me that the bulk of your testimony was in fact written when either the markets were at their lowest

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or in the immediate aftermath of them having been the lowest?
MS. MCSHANE:
A. They would have -- it would have been prepared around the time of the worst part of the crisis.
MR. JOHNSON:
Q. And you're familiar with the concept of the yield on the TSX composite?
MS. MCSHANE:
A. Yes, I am.
MR. JOHNSON:
Q. And would you accept, subject to check, that your report, at page 129, in your last -- in the last GRA report, you said that the yield on the TSX was about 4.2 percent?
MS. MCSHANE:
A. I would take that, subject to check, yes.
MR. JOHNSON:
Q. At page 129. And are you aware what the yield on the TSX composite index is now?
MS. MCSHANE:
A. Not specifically today, no. I knew what it was in July.
MR. JOHNSON:

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Q. Would you accept, subject to check, that as of January 11th, 2013, that the yield on the TSX composite index is three percent?
MS. MCSHANE:
A. That sounds about right, yes.
MR. JOHNSON:
Q. And directionally, what does that say to you that it's gone down from the 4.2 percent?
MS. MCSHANE:
A. Well, all other things equal, it would be a reduction in the cost of equity. I mean, you have to look at how that relates to growth expectations, but all other things equal, it would be considered a declining trend in the cost of capital from that point in time.
MR. JOHNSON:
Q. And would you accept that at the time of your report in 2009 that at page 139 of your report, that you stated that the volatility index had averaged over 40 in the first quarter of 2009? You recall referring to the volatility index?
MS. MCSHANE:
A. I don't recall specifically, but I'm familiar with that level.

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MR. JOHNSON:
Q. Pardon me?
MS. MCSHANE:
A. I'm familiar with that level of volatility at that point in time.
MR. JOHNSON:
Q. Right. And would you accept, again subject to check, that as of January 11th, 2013, that the volatility index is down to 13?
MS. MCSHANE:
A. I haven't looked at it in the last couple of days, but I know the volatility has been lower in the last little while than it was when I prepared this evidence.
MR. JOHNSON:
Q. Have you -- you've referred to the volatility index in your reports.
MS. MCSHANE:
A. I do, yes, on page 41.
MR. JOHNSON:
Q. Page 41, and sometimes I think you refer to it as the fear index.
MS. MCSHANE:
A. I think -- I'm not sure I referred to it here as that, but that's -

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MR. JOHNSON:
Q. And when we say fear, F-E-A-R.
MS. MCSHANE:
A. Yes, fear.
MR. JOHNSON:
Q. So what does it indicate, MS. McShane, if as we've indicated to you the VICS (phonetic) has dropped, you know, to that level, what does that tell you about volatility in the market?
MS. MCSHANE:
A. It means today, compared to say March, 2009, that investors expect less volatility.
MR. JOHNSON:
Q. And as of the date of--as of the late fall of 2009, were financial thinkers thinking there was going to be a pick up over 2010, 2011, 2012, at that point in time?
MS. MCSHANE:
A. Sorry? What point are we talking about?
MR. JOHNSON:
Q. As of around the time of the hearing, we're -
MS. MCSHANE:
A. Okay, so October, late October.
MR. JOHNSON:
Q. October, November.

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MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. Were financial experts, were they thinking that things were going to be improving over 2010, 2011, 2012 relative to where they'd been?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And the interest rate outlook was looking up, interest rates were expected to increase?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And recovery was expected?
MS. MCSHANE:
A. Yes, I mean this is all set out basically I think in my testimony where I go through what basically happened since the time of the hearing in 2009.
MR. JOHNSON:
Q. And your report indicates, I think, that the Board should pay attention to what has happened between 2009 and the date of this

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hearing, correct?
MS. MCSHANE:
A. Well I think what I was trying to do was to give the Board an appreciate of, you know how much change there's been, ups and downs, since it last looked at the cost of capital in 2009.
MR. JOHNSON:
Q. And I've just pointed to you to things that have changed favourable since 2009, haven't I?
MS. MCSHANE:
A. Since they have improved, since March 2009 for sure.
MR. JOHNSON:
Q. And since the time of your report, for sure.
MS. MCSHANE:
A. Well, of course, I mean the report was, as you say, focused on a period prior to when it was filed, but of course, when the hearing occurred, I mean the Board did have the benefit of what had been going on in the market from March or since before March, actually, but from the worse of financial crisis to the latter part of 2009.
MR. JOHNSON:
Q. Yeah. If I could turn you to documentation or

a document by RBC dated November 6th, 2009.
MS. GLYNN:
Q. That would be entered as Information Item No. -
KELLY, Q.C.:
Q. Note, Mr. Chairman, while the information request is coming up that none of the authors of these reports from TD or RBC are on the Consumer Advocate's witness list for this hearing and so, while I'm not objecting to the cross-examination, the underlying data and conclusions in relation to these reports I take it are never going to be proven in this hearing, so I'm not sure where this advances the boat at the end of the day, so to speak. I simply make that observation while the-- because if the report is not proven, we have no basis to judge what the content of that is and how that particular witness came to that particular conclusion. For example, we have the TD one where my friend went from adjustments from geometric to arithmetic, then looked at the portfolio, it's not even the Long Canada Bond portfolio, so there's a whole bunch of information which is not provided in



the report.
CHAIRMAN:
Q. Yes.
KELLY, Q.C.:
Q. And I simply observe there is limited utility in this process simply in terms of these reports, simply because I take it these witnesses are not coming to explain to the Board how they went about reaching their conclusions.
CHAIRMAN:
Q. Uh-hm.
MR. JOHNSON:
Q. Well the Conference Board of Canada is not coming and that's a report that Newfoundland Power filed with their documentation. Yahoo is not coming and Reuters is not coming. I mean that's not to say that the Board can close its mind to what financial institutions are saying, whether it be Mercers or TD or RBC, I mean, to say it's not relevant -
KELLY, Q.C.:
Q. No, and I want to make clear I didn't say it's not relevant because in so far as we're talking about financial markets generally, in



terms of economic conditions, yes, there is some relevance in it.
CHAIRMAN:
Q. It has some indicative value, but it has no fundamental value because the author is not here to be cross-examined. That's what you're basically saying.
KELLY, Q.C.:
Q. Exactly, and you can't drill down to what forms the more important components of them trying to extrapolate out market portfolios, risk premiums, et cetera, and Mr. Chairman you obviously have the point.
CHAIRMAN:
Q. Because I wanted to introduce one (unintelligible) because I thought it was interesting. Anyway, no, no, well I take your point, but I guess we can, I mean do you want to allow as broad a possible discussion on these issues as we can and I mean, the Board in its deliberations will attach, I would hope, appropriate significance to any of the information that's put into--I guess not evidence, is it, in this case, that's put into the record.



(12:15 p.m.)
KELLY, Q.C.:
Q. Well, exactly, it's not evidence on the cost of capital for the utility. At the end of the day the Board has to decide based upon the evidence that it has heard from the witnesses and the reports that are filed.
CHAIRMAN:
Q. Yes.
KELLY, Q.C.:
Q. So it's a cautionary notice that you can't simply extrapolate something from a report which is not proven and use that. Yes, it tells you something about general economic conditions, but you can read the newspaper and get that. Anyway, I -
CHAIRMAN:
Q. You can't read the newspaper.
MS. GLYNN:
Q. There is no objection to the information being filed.
KELLY, Q.C.:
Q. There's no objection, it' -
MS. GLYNN:
Q. And this can be addressed during -

KELLY, Q.C.:
Q. - the observation as to what use gets made of it.
CHAIRMAN:
Q. Yeah. No, no, we'll attach whatever significance we deem to be appropriate to -
GREENE, Q.C.:
Q. It's really a matter to go to the weight and it's a matter of argument for submission. If Mr. Kelly is not objecting to this line of cross, we're really taking time to get into argument which isn't necessary at this time.
CHAIRMAN:
Q. Carry on sir.
MR. JOHNSON:
Q. Thank you, Mr. Chairman. In terms of the financial markets monthly, I think it's sort of illustrative of at least RBC's thinking at the time because this is dated November, 2009, just after the hearing portion concluded and if I could just turn you to the interest rate outlook at the time, Ms. McShane, which they have at page 5. And for Canada, they were forecasting and you refer to and consult with materials like this in your normal practice, I



would think, as a financial--cost of capital expert, would you not?
MS. MCSHANE:
A. I certainly read these kinds of reports, yes.
MR. JOHNSON:
Q. Yes, to inform yourself as to what others are saying, correct?
MS. MCSHANE:
A. Sure.
MR. JOHNSON:
Q. Sure. and they were indicating an interest rate outlook of the interest rate ticking upwards in the first quarter or second quarter of 2010, again the third quarter of 2010 and onward into 2011, right? And the sort of same line was being expected in the United States on their 30 year treasuries at that time.
MS. MCSHANE:
A. Right, and I think that's sort of consistent with where the Board's decision was in 2009. I mean, if you look at one underlie their allowed rate of return, I recall that it was based on a forecast Long Term Canada Bond yield of four and a half percent.
MR. JOHNSON:



