Consumers Council of Canada and the Vulnerable Energy Consumers Coalition (CCC) and (VECC) INTERROGATORY #26 List 1

Interrogatory

Ref: B1/T3/S1 p. 56

Issue 4.0
Issue: Cost of Capital/Capital Structure

Topic: Book Values

Request:

Can Ms. McShane confirm

1. that the use of an historic based book value for regulation means that the ROE should be a nominal ROE and that all of the investors' return should come through the ROE and not a capital gain similar to an investor holding a nominal bond to maturity.

2. that if a utility investor also earns a capital gain through a revision to the value of the rate base to reflect current replacement cost then the correct allowed ROE should then be the real ROE and *not* the nominal ROE.

3. that earning a nominal rate of return on an inflation protected rate base means double counting the effects of inflation and allowing an excessive ROE.

4. that non-utility investors can earn a capital gain on the increase in the value of the underlying assets, which means that comparable earnings estimates comparing competitive firm's ROE's with those of utilities are automatically biased high.

Response

1. Ms. McShane agrees that the use of a historic book value means that the ROE to be applied is a nominal ROE. She does not agree, however, with the implication that the equity of public utilities should be treated as if equivalent to fixed income securities.

2. Ms. McShane is not suggesting that the rate base should be restated at replacement cost. The point is that the objective of competition is to emulate competition, and that under competition, there is no reason to conclude that market value should equal book value, but rather that in equilibrium, market value

should be equal to replacement cost. The return that is estimated by reference to market-based tests (risk premium and discounted cash flow tests) is the return that investors expect on the market value, and that return is a nominal return.

3. All other things equal, application of a nominal return to an original cost rate base (with original cost straight-line depreciation) will produce the same net present value of cash flows as the application of a real return to an inflation-protected rate base and inflation-protected recovery of capital (depreciation expense).

4. Ms. McShane does not agree with the premise of the question. If the objective of regulation is to emulate competition, and unregulated companies are able to maintain market values in excess of book value, regulation should not preclude utilities from achieving a commensurate degree of financial integrity.