Volume 3, Section 1 – McShane, Cost of Capital

Q. (page 30, lines 799-808)

a. Please confirm that the debt ratings issued by Moody's, S&P, and DBRS are intended to measure the risk exposure of a company's bondholders to events or circumstances that might jeopardize the values of their bond holdings.

b. Please confirm that the debt ratings issued by Moody's, S&P, and DBRS are neither intended nor designed to measure the investment riskiness of a company's equity shares.

c. Please confirm that when an expectation arises that a private equity firm or other investor may take over control of a publicly-traded firm, there is often a disconnect between the firm's bond ratings and its riskiness in the eyes of equity investors - with the bond riskiness rising and its bond ratings being lowered to reflect the expected actions of the potential new owners/managers, while the risk of the equity declines with the evidence of expanded investor interest in the firm's shares.

d. Please confirm that the statement starting on line 806 and ending on line 808 is Ms. McShane's own opinion and that this assertion cannot be found in any text or treatise on regulatory economics and would certainly not apply if the senior debt issues of all major regulated utilities were below the single-A category.

A. (a) Confirmed.

(b) Confirmed that debt ratings do not measure investment risk from the perspective of an equity investor. However, they are based on an assessment of both business and financial risk, which are key components of equity risk.

(c) Ms. McShane agrees that if a private equity firm or other investor takes control of a publicly-traded company, there can be an increase in the perceived riskiness of the company's bonds due to uncertainty around the actions of new management. The opposite can also occur, depending on the identity of the new investor. With respect to the risk of equity, when a private equity firm or other investor takes control, the equity risk may actually rise, because the private equity firm now holds a less liquid investment than when the shares were widely held.

(d) The statements represent Ms. McShane's opinion, reflecting (1) the need to specify or define a benchmark for comparative purposes; (2) the actual debt ratings maintained by the typical Canadian utility; and (3) the characteristics of the Canadian debt market (e.g., a relatively small BBB debt market). If the debt ratings of the Canadian utility industry were, on average, in the BBB category, and the utilities in the aggregate were able, as such, to raise long-term debt capital on reasonable terms and conditions, it would be reasonable to specify a different benchmark.