Q. If we could just turn to page 8.
MS. MCSHANE:
A. Of the same -
MR. JOHNSON:
Q. Document.
MS. MCSHANE:
A. - witness.
MR. JOHNSON:
Q. And this is Central Bank Watch and we see at the top, Bank of Canada. We have Canadian real GDP growth and we see it into negative territory and the source for this is Statistics Canada and RBC Economics Research and they're forecasting economic growth after the trough of '09 in 2010 and continue on into 2011, correct?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And Federal Reserve is similarly anticipating or forecasting U.S. real GDP growth in 2010, 2011.
MS. MCSHANE:
A. Yes.
MR. JOHNSON:



Q. And that would be from the Federal Reserve, would they be--would the Bank of Canada and Federal Reserve be reliable resources, Ms. McShane?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. Okay.
MS. MCSHANE:
A. My report at page 33 refers to the October 2009 consensus economics, which indicated that economists generally anticipated positive real GDP growth by--fourth quarter of 2009 and two percent--sorry, 2.6 percent real GDP growth in 2010.
MR. JOHNSON:
Q. And so in late 2009, the Bank of Canada has Canada in recession from--so we're in recession at the time of the hearing, would that be correct?
MS. MCSHANE:
A. I think that it had not been announced that the recession was over, it was in early 2009 that the finance minister announced that there were signs that the economy was improving. I

don't recall off the top of my head what the specific date that the recession was called over.

MR. JOHNSON:

Q. I'd like to talk about the next thing that has to do with your market risk premium and that is BETA, because it's one thing to say that the market as a whole can expect a risk premium of eight percent, but then we talk about BETA and the CAPM and if I could turn you to Dr. Booth's appendix C, Ms. McShane, and particularly page 11, and you've read Dr. Booth's report, obviously.

MS. MCSHANE:

A. I have.

MR. JOHNSON:

Q. And as you can see on that page, on page 11, Dr. Booth has reported on the BETAs for Enbridge, TransCanada, Canada Utilities, TRANSALTA, Emera, Fortis, et cetera, and he reported his own BETAs, he's in the third column, RBC's BETAs, Google's BETAs, and I guess Ms. McShane, in terms of his reporting of BETAs do you, is there much difference between yourself and Dr. Booth in terms of



what the BETAs are?

MS. MCSHANE:

A. In terms of these regressions? No.

MR. JOHNSON:

Q. No. So there's no dispute there on that and they would be rather similar to what your BETA estimates are for Canadian utilities in your Schedule 12, right?

MS. MCSHANE:

A. Well, I guess - if we could just sort of back up. I mean, all these are, are regressions of changes in prices or changes in returns against - for individual companies against the market. So the differences are going to stem from what period they're estimated over, what interval you choose, whether it's a monthly price change, a weekly price change, and they may vary depending on what composite you use as the measure of the market, if you're using the S & P TSX 300, or if you're using the 60 or if you're using the - I'm trying to think of another, the EMC Canada Index, but they're all going to be basically the same value. The question is what do they mean.

MR. JOHNSON:



Q. Right, and -

MS. MCSHANE:

A. And whether or not they really measure, you know, the relative risk of a utility fundamentally or not.

MR. JOHNSON:

Q. And so the debate is, I guess, what you do with the Betas. So let us turn to your report for a moment at Schedule 12, which talks about the Betas for regulated Canadian utilities, and I'm referring to Schedule 12, page 1 of 6.

MS. MCSHANE:

A. I have that.

MR. JOHNSON:

Q. Ms. McShane, the top part of Schedule 12 on page 1 of 6, this has what's known as the raw monthly price betas, and what do you mean by "raw"?

MS. MCSHANE:

A. Raw just means it's a simple regression. There's no adjustment made to it whatsoever.

MR. JOHNSON:

Q. And so if we look at, say, 2008 for these five Canadian companies, we have an average or a mean beta of .25, and in 2009, it's .22, .23,



.21, and Ms. McShane, if we go down below we see the adjusted betas. As I see it, when you adjust the betas, they increase in size. For instance, in -

MS. MCSHANE:

A. No, no, not unless they're under one. If they're over one, they decrease in size.

MR. JOHNSON:

Q. But you're putting these through a Blume adjustment, correct?

MS. MCSHANE:

A. That's what it's been termed shorthand-wise, yes.

MR. JOHNSON:

Q. And that's when you take betas, observed actual betas, and then you adjust those raw betas towards one?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. And a company with a beta of one is an average risk company?

MS. MCSHANE:

A. Correct.

MR. JOHNSON:

Q. Okay. Now when companies like Google, RBC, and Yahoo, and I understand Yahoo uses Standard and Poors beta, they do not adjust them like that, correct?
MS. MCSHANE:
A. They don't report them that way, but all they're doing is reporting values.
MR. JOHNSON:
Q. Okay, and if we could turn back to the year 2011, as an example, when you compare your .21 beta and you do the Blume adjustment, it increases by up to .47 in the case, obviously, right?
MS. MCSHANE:
A. In that particular instance, yes.
MR. JOHNSON:
Q. And a the bottom footnote 1, that explains how you go about doing that. So that's the Blume adjustment that we're talking about where you take the raw beta, multiple it by 67 percent, add the market beta of 1, and times it by 33 percent, that's how you do it?
MS. MCSHANE:
A. Right.
MR. JOHNSON:



Q. Okay, and Dr. Booth cites in his report, and we needn't go to it right now, but he cites a paper by - I believe they are finance professors, Gombala and Kahl, and they published a paper that I'm sure you're familiar with in finance management, correct?
MS. MCSHANE:
A. Financial management.
MR. JOHNSON:
Q. And they said that utility betas, they tend to revert to their long run average levels, not to 1, and not to 1, which would be the beta of the market as a whole. Are you familiar with that paper?
MS. MCSHANE:
A. I am. It was published a number of years ago and it's the only one I'm aware of that's ever done any such analysis on utility betas.
MR. JOHNSON:
Q. It's a well known paper, no doubt.
MS. MCSHANE:
A. It's the only one that's ever been done on utility betas. It's very well known to those of us in the utility cost of capital business. It's doubtful that it's well that known to



anybody else.
MR. JOHNSON:
Q. Could be.
CHAIRMAN:
Q. Not a best seller.
MS. MCSHANE:
A. Not a best seller.
MR. JOHNSON:
Q. Beta never did well. So Canadian unadjusted betas are .21. You adjust them and you get the .47. Let's look at your US utility betas at Schedule 12, page 4 of 6. Again it's the same concept, but this time now we're looking directly at your chosen US sample, and these are up top the raw or observed betas.
MS. MCSHANE:
A. This is - sorry, page 4 of 6?
MR. JOHNSON:
Q. Page 4 of 6.
MS. MCSHANE:
A. Okay.
(12:30 p.m.)
MR. JOHNSON:
Q. Monthly beta for the sample of US utilities, and they are - for 2011, for instance, they're



.43, and 2010, they're .44, and 2009, they're .42, and then if you come down, you see that when you adjust them using that Blume methodology, they go up to in the low .6's, right?
MS. MCSHANE:
A. Yeah.
MR. JOHNSON:
Q. And so, Ms. McShane, I guess it's true that regardless of whether you adjust the betas or not, US betas are simply higher than Canadian betas for utilities? I mean, we've gone from .21 to .43, and even when you adjust the Canadian's, you get to .4 odd, and if you adjust the American sample, you get to .62. So that's the conclusion, isn't it?
MS. MCSHANE:
A. No, I don't think that is the conclusion. I think that that is the conclusion in those very specific years, but if you look at the data over the entire period that's there, there's very little difference between the betas of the US and Canadian utilities.
MR. JOHNSON:
Q. What explains the significantly higher betas

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over this last several years? I see from 2006, you know, they've been running at .63, in 2007 - this is adjusted now, they've been .76, then down to .6, and remained there for 2008 and 2009. What explains that?

MS. MCSHANE:

A. I don't know specifically what factors have been at play in that particular time frame. I mean, we are dealing with a somewhat different composite. I mean, you've got a more diversified composite in the United States than you do in Canada, or the Canadian composite is more characterized by the dominance of a couple of different sectors, so it could have something to do with, you know, how the composite or the pieces of the composite have behaved over that time frame.

MR. JOHNSON:

Q. Ms. McShane, is it actually correct that each beta estimate for each year is actually an estimate over the five years? Is that how it works?

MS. MCSHANE:

A. I'm not sure what you mean by that.

MR. JOHNSON:

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Q. Is it five years of data?

MS. MCSHANE:

A. Five years of data, yes.

MR. JOHNSON:

Q. Just explain to us now how that works because we might forget it?

MS. MCSHANE:

A. So you take five years of price changes or excess returns or however you're going to measure the change in the return for a stock, and you estimate the change in the return for the composite, whichever one you're using, using the same approach and you do a regression to see how closely the change in the returns for the stock correlated with the change in the returns on the composite.

MR. JOHNSON:

Q. And so let's use a real life example now. Let's take AGL - no, let's take your 2011 because that's the composite, and the average is .43 of a beta. That's on an unadjusted basis. So what data is reflected - what year's data is reflected in that .43?

