Volume 3, Section 1 – McShane, Cost of Capital

Q. (pages 55-59 and Appendix E) Please explain in full detail how, if at all, the sample selection criteria and procedure for conducting the comparable earnings test, for both the Canadian and U.S. industrial samples, in this proceeding differ from those which Ms. MsShane employed in NP 2003GRA. Please explain the rationale or reasons for any changes.

A. The selection criteria for the Canadian industrial sample in this proceeding are provided in Appendix E. The corresponding selection criteria utilized in the NP 2003GRA are contained in Attachment A. The principal reasons for changing the selection criteria were:

(1) to have as a point of departure a larger universe (i.e., all firms traded on the TSX in a range of industry classifications versus only those in the S&P/TSX composite), while, simultaneously applying sufficient criteria to eliminate higher risk companies;
(2) to address the concern that the criteria previously used allowed the selection of companies with extraordinary high or chronically depressed returns.

Comparable Earnings Test

APPENDIX D

COMPARABLE EARNINGS TEST

PRINCIPAL APPLICATION ISSUES

The principal issues in the application of the comparable earnings test are:

- The selection of a sample of industrials of reasonably comparable risk to an average risk Canadian utility.
- The selection of an appropriate time period over which returns are to be measured in order to estimate prospective returns.
- The need for an adjustment to the "raw" comparable earnings results to reflect the differential risk of an average risk Canadian utility relative to the selected industrials.

CANADIAN INDUSTRIAL RETURNS

Selection of Canadian Industrials

The selection process starts with the recognition that industrials are generally exposed to higher business risk, but lower financial risk, than an average risk Canadian utility. The selection of industrials focuses on total investment risk, i.e., the combined business and financial risks. The comparable earnings test is based on the premise that industrials' higher business risks can be offset by a more conservative capital structure, thus permitting selection of industrial samples of reasonably comparable investment risk to an average risk Canadian utility.

Utilities are generally characterized by relatively low volatility with respect to both earnings and stock market performance. Consequently, the initial universe

(275 companies) was comprised of all companies in the S&P/TSX Index in Global Industry Classification Standard (GICS) sectors 20-30. The sectors represented by the GICS codes in this range are: Industrials, Consumer Discretionary and Consumer Staples.[1] The resulting sample contained 90 firms.

From this group of 90 companies,[2] all firms with missing book equity or negative common equity during the period 1990-2001, and/or missing market data (December 1996 to December 2001) were removed, as were all companies which paid no dividends in any year 1992-2001. To ensure that low risk companies were selected, all companies with betas over 0.70 were removed, as well as any companies whose stock is ranked Higher Risk by the Canadian Business Service (CBS).[3] The final sample of low risk Canadian industrials is comprised of 15 companies (Schedule 18).[4]

Time Period for Measuring Returns

Since industrials' returns on equity tend to be cyclical, the appropriate period for measuring industrial returns should encompass an entire business cycle, covering years of both expansion and decline. That cycle should be representative of a future normal cycle, e.g., similar in terms of inflation and real economic growth. Over the past trough-to-trough business cycle (1992-2001), the experienced returns on equity of the sample of 15 industrials were as follows.

[1] Included in these sectors are major industries such as: Food Retail, Food Distributors, Tobacco, Packaged Foods, Soft Drinks, Distillers, Household Appliances, Aerospace and Defense, Electrical Components & Equipment, Industrial Machinery, Publishing & Printing, Department Stores, and General Merchandise

[2] SNC-Lavalin was removed due to its recent purchase of regulated electric transmission assets in Alberta.

[3] Canadian Business Service (CBS) ranks stocks "Very Conservative", "Conservative", "Average", "Higher Risk", or "Speculative".

[4] In light of the controversy surrounding the use of coefficients of variation (COVs) as a relative risk measure, I have eliminated reliance on COVs as a selection criterion.