Consumers Council of Canada and the Vulnerable Energy Consumers Coalition (CCC) and (VECC) INTERROGATORY #25 List 1

Interrogatory

Ref: B1/T3/S1 p. 53

Issue 4.0
Issue: Cost of Capital/Capital Structure

Topic: DCF Estimates

Request:

a) Please confirm that in her two stage growth models Ms. McShane assumes that dividend growth continues at the long run GDP growth rate.

b) Please provide a regression estimate for each utility in her sample of the actual growth rate of the dividend regressed against that of GDP. Is the coefficient of this regression 1.0 as assumed in a) above?

c) Will Ms. McShane agree that the two stage growth model is normally implemented with long run GDP growth as the second stage growth rate for estimates of the market as a whole, rather than any sub-sector such as utilities?

d) Will Ms. McShane agree that on average utilities have higher dividend yields than the market as a whole and her procedure will, all else constant, lead to a higher equity cost for the market as a whole than for utilities? Does she believe that such a conclusion is valid?

Response

a) It is confirmed.

b) Ms. McShane has not compiled the dividend data to do this analysis; however, she would expect the dividend growth over the period in question to be lower than the GDP growth for the same reason as provided in response to J.1.128 with respect to earnings growth. She would not expect the coefficient of a regression to be 1.0 in any event, since annual GDP growth would be more variable than annual dividend growth.

c) No. For example, FERC relies on GDP growth to estimate expected long-term growth in its standard DCF models for gas and oil pipelines. The development of

their model was in part validated by the valuation practices of Merrill Lynch and Prudential Securities who relied on the growth in the economy as a long-term growth figure for all firms, including regulated firms.

d) Yes. If the model were applied precisely as applied to the utilities, the result would be a higher cost of equity for the utilities. It is perhaps obvious that the results for the market are dependent on how long investors expect the growth as forecast by analysts to persist, and whether there are any interim periods of declining growth (to the level of the economy) that need to be taken into account in the model.