MS. MCSHANE:

A. Sorry, which page are we on now?

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MR. JOHNSON:

Q. Page 4 of 6 of Schedule 12.

MR. JOHNSON:

Q. Which company?

MS. MCSHANE:

A. I'm looking at your 2011 - never mind the company for a moment. I'm just looking at your 2011 column.

MS. MCSHANE:

A. Yeah.

MR. JOHNSON:

Q. And the raw beta is - up top it says, raw monthly price betas, five year period ending. Do you see that up top?

MS. MCSHANE:

A. Yes, I do.

MR. JOHNSON:

Q. Okay, so tell us what that means, that five year period ending business in 2011? Would that mean the 2011 would incorporate data over the previous years?

MS. MCSHANE:

A. Yes, five years ending 2011.

MR. JOHNSON:

Q. Okay. So would that mean that the difference

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in beta levels between Canada and the US utilities have lasted for about ten years, not just the last few years - because you go back five years, '07 to '11, but that would incorporate data going back prior to '07, wouldn't it?

MS. MCSHANE:

A. Sorry, ask me that question again, please?

MR. JOHNSON:

Q. If we know that each of these years incorporates a five year period that actually ends in that year -

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. That would mean that your 2007, for instance, raw beta of .64, that would actually reflect five years of - you fill in the word, observation -

MS. MCSHANE:

A. Data.

MR. JOHNSON:

Q. Data, data.

MS. MCSHANE:

A. Five years of observations, right.

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MR. JOHNSON:
Q. So that would mean that that is reflective, that .64 in 2007 is reflective for not only 2007, but a prior five year period?
MS. MCSHANE:
A. Well, it includes all the -
MR. JOHNSON:
Q. It includes all of it.
MS. MCSHANE:
A. Yeah, and so it may really be reflective of a couple of observations during that because several observations can have a significant impact on the result, but, yes, it covers a full five year period.
MR. JOHNSON:
Q. And so let's just bring this back now to basics. If a stock - if Stock "A" has a higher beta than Stock "B", what does that say about the risk of Stock "A" relative to the risk of Stock "B"?
MS. MCSHANE:
A. In a particular period, it means that the company with the higher beta has correlated more closely with the market than the company with the lower beta.

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MR. JOHNSON:
Q. And so by correlated more with the market, you mean it -
MS. MCSHANE:
A. It doesn't necessarily mean anything about the relative riskiness of the company. It simply is a measure of the extent to which that particular stock moved with the market over that period.
CHAIRMAN:
Q. Can I just - so it doesn't mean that company "A" is riskier than company "B"?
MS. MCSHANE:
A. Not necessarily, no. I mean, I think it's fair to say that when you're looking at that overtime that if you've got companies that are generally below 1, it's fair to conclude that they're as a group less risky than groups that have betas over 1, but once you start getting into, you know, is .21 a riskier stock than one that's .41, it becomes more difficult to draw that conclusion.
MR. JOHNSON:
Q. But you can draw the conclusion, can you not, Ms. McShane, that the .41 group of companies

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correlates more closely with the average company?
MS. MCSHANE:
A. It correlates more closely with the market.
MR. JOHNSON:
Q. With the market?
MS. MCSHANE:
A. Yes, which is a portfolio of companies, and it depends on what you're measuring when you're measuring the market.
MR. JOHNSON:
Q. So it would have more market risk because it moves more closely with the market?
MS. MCSHANE:
A. Because beta is defined as, you know, the extent really, the extent to which a company stock price moves relative to the market. In principle, a stock that has a higher beta has higher market risk. Capital market risk, that is.
MR. JOHNSON:
Q. So the next way that you went about determining the risk premium was through the DCF based equity risk premium model, correct?
MS. MCSHANE:

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A. I did, yes.
MR. JOHNSON:
Q. You used that one, and according to my understanding is that using the DCF based equity risk premium test, you came up with a risk premium of 6 percent, would that be right? That would be at page 93, I think, of your report.
MS. MCSHANE:
A. Yeah, the summary of all of the tests, all of the various individual test results is on page 89, Table 24.
MR. JOHNSON:
Q. Well, I think it's very conveniently located at Table 28 as well on page 93.
MS. MCSHANE:
A. Okay, that's fine. That's just the one number - the Table 24 just shows - done in several different ways.
MS. MCSHANE:
A. Done in several different ways, but in terms of the utility risk premium, so far to recap, by using the risk adjusted equity market which is the beta analysis, we come up with a utility risk premium of 5.4 percent, which

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would imply cost of equity of 8.9 percent, and for DCF based, your equity risk premium was 6 percent. So that's where we are so far.

MS. MCSHANE:
A. Okay.

MR. JOHNSON:
Q. And then to be more specific because this is the first real discussion of discounted cashflow, you are deriving your equity risk premium under that discounted cashflow approach by analysing the forecast of earnings growth of your sample of US electric and gas utilities?

MS. MCSHANE:
A. I'm not analysing the forecast growth rates. What I have done is created a time series of DCF costs of equity for the sample, from which the corresponding long term government bond yield was subtracted for each month for a period since 1998, and the DCF costs themselves were estimated two different ways. One was by combining the dividend yield for the sample with an estimate of growth based on investor - sorry, analyst forecast of growth, and the other was using a discounted cashflow

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methodology that combined the dividend yield with an estimate of investor growth expectations that was comprised of both analyst forecast of earnings growth, and in a long term perpetual growth rate equal to the expected return in the economy. So then I looked at the risk premiums in each of those monthly periods and estimated what the relationship was between the DCF cost of equity and the long term government bond yield to figure out what the risk premium should be under current market circumstances, given where we expect long term Canada Bond yields to be.

MR. JOHNSON:
Q. Okay, you've gone ahead a few steps and I'm just going to try to come back a little bit by turning you to Schedule 14, page 1 of 4. This is DCF based equity risk premium study for sample of US utilities constant grown DCF model, and so let's just follow, say, 1998, just to walk through it for a second. So we have the year, 1998, we have an expected dividend yield of 5.1 percent, we have an analyst forecast earnings per share growth

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forecast of 4.3. We sum that and we arrive at 9.4. Then we've got to find out what the long term treasury yield is, which we deduct from the DCF cost of equity, and we arrive at the equity risk premium of 3.9. That's what we're looking at in the table?

MS. MCSHANE:
A. Yes.

MR. JOHNSON:
Q. And in terms of how you arrive at the expected dividend yield, how did you arrive at that?

MS. MCSHANE:
A. So the dividend yield is equal to the last paid dividend as of each month annualized, divided by the monthly closing stock price, and that yield is then increased by the expected growth rate, the number that's in column 2 essentially, to come up with the expected dividend yield.

MR. JOHNSON:
Q. Okay, and then it talks about then the analyst forecast, EPS growth forecast, and how did you get those?

MS. MCSHANE:
A. I have a database that has the historical -

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the history of the forecasts made by analysts for each of the companies in the sample, monthly, going back, I think, until the 1970s.

MR. JOHNSON:
Q. Okay, for the companies in your sample?

MS. MCSHANE:
A. Yes.

MR. JOHNSON:
Q. And you've got a Moody's column as well, a Moody's spread, and that's the spread between a corporate long term "A" rated utility index bond over the 30 year treasury?

MS. MCSHANE:
A. Right.

MR. JOHNSON:
Q. Why do you report the Moody's spread - because you use it in one of your DCF tests later on?

MS. MCSHANE:
A. I use it in this DCF based risk premium test.

MR. JOHNSON:
Q. Okay. Now in terms of constant growth, when you say "constant", you mean constant, perpetual?

MS. MCSHANE:
A. Yes, the premise is that the same growth rate

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will persist into perpetuity.
MR. JOHNSON:
Q. So to use 1998 as an example, we would consider that 4.3 growth forecast to go on in perpetuity?
MS. MCSHANE:
A. Right. This would be - in this case of the 4.3 percent would equal to actually an average of monthly numbers that were averaged for the purpose of making this schedule look a lot smaller.
(12:45 p.m.)
MR. JOHNSON:
Q. Okay. So, I guess, at each point in time we can see the expected rate of return. So for 1998, it will be 9.4 percent?
MS. MCSHANE:
A. On average.
MR. JOHNSON:
Q. And -
MS. MCSHANE:
A. Based on this methodology, yes.
MR. JOHNSON:
Q. Yes, and at each point in time we can see the derived equity risk premium. So, for instance,

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if we go to 2009, we see a - that's premised on a dividend yield of 5.6, analyst forecast of 5.5, a DCF cost of equity of 11.1 percent, and at a long treasury of 4.1 percent, and we have an equity risk premium derived through this method of 7 percent. Your last estimate is through the second quarter of 2012, and I observed that we see a drop in the DCF cost of equity to 9.3 percent, which that would be a drop of 180 basis points relative to 2009's 11.1 percent, and at the same time we see a drop in the long term treasury yield from 4. 1 percent in 2009 to 3 percent. So 110 basis points. So, Ms. McShane, I guess in terms of this data and in terms of looking at your data and the time period of relevance to the Board being, say, the last GRA in 2009 to the present, I take it we can accept that while the long treasury bond has dropped by 110 basis points, what has also dropped is the DCF cost of equity for your US utilities - have dropped by even more, by 180 basis points. That's what we conclude from this.
MS. MCSHANE:
A. Based on this specific estimate, that would be

