Consumers Council of Canada and the Vulnerable Energy Consumers Coalition (CCC) and (VECC) INTERROGATORY #21 List 1

Interrogatory

Ref: B1/T3/S1 p. 48

Issue 4.0
Issue: Cost of Capital/Capital Structure

Topic: utility risk premiums

Request:

a) Can Ms McShane confirm that if the allowed ROE has been consistently set too high and not been downwardly adjusted to reflect lower interest rates, then this could explain why utility prices and realized returns have been higher than expected in the same way that bond returns have been higher than expected?

b) Would Ms. McShane agree that looking at realized returns from utility stocks can be seen as circular reasoning and not reflecting risk but simply regulatory lag in failing to adequately adjust allowed ROEs. If not why not?

c) Can Ms. McShane please indicate any Canadian regulator that has specifically accepted looking at the realized return performance of Canadian utilities as a proxy for their risk and the required level of ROE.

Response

a) It is a theoretical possibility. If it were true, it would mean that regulators in both Canada and the U.S. have consistently over-estimated a fair and reasonable return on average over the entire period for which the returns were estimated (1947/1956-2005).

b) See responses to a) and c).

c) Ms. McShane is not aware of any decisions that have explicitly given weight to the historic risk premiums. However, it is appropriate for regulators to do so. Achieved market returns generally may differ from what investors had expected. More stable sectors of the market are more likely to have actual returns that are closer to what investors had expected. As utilities are relatively low risk equity investments, the expected and actual returns are more likely to converge over the

long-run than those of more volatile sectors, and thus provide a better estimate of the expected utility risk premium than a CAPM or CAPM-like risk premium test.