

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

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3 **Q. Volume 3, Cost of Capital Report by James Coyne, page 45, Figure 26. Further to**  
 4 **PUB-NP-075 state what the unadjusted CAPM would be if Mr. Coyne had made no**  
 5 **adjustments to his CAPM analysis for current market conditions.**

6

7 **A.** If Mr. Coyne had used the current risk free rate in Canada (1.94%) and the U.S. (2.34%)  
 8 and an average of the historical and projected market risk premium, the CAPM results  
 9 would be as shown in the figure below:

**Revised Figure 26 – CAPM Results – Risk Free Rate Adjustment**

	<b>Average MRP</b>
Canadian Utilities	10.11%
U.S. Electric Utilities	10.54%
North American Electric Utilities	10.20%

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If Mr. Coyne had used both the current risk free rate in Canada and the U.S. and only the  
 11 historical market risk premium, his CAPM results would be as shown in the figure below:

**Revised Figure 26 – CAPM Results – Risk Free Rate and MRP Adjustments**

	<b>Historical MRP</b>
Canadian Utilities	7.44%
U.S. Electric Utilities	9.40%
North American Electric Utilities	8.66%

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Mr. Coyne, however, does not agree with the use of the current average 30-year  
 13 government bond yield as the risk free rate because bond yields are expected to increase  
 14 substantially from current levels over the next two to three years as shown by the  
 15 Consensus Economics forecast, or with the use of the historical market risk premium  
 16 because it does not reflect the inverse relationship between interest rates and the equity  
 17 risk premium. That is, when interest rates decrease, the equity risk premium increases,  
 18 and the average bond yields that prevailed during the historic period are well below those  
 19 prevailing today. Both of these adjustments are essential to meet the test of a forward  
 20 looking cost of capital.