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what this would indicate. However, the cost of equity is not based, or the return on equity recommendation is not based solely on this test. It's based on a number of tests and doesn't just reflect these estimates, specific estimates.
MR. JOHNSON:
Q. But certainly in terms of these companies looked at in this context, we see the DCF cost of equity coming down?
MS. MCSHANE:
A. Yes, there's no doubt that the DCF cost of equity is showing a lower number today. I don't disagree with you.
MR. JOHNSON:
Q. And not only -
MS. MCSHANE:
A. The question is, you know, when you estimate the cost of equity, are you looking solely at this test; no, of course not. You're looking at a number of tests, and your recommendation is based on a number of tests. So you need to look at how your recommendation compares today to where it was in 2009.
MR. JOHNSON:

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Q. Could I ask you to turn up CA-NP-377. I'm looking at attachment, page 3 of 4. This was a question directed towards yourself, Ms. McShane, regarding your DCF risk premiums and the question asked to provide the data required to replicate the estimates for the constant growth and three stage growth models presented in Table 23, and you did so. At page 3 of 4, could I draw your attention to the period of February/March, 2009. Just to explain to us what February and March of '09 - these are the monthly observations, I take it, is it?
MS. MCSHANE:
A. Yes, they are.
MR. JOHNSON:
Q. And from February and March of '09, the equity risk premium was 8.35 in February, and 8.44 under this methodology in March, would that be correct?
MS. MCSHANE:
A. That's what these estimates would show, yes.
MR. JOHNSON:
Q. And if we go over to June of 2012, we're down to 6.77 percent under this methodology as of

June?
MS. MCSHANE:
A. Right.
MR. JOHNSON:
Q. Okay, so obviously a fairly significant drop in the equity risk premium over that period of time?
MS. MCSHANE:
A. Estimated on a monthly basis, yes.
MR. JOHNSON:
Q. And these equity risk premiums that are reported for February/March period of 2009, just prior to the hearing - prior to the filing of the Application, is there any period at all where the equity risk premium would have been higher than during those months over this whole observation period?
MS. MCSHANE:
A. Doubtful. I mean, that was the worst of the financial crisis.
MR. JOHNSON:
Q. And again you would have been working on your testimony in that late March, early April period, right?
MS. MCSHANE:



A. Correct.
MR. JOHNSON:
Q. Now Ms. McShane, the other thing that I note, and we can note the same thing on Schedule 14, actually, if we could go back there for a moment, page 1 of 4. Again we see the drop off in the equity risk premium. It was at 2.7 in 2008, and again relative to 2008, it dropped off in 2009 under this - I'm sorry, in 2009, it was 7; 2010, 5.9; 2011, 509; and so the second quarter of 2012, 6.3. So still down, obviously, from where it had been in 2009. The other thing about the Moody's spread, that has also come down since 2009, correct?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. And in terms of if we were looking at the spread in 2009, would you have characterized that as significantly up over what we've seen since then?
MS. MCSHANE:
A. The spreads were considerably higher on average - they were higher in 2008 on average



than they were in 2009 on average.
MR. JOHNSON:
Q. And if we look to periods immediately prior to the crisis - I mean, there was troubles happening in August of 2007. I think you're probably familiar with that.
MS. MCSHANE:
A. That was sort of the -
MR. JOHNSON:
Q. The beginning?
MS. MCSHANE:
A. The beginning of the crisis in August, 2007.
MR. JOHNSON:
Q. And specifically, just for the record, what was happening in August of '07.
MS. MCSHANE:
A. I can't remember the specific events, but I know that, I mean, the sub-prime mortgage problems started to really rear its head.
CHAIRMAN:
Q. Well, you had Bear Sterns, didn't you?
MS. MCSHANE:
A. Was that in August of 2007?
CHAIRMAN:
Q. I think.



MS. MCSHANE:
A. Maybe so, okay.
CHAIRMAN:
Q. And you had Lehman Brothers.
MS. MCSHANE:
A. Wasn't that in - that was in September, 2008.
CHAIRMAN:
Q. Was it?
MS. MCSHANE:
A. Yeah.
CHAIRMAN:
Q. That's when they started - that's when Paulson came up with -
MS. MCSHANE:
A. Yeah.
CHAIRMAN:
Q. A lot of funny money.
MR. JOHNSON:
Q. Do you recall that there was Bear Stern hedge funds got into difficulty in August of 2007?
MS. MCSHANE:
A. Oh, is it, okay. That's right, yeah.
MR. JOHNSON:
Q. And so let's go immediately prior to the period, prior to 2007. Let's on this Schedule

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look at 2005. What we see there is in 2005 the Moody spread is about 1.1, not too far off where it is today, and the DCF cost of equity is at 8.8 percent. In 2006, DCF is at 9.2. Again the spread is only 1.2 percent, and 2007, 9.2 on the DCF cost of equity. So in the crisis time then in 2008, the DCF cost of equity is 10 percent with these higher spreads, and it goes up in 2009 by a percentage point and the spread actually comes down a little bit. So there's no question that around the time of the hearing when we were last before here, that was a troubled period of time.

MS. MCSHANE:

A. Again, I mean, by the time we showed up for the hearing there had been significant improvements since the earlier part of the year and these numbers are averages for the year.

MR. JOHNSON:

Q. What we do see, as I mentioned earlier, is that we see the - as the long term treasury yield has been coming down relative to 2009, you know, 4.1, 4.2, 3.9, down to 3, we see the

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equity risk premium also coming down over that period, and Ms. McShane, we're not seeing an inverse relationship there between the long term treasury yield going down and then the equity risk premium going up. We're seeing both of them come down, are we not, and we're seeing the DCF cost of equity come down?

MS. MCSHANE:

A. Yeah, in that particular period, yes. I mean, on average over this entire period there is an inverse relationship. I agree that the last couple of years have been fairly unusual. As I indicated this morning, I mean, there's not really been a predictable relationship between long term government bond yields and utility cost of equity.

MR. JOHNSON:

Q. So for the last - how long has it been since the inverse relationship has been in play, four years?

MS. MCSHANE:

A. I don't know. I'd have to go back and do the regression over specific periods to see.

MR. JOHNSON:

Q. I certainly see since '09 that there's no

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inverse relationship. Do you see that from your table - from your Schedule 14?

MS. MCSHANE:

A. I mean, there is some inverse relationship after 2009. We do see the risk premium in 2012 being higher than the risk premium in 2010.

MR. JOHNSON:

Q. Now you apply some adjustments to your -

(1:00 p.m.)

CHAIRMAN:

Q. Mr. Johnson, we're at shortly after one, and I thought we'd agreed we would - I mean, if you got another question that would finish off.

MR. JOHNSON:

Q. No, Mr. Chairman.

CHAIRMAN:

Q. Okay, I think we'll take the fifteen minute break now then.

MR. JOHNSON:

Q. Thank you.

(RECESS - 1:00 p.m. )

(RESUME - 1:21 p.m. )

MR. JOHNSON:

Q. Ms. McShane, continuing on, at page 84 of your report, at the top of that page, you state

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that for the sample of US utilities the constant growth DCF based equity premium test indicates that the average 1998 to 2012 quarter two utility risk premium was 5.2 percent, corresponding to an average long term government bond yield of 4.9 percent, and you go on then to say that the data also shows that the risk premium averaged 4.8 percent when long term government bond yields were 6 percent or higher, and 6.7 percent when the long term government bond yields were below 4 percent. If we just turn quickly to your Schedule 14, again page 1 of 4, the thing that we observe is that over this reporting period there was, in fact, while only 2011 and 2012 had the long term treasury yield below 4, we see no instance of where the equity risk premium rose above, say, 6.3. In fact, when the long term treasury yield was 3.9 in 2011, your equity risk premium was 5.9, etc. You see that?

MS. MCSHANE:

A. I see these are averages, yeah, so they're individual numbers that make up - so that 2011 number is an average of 12 numbers.

