Consumers Council of Canada and the Vulnerable Energy Consumers Coalition (CCC) and (VECC) INTERROGATORY #22 List 1

Interrogatory

Ref: B1/T3/S1 p. 53

Issue 4.0
Issue: Cost of Capital/Capital Structure

Topic: Market risk premium

Request:

Ms. McShane is recommending an ROE of 10.5% for the low risk utility for a utility risk premium of 5.50% over her long Canada yield. With her beta or relative risk coefficient of 0.65-0.70 this implies a market risk premium over 8.0% (using the mid point). Can Ms. McShane provide any recent estimates of the market risk premium in the US or Canada that supports a market risk premium of over 8.0% over long term government bonds.

Response

Ms. McShane is unable to respond to the question as posed since she does not agree with the premise of the question. First, the CAPM or risk-adjusted market risk premium test represents one way of estimating the required return on equity, using a simple model that depends on a single risk factor, beta. Other risk premium methodologies and the DCF test would not necessarily produce results that are consistent with the CAPM results. Consequently, the CAPM results should not be viewed as the yardstick. Second, the risk premium and DCF tests include a financing flexibility adjustment that would need to be excluded for purposes of estimating the corresponding market return. Third, the 10.5% recommended return gives weight to comparable earnings, which is not a market-derived test.