***Consumers Council of Canada and the Vulnerable Energy Consumers Coalition (CCC) and (VECC) INTERROGATORY #14 List 1***

***Interrogatory***

Ref: B1/T3/S1 p. 36

Issue 4.0
Issue: Cost of Capital/Capital Structure

Topic: Comparable Earnings

Request:

With reference to the use of comparable earnings estimates can Ms. McShane indicate the last time a Canadian regulator *specifically* incorporated a comparable earnings estimate into the allowed ROE. Please provide the full documentary support

***Response***

In E.B.R.O. 485 (12/93) for Consumers Gas, the Ontario Energy Board stated,

> "With respect to the results of the equity return tests, the Board notes that the experts reach different conclusions as to the appropriate (in their judgements) return on equity based on their use and various applications of the different tests. Despite the lack of precision as to the ultimate resolution of a fair rate of return on equity based on the results of the various tests, in general the Board finds the analyses helpful. The Board has taken account of the different results of all the tests and the other evidence presented in the proceeding in its deliberations."

In RH-2-92 (2/93) for TransCanada PipeLines the National Energy Board stated,

> "Both the comparable earnings and equity risk premium techniques provided the Board with useful information in its determination of the appropriate rate of return to be allowed on TransCanada's deemed common equity component. However, the Board remains of the view that the results of the risk premium method should be given more weight than those of the comparable earnings method. The Board shares the concerns expressed by all rate of return witnesses as to the usefulness of the DCF test results in this case and has therefore given these little weight."

In E95070 (6/95) for Edmonton Water, the Public Utilities Board of Alberta stated,

> "In arriving at a rate of return on common equity, the Board considers that, for the purposes of this Decision, all three tests of measuring common equity return are relevant. The Board does not agree with the opinion of the witness for the ERWCG, Mr. Kahal, that the comparable earnings test is of little help or relevance to these hearings because it does not attempt to measure the market cost of equity for the companies in the comparison sample. Rather, the Board considers that there is still some merit in the comparable earnings test to the extent that regulation is considered a surrogate for competition and the comparable earnings test attempts to measure the achieved accounting rates of return on common equity of enterprises of similar risk. The Board does, however, recognize that there may well be distortion in the market to book ratios caused by the effects of inflation on retained earnings of companies, notwithstanding their similarity in risk. Similarly, the comparable earnings test may be sensitive to the selection of the business cycle under study. "

However, please see page E-5 to E-8 of Ms. McShane's testimony with respect to the recent conclusions of the BCUC with respect to the usefulness of the comparable earnings test and her response to the issue of whether a market/book ratio adjustment is justified. The relevant pages of the BCUC decision are attached as Attachment A "BCUC TGI TGVI ROE March 2006.pdf."

**IN THE MATTER OF**

**TERASEN GAS INC. AND
TERASEN GAS (VANCOUVER ISLAND) INC.
APPLICATION TO DETERMINE THE APPROPRIATE
RETURN ON EQUITY AND CAPITAL STRUCTURE
AND TO REVIEW AND REVISE THE
AUTOMATIC ADJUSTMENT MECHANISM**

# DECISION

**MARCH 2, 2006**

**Before:**

**R.H. Hobbs, Panel Chair
R.J. Milbourne, Commissioner
A.J. Pullman, Commissioner**

The Commission Panel notes that this issue received some attention during the AEUB generic hearing, but that it was not enough to convince the AEUB to change the 50 basis point flotation cost allowance used in recent decisions (Exhibit A3-1, p. 29).

The Commission Panel tends to agree that it is difficult to rationalize any flotation cost allowance since there was little, if any, evidence placed before it of utilities trading at market to book ratios, which would justify a flotation cost allowance addition to their return on equity. Elsewhere in this decision the Commission Panel addresses market to book ratios and the need to establish a fair rather than lowest possible return. Accordingly, the Commission Panel will not automatically add a 50 basis point surcharge to whatever return it deems appropriate, but will exercise its judgment each time.

#### 6.4.6 DCF Test

The Commission Panel notes that the DCF test is the most widely used test by regulatory bodies in the United States. Of the three methodologies before it, the DCF test is the only one to use current and prospective data to derive its results. The major criticism of the DCF method is that it relies on analysts' forecasts, which may be biased upwards. The Commission Panel does not find Dr. Booth's comments helpful in that his observations mostly cover U.S. technology analysts and the scandal on Wall Street concerning inappropriate analyst behaviour in an investment banking milieu. The Commission Panel finds that Dr. Booth's use of DCF estimates for U.S. Utilities covered by Standard & Poors, which included "multi-utilities" and energy marketing firms, should not be used as representative of U.S. utility returns. The Commission Panel is more persuaded by Ms. McShane's evidence which compares Value Line and I/B/E/S forecasts and finds no upward bias in the latter. Accordingly, the Commission Panel will give weight to Ms. McShane's first DCF Test, which yielded an indicated return of 8.8 percent. The Commission Panel agrees that this is a "bare bones" cost of equity, to which the addition of a "pure" flotation allowance of 25 basis points is required.

#### 6.4.7 Comparable Earnings

Ms. McShane continues her practice of including in her evidence a study of the returns on book equity earned by a sample of low risk Canadian industrials in the period 1993-2004. This would suggest that low risk companies in Canada are earning an average of approximately 13 percent on their book equity.

On cross-examination, Dr. Booth agreed that some of the "problems" with the CE test also appear in the process of setting rates under regulation, notably that both use an accounting rate of return; it is an average, not a marginal, return; it is based on historic book equity; and based on non-inflation adjusted numbers. This leaves

the sample selection itself. The Commission Panel recognizes that the sample selection can lead to very different results, which is why regulatory bodies are reluctant to re-embrace Comparable Earnings.

Dr. Booth reminded the Commission Panel that the last jurisdiction in Canada to use Comparable Earnings used to adjust the results as follows:

> "And Dr. Cannon tended to be the board (sc OEB) witness and he would do comparable earnings with market-to-book adjustments. And stretching my memory, but Ms. McShane I think estimated correctly that you'd look at rates of returns and try to work out what these rates of returns from non-regulated first would be if they had to have a market to book ratio of 1.5 or 1.2, which was sort of the target for regulated firm" (T6: 935).

The Commission Panel believes that there is not enough evidence before it to determine if such an adjustment is merited or how it might be accomplished. The Commission Panel is of the view that for these reasons it can give little or no weight to Ms. McShane's CE test results. However, the Commission Panel is not convinced that the CE methodology has outlived its usefulness, and believes that it may yet play a role in future ROE hearings.

#### 6.4.8 Conclusion

In the Commission Panel's view, the suitable return on equity for a benchmark low-risk utility is 9.145 percent, assuming a 30-year long Canada bond yield of 5.25 percent, for a premium of 3.895 percent.

### 6.5 Impact of the Commission Panel's Determination

#### 6.5.1 Impact on TGI

The Commission Panel determines that TGI is the benchmark low-risk utility. For 2006 TGI's ROE will be 8.80 percent viz 9.145 minus (.75*(5.25-4.79), on an equity component of capital structure of 35 percent, which the Commission Panel earlier determined to be appropriate. Based on Exhibit B-13, the Commission Panel believes the impact on TGI's 2006 revenue requirement will be a net increase of $1.9 million over TGI's approved 2005 revenue requirements, as follows:

| | **$ million** |
|---|---|
| Increase in capital structure to 35% | 4.742 |
| Decrease in ROE to 8.80% from 9.03% | (2.842) |
| | 1.900 |