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MR. JOHNSON:
Q. Okay, so you're not disagreeing with me that this document doesn't establish the proposition that when the long term treasury yield falls below 4, that the equity risk premium averages 6.7 or more?
MS. MCSHANE:
A. Well, in a sense it does. I mean, there's a line on that schedule that shows the means for long term treasury yields. The first line says below 4 percent.
MR. JOHNSON:
Q. Okay. Maybe it would assist if we could go back to CA-NP-377F. If you could go to page 3 of 4, and if you see down around November of 2008, we see the 30 year treasury is down below 4, and then we see the risk premium is at 7, '07, and we see then in December of '08 the risk premium - or the 30 year treasury is at 2.69, and the equity risk premium goes all the way up to 8.30, and in January '09, the 30 year treasury is at 3.58, and the equity risk premium was at 7.58, and then February/March of '09, in February, you had 3.71 on a 30 year treasury and the risk premium has jumped up to

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8.35, and 3.56 for the 30 year treasury in March, with the equity risk premium going up to 8.44, and so I take it those were the numbers that you were speaking of to establish the proposition that when bond yields where the 30 year treasury falls below 4, that the equity risk premium goes up above 6.7?
MS. MCSHANE:
A. I'm going to take issue with the way you've stated that. I mean, all this says here on page 84 is the data show that the risk premium averaged 4.8 and long term government bond yields were 6 or higher, and 6 and 7 when they were below 4. I mean, there's nothing that's intended in this paragraph that goes to what the equity risk premium should be at below 4 percent based on the whole pattern of the data. I mean, you need to actually look at the entire regression analysis, not just these particular averages here to determine what the data indicate the risk premium should be below 4 percent.
MR. JOHNSON:
Q. But, Ms. McShane, I understand that it is a premise of your report that when bond yields

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fall below or fall, that the equity risk premium goes up. There's an inverse relationship, and we get that in the historical utility context, for instance, right? That's - your report says that when the 30 year treasury falls below 4, we see at page 84, I think, of your report - as a matter of fact, you have a table dedicated to it, Table 21, and in bold, government yield below 4, utility equity risk premium, 6.7 percent.
MS. MCSHANE:
A. Right, so this was the observed utility equity risk premium at various long term government bond yields. This was sort of the - call this the base data, and then the analysis of the actual relationship over time is conducted later, starting on page 85 under the relationships between equity risk premiums and interest rates.
MR. JOHNSON:
Q. Yes, but still and all your statement back at page 84, at line 2084, the data indicates that utility equity risk premium is higher at lower levels of interest rates than it is at higher

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levels of interest rates, i.e. there is an inverse relationship between long term government bond yields and utility equity risk premium, and then in Table 21, you state that when the government bond yield is below 4 percent, the utility equity risk premium is 6.7 and when we see the government bond yield going up to 4 or 5, the utility equity risk premium drops to 5.2, etc, etc.
MS. MCSHANE:
A. Yeah.
MR. JOHNSON:
Q. So that's a key point that you're trying to make.
MS. MCSHANE:
A. What this data in Table 21 was attempting to show is just by taking simple averages, there is an indication that there's an inverse relationship.
MR. JOHNSON:
Q. Right.
MS. MCSHANE:
A. So having seen those simple averages, I went on to determine with the full range of the data what the relationship is.

MR. JOHNSON:
Q. And part of that - how you could make the statement that when long term government bond yields went below 4 percent, you'd see risk premiums being 6.7 percent or higher, part of that was the experience that we saw in 377F at the very heart of the financial crisis in January, February, March of '09, when we saw in January an equity risk premium of 7.58, in February of '09, 8.35, and March of '09 at 8.44. I mean, you know, nearly off the chart and so, Ms. McShane, those numbers were taken into consideration by you in making the statement that there's an inverse relationship, first of all, right?
MS. MCSHANE:
A. Yes. However, this proposition that there's an inverse relationship, I mean, I have found this to be the case well before the financial crisis. So the conclusion that there's an inverse relationship is not at all dependent on the specific numbers for the risk premium calculated at bond yields below 4 percent.
MR. JOHNSON:
Q. But in terms of - I guess, you'll concede



we're not in the heart of a financial crisis right now like we were back in February and March or anything like that of 2008 when those huge risk premium numbers came out of the data?
MS. MCSHANE:
A. True.
MR. JOHNSON:
Q. And since - maybe we'll have to go back there to CA-NP-377. If we look at the times since the big crisis in early '09, when the 30 year treasury fell below 4 percent, we see, in fact, do we not, Ms. McShane, the equity risk premiums had been below your 6.7 certainly, 6.2 in May of - in June of 2010, when the 30 year treasury was at 3.9; 5.94 when the treasury was at 3.98, etc.
MS. MCSHANE:
A. That's true, and I would show you Table 24 again where there is a summary of the results coming out of this test once the regression analysis is done, and the indicated equity risk premium looking at the full range of the data from back to 1998 suggest that the equity risk premium with a forecast long term



government bond yield of 3.5 percent is 6.1, 6.2, 6.1, 6.1, not 6.7. So while there are specific data points within that group of observations that show 6.7 percent at below 4, when you do the full analysis and look at the entire pattern of the data, the equity risk premium that's indicated at 3.5 percent long term Canada Bond yield and a spread of what I used here was 155 basis points, is around 6. 1 to 6.2, not 6.7.
MR. JOHNSON:
Q. Ms. McShane, I'd like to ask you to provide an undertaking that you provide the average risk premium when treasury yields were below 4 percent outside of the period from September 2008 to March of 2009. Would you be able to do that?
(1:30 p.m.)
MS. MCSHANE:
A. I can do that.
MR. JOHNSON:
Q. Okay. I'd like to turn next to the historic utility equity risk premium test, and as we see from the outline in terms of the summary of your recommendations, this test provides



you with your highest risk premium and it brings it up to 6.75 percent, correct?
MS. MCSHANE:
A. Sorry, when you say "it brings it up", it brings what up to 6.75 percent?
MR. JOHNSON:
Q. The risk premium that you arrive at through the historical utility methodology is the highest one that your test produced?
MS. MCSHANE:
A. It's the highest of the three equity risk premium test results, correct.
MR. JOHNSON:
Q. Okay. Now as well that historic utility equity risk premium test, that gets you up to about 10.25 percent for the return on equity?
MS. MCSHANE:
A. The result of that test is 10.25 percent.
MR. JOHNSON:
Q. So let me turn to page 90 of your report. Specifically, at line 2232 in your overview section of the historic utility equity risk premium test. You say that the historic experienced market returns for utilities provide an additional perspective on a

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reasonable expectation for the forward looking utility equity risk premium. Similar to the DCF based equity risk premium test, this test estimates the cost of equity for regulated companies directly by reference to return data for regulated companies. Then as I understand it, the next sentence is where you basically give the premise. You say, "Reliance on achieved equity risk premiums for utility as an indicator of what investors expect for the future is based on the proposition that over the longer term investor's expectations and experience converse", and you say, "the more stable an industry, the more likely that this is likely to converge". So that's the underlying premise behind looking at these historic utility earned premiums, right?

MS. MCSHANE:
A. Returns.

MR. JOHNSON:
Q. Earned returns, okay. Now let's look then at Table 26 to see what were the actual returns, and that's at page 91, and I take it, Ms. McShane, that this is over a very lengthy period from 1956 to 2011 that this table is

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based on?

MS. MCSHANE:
A. For Canada, yes.

MR. JOHNSON:
Q. For Canada, and for what period for the United States, 1947 to 2011, right?

MS. MCSHANE:
A. That's right, yes.

MR. JOHNSON:
Q. Okay, now for Canadian utilities, we're talking about utility equity returns of 12.1 percent, right?

MS. MCSHANE:
A. Yes.

MR. JOHNSON:
Q. And bond total returns of 7.9 percent, bond income returns of 7.3 percent. What's a bond income return? Is that just a yield?

MS. MCSHANE:
A. Effectively, yes, it's the yield.

MR. JOHNSON:
Q. Why don't you call it the yield as opposed to bond income return?

MS. MCSHANE:
A. Because the way it's calculated for the US, I

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believe it takes out the capital appreciation, only the capital appreciation part of the return, and includes - I think it includes the reinvestment return, but I'm not positive.

MR. JOHNSON:
Q. Okay, and so in terms of the bond total return, what is that meant to be?

MS. MCSHANE:
A. That's the return over time if the bond holder bought and sold bonds every year.

MR. JOHNSON:
Q. Didn't hold them to maturity?

MS. MCSHANE:
A. Correct.

MR. JOHNSON:
Q. Okay.

MS. MCSHANE:
A. But not only didn't hold them to maturity, but -

MR. JOHNSON:
Q. Bought and sold them every year?

MS. MCSHANE:
A. Sold them every year.

MR. JOHNSON:
Q. Yes, did the very opposite of holding them to

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maturity, and as I understand it, this table would indicate that when we - that the utility risk premium relative to the bond total returns equals 4.2 percent for Canadian utilities. So that was the premium that the utility could expect to earn over that period?

MS. MCSHANE:
A. That's the return -

MR. JOHNSON:
Q. Oh, they earned actually over that period?

MS. MCSHANE:
A. If you're measuring the return relative to the annual total bond return, yes, over that period, that's what they actually - that's the actual equity risk premium.

MR. JOHNSON:
Q. Okay.

MS. MCSHANE:
A. And if you measure it over the income return for Canada, it was 4.8 percent.

MR. JOHNSON:
Q. Yes, okay, and, well, either one you use, Canada would be less than the American's, is that right?

MS. MCSHANE:

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A. Yes, because if you look at the columns that have the bond total returns and the bond income returns, it's because there were higher interest rates in Canada than in the United States over this period of time, a situation that's no longer the case, but the utility equity returns themselves were higher in Canada than in the United States.

MR. JOHNSON:

Q. Could we look at this and say, well, Canadian utilities are less risky than the American's utilities because the premium is not as high?

MS. MCSHANE:

A. Absolutely not. I just explained that the reason for the difference is because of the difference in the bond returns. The actual equity returns for the Canadian utilities are higher.

