Reference: Volume 3, Cost of Capital Report by James Coyne

Q. Volume 3, Cost of Capital Report by James Coyne, page 34, line 7 to page 38, line 5. In Order No. P.U. 13(2013), page 31, lines 13-16 and Order No. P.U. 18(2016), page 39, lines 14-15 the Board expressed concern on the assumption of constant growth in perpetuity and no offsetting adjustment for analysts' bias in the Constant Growth DCF method used by Mr. Coyne to estimate a fair return for Newfoundland Power. Mr. Coyne addresses this concern and referred to various factors which, in his opinion, demonstrate that projected analysts' growth rates are reasonable but all pre-date 2016. Have there been any changes since the Board's decision in 2016 that would lead the Board to now reach a different conclusion on the issue of analysts' bias in the Constant Growth DCF method?

A. Mr. Coyne is mindful of the Board's 2016 decision and believes it is important to consider that regulated utilities generally operate within a mature, stable industry with considerable disclosure and transparency that provide analysts with a sound basis for their earnings growth estimates. The Constant Growth DCF model was originally developed by Professor Myron Gordon to estimate the cost of equity capital for companies in mature industries such as regulated utilities because the underlying assumptions of the Constant Growth DCF model are generally reasonable for companies with stable, predictable growth rates.

Mr. Coyne also newly provides a comparison of historical earnings per share and dividend per share growth rates for the U.S. Electric, Canadian and North American Electric proxy groups against historical GDP growth rates over the period from 2009-2019, as well as a comparison of projected earnings per share growth and forecast GDP growth. Those results are summarized in Figure 19 of Mr. Coyne's report. Based on this comparison, Mr. Coyne draws the following conclusions, as stated on pages 37-38 of his report and summarized below:

(i) Dividends track reasonably well with earnings growth and earnings growth is a reasonable proxy for dividend growth, especially with a broad enough sample.

(ii) Both earnings and dividend growth exceeded GDP growth by a wide margin, with the exception of DPS growth for the U.S. proxy group, where the two measures are approximately equal. There is no fundamental basis to assume that economy-wide GDP growth serves as a limit on utility earnings growth.

(iii) Looking to the future, it is not unreasonable to rely on analyst projections just because they exceed GDP growth. Further, over the historical period, dividend growth for the three utility proxy groups exceeded historical GDP growth by a wide margin.

Given this additional evidence, Mr. Coyne believes it is reasonable and appropriate for the Board to find that analyst optimism bias is not a concern that should cause the Board to give less weight to the results of the Constant Growth DCF model in this proceeding.

Mr. Coyne also provides the results of a multi-stage DCF analysis that uses projected long-term GDP growth as the terminal growth rate for situations where the analysts' forecast growth rate may not be sustainable over the longer-term. The Board expressed its preference for the multi-stage model in its 2016 Order. These ROE estimates range from 9.44% to 10.86% (depending on proxy group) and average 9.9%, which would still support Mr. Coyne's 9.8% recommendation.