MR. JOHNSON:

Q. Only for that, could we make that conclusion?

MS. MCSHANE:

A. No.

MR. JOHNSON:

Q. Well how about if we looked at US electric utilities, they seem to have a lower utility

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risk premium relative to total returns, total bond returns and bond income returns, than the US gas utilities, could we make a conclusion there that US electrics are less risky than US gas?

MS. MCSHANE:

A. I don't think that you could draw that conclusion based on history, no.

MR. JOHNSON:

Q. Why couldn't you? I mean the risk premiums is, you know, it is what it is.

MS. MCSHANE:

A. That's right, that's exactly the point, it is what it is. I mean there may be circumstances that cause the actual returns to deviate from, you know, what you might expect on a go-forward basis if the return in risk trade off held perfectly, and it doesn't always hold perfectly.

MR. JOHNSON:

Q. And about this premise that the achieved equity risk premiums for utilities is an indicator of what investors expect for the future being based on a proposition that over the long term investors' expectations and

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experience converge, so would a Canadian, an investor in Canadian utilities, they would expect a risk premium of 4.2 percent on, relative to the bond total return or 4. 8 percent relative to the bond income return, would they not?

MS. MCSHANE:

Q. Well I think what you need to do is to read the rest of the section, starting with trends in equity returns and bond returns, and what I did here was to look at an analysis of the underlying data to determine whether there had actually been a trend in the utility equity returns and if you look at lines 20260 and on, you can see that my analysis showed that when I looked at a trend in the utility equity returns for these different samples of companies, I found that there has been no downward trend or secular downward trend in the returns for the utilities and over time they remained in the range of 11 to 12 percent, but at the same time we have seen a trend in bond yields. Now we're at very low bond yields, compared to the average over the period, so what I have taken from that

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analysis is that there is no reason to believe that this utility risk premium has been constant over this period. Instead, I mean I think it's fair to conclude that this inverse relationship, as far as equity investors are concerned, would equally apply to this kind of test as it would to the DCF base test. So that's what I've tried to do in Table 27 is to--which is on page 92, is to assess the relationship between the utility equity risk premium at--with interest rates and determine what it would be at current levels of interest rates and forecast levels of interest rates.

(1:45 p.m.)

MR. JOHNSON:

Q. But the bottom line is that between pages 91--at 91 we've got say a bond total return, utility risk premium relative to the bond total return for Canadian utilities of 4. 2 percent, right?

MS. MCSHANE:

A. That's right.

MR. JOHNSON:

Q. And when we flip over to Table 27, we don't see 4.2 percent anymore, that's now 6. 7

percent after you do your analysis on the number. So you take the historic number and you adjust it and you end up with a risk premium of not 4.2 percent, but 6.7 percent.

MS. MCSHANE:

A. Right, so if you look at Table 27, then you can see on the third line the starting point is the historic achieved equity risk premium at the historic levels of bond income returns, and then adjust it for the difference in bond yields as forecast for the test period, relative to the average over the historic period.

MR. JOHNSON:

Q. So, Ms. McShane, you know, wouldn't the investor in Canadian utilities say look, over the long run, you know, this is the premium that was actually earned and, you know, that's how we view the forward looking prospects. Would they be thinking in 6.7 when the actual experience has been 4.2?

MS. MCSHANE:

A. Well I think they would be looking at that because they would also be looking at the fact that there has been no downward trend in the



utility equity returns over time, although we have seen a trend downward in bond returns. So I think they would be as focused on the return component as they would on the risk premium component.

MR. JOHNSON:

Q. And have you--you've presented this type of analysis to other regulators, I take it?

MS. MCSHANE:

A. Yes, I have.

MR. JOHNSON:

Q. And you presented it before the Alberta regulator in the Generic Cost of Capital hearing in 2011?

MS. MCSHANE:

A. I believe that's the case.

MR. JOHNSON:

Q. Yeah, and could we turn to the Generic Cost of Capital decision, 2011-474 which would be part of the cross aide materials.

MS. GLYNN:

Q. I think that would be entered as Information Item No. 9.

MR. JOHNSON:

Q. I'm referring to page 18 or page 19, sorry,



paragraph 96. No, you're not in the 2011, you're in the 2009 decision. Section 3.5.1 and just for the record I will read what the board had to say in Alberta. "In her evidence, Ms. McShane examined the historic returns for utilities. According to Ms. McShane, the historical average utility return in both Canada and the United States has clustered in the 11 to 12 percent range. She submitted that investors tend to base their expectations on experienced returns and that there was no long term upward or downward trend. She submitted that the utility returns had varied by approximately 50 percent of the change in Long Term Government Bond yields." The board went on in paragraph 97, "Ms. McShane also uses historical data on the experience returns of utilities to provide an additional equity risk premium estimate derived from the observed equity risk premiums achieved by utilities. This resulted in an equity risk premium of 6.25 to 6.5 percent. At Ms. McShane's forecast Canada Bond yield of 4.25 percent, the indicated utility cost of equity was approximately 10.5 to 10.75 percent



or 11.5 to 11.75 percent after adding her recommended 1 percent for floatation." Paragraph 98, "The UCA, which is an Intervenor group, noted that Ms. McShane had provided evidence indicating that utility investors have made returns that are higher than the overall market and have stated that at best this was evidence that regulators have over estimated the risk adjusted cost of equity and thereby had provided a return that is too high." 99, "The commission agrees with UCA that part of the reason for historic, higher historic returns may be that allowed returns have been above the actual ROE that investors expected and required for investments of comparable risk. The commission finds that the evidence on historic returns is inconclusive with respect to the return investors expect on comparable investments." So Ms. McShane, there is no material difference from what you presented on behalf of Newfoundland Power as regards to historic utility premium before, in this case to what you provided to the Alberta case, right?

MS. MCSHANE:

A. It's a very similar analysis, correct.
MR. JOHNSON:
Q. And obviously they did not accept that evidence. Now I think this method, this historic utility risk premium method, this is referred to by Dr. Vander Weide, I believe, in his report as the Ex Post method, right?
MS. MCSHANE:
A. I think this methodology is similar to his, yes.
MR. JOHNSON:
Q. Exactly, it's just referred by a different name. And now if we go to your report, again at Table 26, page 91, as you indicated to me when I asked you what a bond income return is, that is the bond yield, right?
MS. MCSHANE:
A. Pretty much, yes.
MR. JOHNSON:
Q. Pretty much. And Ms. McShane, this is not always the way, you didn't do it like this all the time, did you? This is a different, a different approach. You used to just look at the actual utility equity return and then look at the bond yield, you didn't look at the bond



total return?
DR. BOOTH:
Q. She did.
MR. JOHNSON:
Q. Oh you looked at the bond total return but not the bond income return, would that be right?
MS. MCSHANE:
A. I think in earlier years that was true.
MR. JOHNSON:
Q. So the result would be is that you, as opposed to going through, going through these, we would just look at the bond yield--we'd have a different number here than if you kept to that methodology here today?
MS. MCSHANE:
A. There would be a different number under that methodology. There are two parts to this, mind you, one is looking at, you know, whether you look at the historic risk premium in relation to the total return verses the income return, I mean that's part of it, and then the other part of it is whether or not you just accept the long term average achieved risk premium or you assess whether that risk premium should be different than the long term



average based on where interest rates are today, verses historically.
MR. JOHNSON:
Q. Right, and so when you used to do it the old way, the historic utility risk premium, that would be lower if you did that approach in this proceeding than it is doing this new approach, correct?
MS. MCSHANE:
A. Well you can see that in Table 26 the difference between the risk premiums based on the assumption that investors buy and sell bonds every year, verses holding them to maturity. But I mean, the basic reason that I changed the methodology is I recognized that what I'm trying to get at is a risk premium over a risk-free rate and so when you look at bond total returns, you don't have effectively a risk-free rate anymore because you've got capital gains and losses due to changes in interest rates and if you had a true risk-free rate, you wouldn't have those capital gains and losses. So that's why I've been measuring it in recent years over the bond income returns to try to get at the return over a



risk-free rate.
MR. JOHNSON:
Q. And in fact before this Board, I think you would agree with me you used to provide the other approach for Newfoundland Power?
MS. MCSHANE:
A. Yes, I mean I consistently did that before regulators until it became clear to me that what I should be trying to do is measure the risk premium over a risk-free rate.
MR. JOHNSON:
Q. So how long had you been doing the other method?
MS. MCSHANE:
A. For many years.
MR. JOHNSON:
Q. For many years, and when did you pick up this new method?
MS. MCSHANE:
A. I don't recall.
MR. JOHNSON:
Q. Ms. McShane, my understanding and perhaps you could confirm this by undertaking to file page 49 of 67 of your October 2002 testimony before the Board, of your report, along with Schedule

10, if you could undertake to provide that as an undertaking, your October 2002 report to this Board for Newfoundland Power.

KELLY, Q.C.:

Q. If my friend has it, he can provide it to us and we can file it if that's a utility.

MR. JOHNSON:

Q. Just as easy to do it by way of an undertaking, I don't have it here, page 49 of 67 and together with Schedule 10.

MS. MCSHANE:

A. Okay, I can do that.

MR. JOHNSON:

Q. And as well my reading of your 2007 evidence is that you were not doing this either, you were doing it like you were doing it in October, 2002, would you confirm that?

MS. MCSHANE:

A. I can, not right this minute I can't, but I will undertake to do that.

MR. JOHNSON:

Q. And will you undertake in that regard to file from your 2007 evidence for Newfoundland Power, pages 47 to 48 and Schedules 15 and 16?

MS. MCSHANE:



A. Sorry, pages 47 to 48 and Schedule?

MR. JOHNSON:

Q. 15 and 16 of your 2007 evidence, which would be different than this. Now, Ms. McShane, in terms of your direct DCF estimates, that starts at page 93 and I'd like to bring you to Table 29 on page 97. So this is the pure DCF cost of equity analysis, nothing to do with risk premium, just DCF straight on, right?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. Okay, now we have gone through previously your risk premium DCF base risk premium estimates and when we look at Table 29, we see that your constant growth DCF estimate is, for US utilities, is 9.4 percent and we previously noted back on Schedule 14 that your last DCF estimate that you provided up to the second quarter of 2012 was 9.30 percent, do you recall that?

MS. MCSHANE:

A. Yes.

MR. JOHNSON:

Q. Okay, and this difference we are assuming is



simply because the estimates on Schedule 14 average over the first six months of 2012, would that be correct?

MS. MCSHANE:

A. That could be part of it, I mean the DCF based equity risk premium test uses one source of an analyst's expected growth rates because I have a single source that goes back historically and if you look at Schedule 17, which is the summary of the DCF cost of equity for the individual US utilities based on analyst's earning's growth forecast, you can see that there are four different sources of forecast, Bloomberg, Reuters, Value Line and Zacks, all of which are averaged in column 8. So the source of the investor growth expectation data is different as between the two tests, as well as there being a somewhat different timing in the estimates.

(2:00 p.m.)

MR. JOHNSON:

Q. And just so I can understand this, in terms of where we left off at Schedule 14 -

MS. MCSHANE:

A. Right. So if we look at Schedule 14, page one



of four, there's a number--well there are two numbers here, there's the expected dividend yield for 2012 which is through -

MR. JOHNSON:

Q. Quarter 2.

MS. MCSHANE:

A. Quarter 2 and then there's the analyst EPS growth forecast and that, as you say, gives you a number of 93. So, you wanted to compare that 93 to the 9.4 percent on Table 29.

MR. JOHNSON:

Q. Yes, and we were wondering is it because the estimates only go up for the first six months.

MS. MCSHANE:

A. So if we look at Schedule 17, if you come across the Mean Line, if you look at column 3, you have the expected dividend yield 4. 3 percent, do you see that?

MR. JOHNSON:

Q. Yes, I do.

MS. MCSHANE:

A. Now come across to column 8, you see the 5. 1 percent?

MR. JOHNSON:

Q. Right.

MS. MCSHANE:
A. And then the column next to that, that's 9.4 percent, okay?
MR. JOHNSON:
Q. Right.
MS. MCSHANE:
A. So if we compare -
MR. JOHNSON:
Q. So if you go down, if I just, not to interrupt, it might be on point, at the bottom of that document where it says "Source, Bloomberg", that takes in May, June and August, 2012.
MS. MCSHANE:
A. Right.
MR. JOHNSON:
Q. And Yahoo, just explain is that bear on what I am asking?
MS. MCSHANE:
A. What I was trying to explain was that, I mean, if you look at the dividend yield, right, the 4.3, I mean, that's identical to the number that we saw in Schedule 14.
MR. JOHNSON:
Q. Right.



MS. MCSHANE:
A. The difference is really in this average of the EPS estimate because the difference is only 10 basis points, right.
MR. JOHNSON:
Q. Yeah.
MS. MCSHANE:
A. So what I am saying is the difference between Schedule 14 and 17 is essentially the source of the growth estimates, there's only one source of growth estimates in Schedule 14 and there's four sources of growth estimates in Schedule 17.
MR. JOHNSON:
Q. Okay. And now when we look at these estimates for constant growth, so at Schedule 17, Ms. McShane, we see the expected dividend yield and we see the analyst forecast long term growth rates for your American utilities and these, I take it, would be expected to go off into perpetuity, these growth -
MS. MCSHANE:
A. That's the assumption underpinning this model.
MR. JOHNSON:
Q. Okay. And so the assumption, the average



growth rate would be 5.1 percent.
MS. MCSHANE:
A. Correct.
MR. JOHNSON:
Q. Okay, and of course we see ranges there like ALLETTE, 6.3, there's others that are a bit lower, WISCONSIN (Energy) is 6, so--and in terms of the people providing these forecasts, Bloomberg, Reuters, apart from Value Line, are some of these analysts from what's referred to as the cell side part of the market?
MS. MCSHANE:
A. Some of them would be, yes.
MR. JOHNSON:
Q. And, of course, there's been discussion in regulatory hearings in other places about optimism on the cell side for these analyst projections, is that right?
MS. MCSHANE:
A. There has been discussion and there has been rebuttal of that discussion, I guess is the best way to put it. I mean, there has been, in my testimony, for example, there's a section on addressing the reliability of analyst's forecasts.



MR. JOHNSON:
Q. But suffice it for the moment to say that the area of disagreement between yourself and Doctor Booth is that you do not judge them to be optimistic or high.
MS. MCSHANE:
A. Correct.
MR. JOHNSON:
Q. Okay. And so then if we look at Table 29 again, we have--it's on page 97--we see that the DCF cost of equity drops from 9.4 percent to 9.1 percent when you employ the three stage model. And as I understand it, the three stage model, that's when you taper down growth estimates or taper them to the long run growth in United States gross domestic product.
MS. MCSHANE:
A. They are assumed to converge over time to the long term growth in the economy, maybe up or down, depending on how the analyst's growth rate compares to the GDP forecast.
MR. JOHNSON:
Q. Okay. And in the three stage model, how long are they in each stage? For instance, in stage one, what's the period of that stage?

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MS. MCSHANE:
A. Five years.
MR. JOHNSON:
Q. And then the second stage is a little less that the first stage in most of these cases, I take it, in terms of the growth estimates? The second stage is five years, I take it, too.
MS. MCSHANE:
A. Yes, and so it's the average of the two. I was looking at, if you look at Schedule 19, you can see whether the first stage and the third stage or whether the first stage is higher or lower than the third stage.
MR. JOHNSON:
Q. And then -
MS. MCSHANE:
A. What I would say to you that if you look at the stage one numbers, the mean and the median of 5.1 and 5.3, I mean I've had different than the stage three numbers which are 4.9.
MR. JOHNSON:
Q. And stage three by that point we are assuming that there will be growth equal to the forecast GDP growth in the United States.

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MS. MCSHANE:
A. Right.
MR. JOHNSON:
Q. And if we go back to Table 29, you report on sustainable growth and that is 8.6 percent, somewhat less even than the three stage model and why would that be less? Or I should ask you what's the sustainable growth concept?
MS. MCSHANE:
A. What is the concept?
MR. JOHNSON:
Q. Yeah.
MS. MCSHANE:
A. The concept is that a company can only grow its earnings as fast as the return on equity that it earns and the amount of--and a proportion of its earnings that it retains to fund the growth, in addition to what it can add to its growth rate by funding externally.
MR. JOHNSON:
Q. And so this four, for instance, Canadian utilities is well--you don't report on the Canadian utilities sustainable growth, what's the reason for that?
MS. MCSHANE:

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A. Because these are based on forecast earnings over an extended period of time and forecast retention rates and I don't have that data for Canada.
MR. JOHNSON:
Q. Okay. And we see that there's quite a difference between the constant growth of Canadian utilities, 11 percent, versus the three-stage model of 8.6 percent?
MS. MCSHANE:
A. That's right.
MR. JOHNSON:
Q. Okay. And I take it, as a truism, Ms. McShane, that by merit of the fact that both for US and Canadian utilities, we see the three-stage model producing smaller numbers than the constant model, that this essentially means that it is because the average analyst growth rate for these utilities actually exceeds the long run growth rate in GDP?
MS. MCSHANE:
A. That's correct.
MR. JOHNSON:
Q. Okay. So when I see, in Table 29, these estimates for the US utilities being for the

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DCF estimate being the highest for the short run analyst growth forecast and the constant growth model and then dropping by 30 basis points when you taper these to the long run GDP growth and the three stage model and then dropping by a further 50 basis points when you use the company's actual profitability data for each company and you don't rely on analyst growth forecast at all, I'm wondering why wouldn't this Board consider this itself as Exhibit A as evidence that these analyst growth forecasts are optimistic?
MS. MCSHANE:
A. Well, I would take issue with what you've said because the sustainable growth rate estimates are based on analyst forecasts. They are not based on actual profitability of the company. So I don't think you can draw the conclusion that the sustainable growth -- and just because it happens to be, in this case, the lowest number, has anything to say about the optimism of analyst growth rates. These are based on analyst forecast.
MR. JOHNSON:
Q. Well, we certainly know that the only reason

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that your three-stage models produce lower numbers than your constant is because these analysts are saying that there's going to be growth in excess of GDP for these companies, right?
MS. MCSHANE:
A. For the next five years, yes, and -
MR. JOHNSON:
Q. But doesn't that go on in perpetuity?
MS. MCSHANE:
A. Well, that's the assumption under the model, but we don't know how long investors would expect these growth rates to persist. I mean, embedded in the prices may well be the expectation that they expect these growth rates to persist and it's not -- in this model, the long term analyst growth model, those forecast are assumed to be investors' best estimates of what they can expect in the long term for growth.
MR. JOHNSON:
Q. Have you done any checks to see whether these utilities have actually growth at the sorts of rates that the analysts are assuming?
MS. MCSHANE:

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A. I have looked at some of the historic growth rates, yes.
MR. JOHNSON:
Q. And I'd like to call up a cross aide. It was an RFI through the Alberta hearing which provided some light on the topic. It is in particular it would have been item two on that letter, okay, no, you're right there. You're right there. Now Ms. McShane, you recognize this RFI from the Alberta 2011 generic cost of capital proceeding?
MS. GLYNN:
Q. Mr. Johnson, we'll enter that as Information Item No. 10.
MR. JOHNSON:
Q. You recognize this reply, Ms. McShane?
MS. MCSHANE:
A. I believe so. So this was a multi -
MR. JOHNSON:
Q. Multi-part.
MS. MCSHANE:
A. - multi-part with the answer only to part of I, L.
MR. JOHNSON:
Q. Right. And -

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MS. MCSHANE:
A. Without any of the explanation around it, if there was any.
MR. JOHNSON:
Q. And you can file that if you feel it's important.
MS. MCSHANE:
A. I don't know because I don't know what the -- I would like to see if there was any actual discussion around it.
(2:15 p.m.)
MR. JOHNSON:
Q. Okay. We have no difficulty with doing that. We'll undertake to do that. Regarding the reference, analyst growth estimates, and the question, the request at I, you are right, asks if the results that are reported in answer to I above -- no, actually it's I. "Please provide a table of the average arithmetic and compound growth rates for dividend earnings and book value per share for each utility in H above since 1990 and compare this with the same growth rate for US GDP and discuss in detail whether these utilities have grown their dividend earnings and book values

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at the GDP growth rate over the 20 years." And if I could just take you to the next page, which actually sets out -- and several of these companies are common to what we were seeing in this proceeding, for instance, Consolidated Edison, Northwest Natural Gas, Piedmont, Vectren, WGL are all part of your US sample in this proceeding, right?
MS. MCSHANE:
A. Con Ed, Northwest, Piedmont, Vectren, WGL, yes, those are.
MR. JOHNSON:
Q. Okay. And the arithmetic GDP growth is at 4.8 percent and on a compound basis, 4.7 percent?
MS. MCSHANE:
A. Correct.
MR. JOHNSON:
Q. And when we look at dividends per share, and dividends per share, that's what the growth analysts are actually trying to forecast, right, in the DCF model?
MS. MCSHANE:
A. In the DCF model, I mean, the idea is that in the model that the cash flows immediately come from dividends, but over the long term, all

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cash flows have to come from earnings.
MR. JOHNSON:
Q. If we look at dividends per share, the sample average of compound growth of dividends per share is just 2.7 percent of that whole -- for that whole group, and that, I take it, is obviously significantly below compound GDP growth over that period of time, Ms. McShane?
MS. MCSHANE:
A. It is.
MR. JOHNSON:
Q. And so would this be evidence of optimism in forecast that these -- well, let's put it this way, this demonstrates, does it not, that US utilities, certain number of those who are in your sample, have not met even compound GDP growth in terms of their dividends per share?
MS. MCSHANE:
A. The historic growth in dividends has been lower than GDP growth. I think that that's reasonable for that to be the case. I think utilities tend to be fairly conservative as far as raising dividends because they want to make sure that they don't have to cut them.
MR. JOHNSON:

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Q. But we -- I mean, we're talking a very lengthy period here, 1990 to 2010.
MS. MCSHANE:
A. We are, and we're talking about a period over which we've seen a fairly steady decrease in allowed returns which has, during that period, would have put a floor, if you will, on the ability to raise dividends.
MR. JOHNSON:
Q. And we see from this, for instance, that the average book value per share has run at compound growth at an average of 4.2 percent, again less than compound growth at 4.7, and the same can be said at earnings per share. Ms. McShane, a lot of utilities are mature utilities. For instance, Newfoundland Power is a mature utility?
MS. MCSHANE:
A. Yes.
MR. JOHNSON:
Q. A lot of these utilities, I suppose, are mature utilities, are they not?
MS. MCSHANE:
A. Well, they all would be considered mature utilities. I mean, they have mature markets.

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MR. JOHNSON:
Q. And what would you make of a forecast that says in perpetuity that they're going to outdo GDP, which is reflected in the three-stage, because we see the number coming down, and when you put on the brakes of GDP, does the maturity of the company cause you to think, gee, these constant growth forecasts over GDP, they're a bit optimistic?
MS. MCSHANE:
A. No, I don't think that that's true. I mean, they're very close to the GDP growth rates.
MR. JOHNSON:
Q. What are you forecasting for or were you assuming would be Canada's GDP growth rate for the purposes of the DCF model, Ms. McShane?
MS. MCSHANE:
A. It's on a schedule. I think it's 4.3 percent.
MR. JOHNSON:
Q. 4.3 percent?
MS. MCSHANE:
A. I believe so.
MR. JOHNSON:
Q. Okay.
MS. MCSHANE:

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A. That's on Schedule 21.
MR. JOHNSON:
Q. And in 21, you've got obviously Canadian Utilities Limited, Emera, Enbridge, Fortis, and each of these forecasters or analysts, they all have growth well above GDP growth at 4.3 percent, don't they?
MS. MCSHANE:
A. They do, and all of these utilities have significant growth opportunities that underlie the EPS forecast. For example, Enbridge Inc., which has the highest long term EPS forecast, I mean, they have a number of major projects that are driving analyst estimates of future earnings growth, which you can see in their relativity low dividend yield. So investors are willing to pay a relatively high price for assess to those growth opportunities. So you have to make sure that you incorporate relatively higher than normal growth opportunities into the DCF model if you're going to couple that with, you know, relatively low dividend yield, which reflects investors' expectations of high growth.
MR. JOHNSON:

Q. Still in all, in the Enbridge example, the DCF cost of equity is eight and a half percent.

MS. MCSHANE:

A. Under the -- well, that's the problem with this three-stage model and the reason that I have, you know, more than one model, because what the three-stage model essentially does is presumes that that higher growth embedded in the price is going to be cut off at a point in time, and so you will sometimes get fairly inconsistent results between a constant growth and a three-stage growth model.

MR. JOHNSON:

Q. Is there any evidence here to substantiate that historically Canadian growth for these utilities has met or exceeded GDP?

MS. MCSHANE:

A. I have not looked at what the specific growth is. I mean, these are -- these numbers are based on what the current opportunities for growth for these companies are. For example, TransCanada, which is looking to build significant new pipelines into the west coast of BC, for example. Enbridge Inc., as I suggested before, has got significant



infrastructure investments that it's making and its president has openly told investment analysts that he expects to be able to maintain ten percent earnings growth for a long period of time. Emera has considerable investment opportunities.

MR. JOHNSON:

Q. But Ms. McShane, if we assume, as these constant forecasts do in a perpetual model, for instance, that -- let's take Emera at 6.5 percent and assume that was perpetual. That would be above GDP growth. I mean, they would become a larger and larger and larger and larger part of the Canadian economy, the utility sector would, after awhile, overwhelm the Canadian economy, wouldn't they, if you assume constant growth like that?

MS. MCSHANE:

A. Well, in principle, yes, but again, I mean, it's fairly obvious that if you look at the dividend yields on these Canadian utilities that the prices are such that clearly investors are expecting much higher growth for these utilities than they are for the US utilities.



MR. JOHNSON:

Q. I think -- we're at 2:30. I think was that as far as we were going to go, Mr. Chairman?

CHAIRMAN:

Q. I think so.

MS. GLYNN:

Q. Yes, it is.

CHAIRMAN:

Q. So you're -

MR. JOHNSON:

Q. I will continue at the next available time.

CHAIRMAN:

Q. I think that's 9:00 tomorrow morning.

MS. GLYNN:

Q. 9:00 tomorrow morning, but we are going to go back to Ms. Perry tomorrow morning and finish with the company evidence to make up for Friday past and Ms. McShane will be back on then on Wednesday morning.

CHAIRMAN:

Q. Okay. We're adjourned until tomorrow at 9:00.



CERTIFICATE

I, Judy Moss, do hereby that the foregoing is a true and correct transcript of a hearing in the matter of Newfoundland Power Inc.'s General Rate Application heard on the 14th day of January, 2013 at the offices of the Board of Commissioners of Public Utilities, St. John's, Newfoundland and Labrador and was transcribed by me to the best of my ability by means of a sound apparatus.

Dated at St. John's, NL this

14th day of January, 2013

Judy Moss

Discoveries Unlimited Inc.

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