BRITISH COLUMBIA UTILITIES COMMISSION

IN THE MATTER OF THE UTILITIES COMMISSION ACT
R.S.B.C. 1996, CHAPTER 473

And

Re: British Columbia Utilities Commission
Project No. 3698659/G-20-12

Generic Cost of Capital Proceeding

Vancouver, B.C.
December 14, 2012

PROCEEDINGS

BEFORE:

D. Cote,	**Panel Chair / Commissioner**
M. Harle,	**Commissioner**
L. O'Hara,	**Commissioner**
R. Giammarino	**Commissioner**

VOLUME 4

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R.B. WALLACE, Q.C.	Association of Major Power Customers of B.C. (AMPC)
C. WEAFER & D. CRAIG	Commercial Energy Consumers of British Columbia

œERRATA

Volume 2, December 12, 2012

Index of Exhibit, B1-37	"Undertaking No. 1" should be "Undertaking No. 2"
Page 120, Line 23	"stating" should be "starting"
Page 132, Line 24	"customer is" should be "customer sees is"
Page 175, Line 6	"undertaking" should be "undertaken"
Page 177, Line 22	"different" should be "difference"
Page 213, Line 9	"of" should be "or"
Page 234, Line 20	"equally" should be "equal"
Page 239, Line 13	"depending on the" should be "depending on what the"
Page 243, Line 1	"produced" should be "reduced"
Page 244, Line 16	"it" should be "in" "grade" should be "trade"
Page 250, Line 16	"AEM" should be "AAM"
Page 257, Line 24	"this machine" should be "Ms. McShane"
Page 290, Line 9	"on" should be "Min"
Page 299, Line 13	"MICRA" should be "MCRA"
Page 299, Line 14	"SECRA" should be "CCRA"

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CAARS

VANCOUVER, B.C.

December 14th, 2012

(PROCEEDINGS RESUMING AT 8:35 A.M.)

THE CHAIRPERSON: Please be seated.

FBCU - PANEL 2, EXPERT OPINION ON BENCHMARK FAIR RETURN:

KATHLEEN McSHANE, Resumed:

THE CHAIRPERSON: Good morning.

MR. GHIKAS: Good morning, Mr. Chairman, Commissioners. I just have a few -- two subject-to-checks that Ms. McShane took yesterday from Mr. Wallace, and she's prepared to speak to those now. So, I will deal with those. If you have your Volume 3 from yesterday, at page 429 is the first one.

And specifically at line 19, Mr. Wallace and Ms. McShane were having an exchange on the capital structure of ATCO Gas and how it had evolved over time. And if -- it starts at line 19. And Mr. Wallace was asking, with respect to 2004 and 2009, and over on the following page Ms. McShane indicated that she didn't recall the 2004 change.

Ms. McShane, could you just outline briefly your understanding of how the capital structure of ATCO Gas evolved?

MS. McSHANE: A: Yes. I went back and I looked at the decisions, and ATCO Gas's common equity ratio was 37

1 percent from at least 2000 until the first generic
2 proceeding and decision in 2004. In 2004, the
3 predecessor to the Alberta Utilities Commission raised
4 the common equity ratio for ATCO Gas to 38 percent.
5 And then in the generic proceeding that had the
6 decision in 2009, they raised it to 39 percent for
7 2008/09 and '10, and then they confirmed it in the
8 2011 decision at 39 percent.
9 MR. GHIKAS: Thank you, Ms. McShane. And if you can go,
10 then, to page 434, please. And just actually starting
11 on the previous page, 433, Mr. Wallace asked at line
12 23 in 2009 in Ontario, both Union Gas and EGDI had
13 their 36 percent common equity ratios maintained, and
14 you indicated over on the following page at line 2
15 that there wasn't a case on equity ratio for the gas
16 utilities in Ontario in 2009. And so on there.
17 Can you please clarify your understanding
18 of what was on the agenda in the 2009 -- sorry, with
19 respect to the capital structure of EGDI?
20 MS. McSHANE: A: The 2009 proceeding was what the
21 Ontario Energy Board referred to as a consultative
22 process. And out of which they issued a cost of
23 capital policy report. On the issues list was the
24 question, are the capital structures appropriate? But
25 -- and there was some evidence filed as to capital
26 structure for the gas distribution utilities. But the

1 OEB's decision stated that the capital structure was
2 not a focus of that proceeding, and determined that
3 its policy as regards the capital structures of the
4 gas utilities would continue, and that is that the
5 capital structures would be dealt with on a case-by-
6 case basis.
7 MR. GHIKAS: Okay. At line 9, Mr. Wallace asked you --
8 my understanding is that on the issues list at that
9 time there was evidence tendered but that there was no
10 change made with respect to the 36 percent. So can
11 you just -- you indicated you would check that. Was
12 there a change made with respect to the capital
13 structure?
14 MS. McSHANE: A: No, there was no change made. But
15 there is absolutely no reference to capital structure
16 in the policy -- cost of capital policy report at all.
17 MR. GHIKAS: Thank you. Thanks, Ms. McShane. Thank you,
18 Mr. Chairman.
19 THE CHAIRPERSON: Thank you.
20 **Proceeding Time 8:40 a.m. T2**
21 **CROSS-EXAMINATION BY MR. WALLACE (Continued):**
22 MR. WALLACE: Q: Ms. McShane, I just want to go back to
23 one of the documents we were discussing yesterday, and
24 it's with respect to standard deviations and we were
25 looking at Schedule 11 and when we went through that I
26 think you confirmed for me that you estimate that the

1 -- I'd better use the right words. That when you
2 estimated the standard deviation for your utilities,
3 you estimated at 4.07 percent, which was 65 percent of
4 the average of all TSX subsectors, or 72 percent of
5 the median?
6 MS. McSHANE: A: That's right.
7 MR. WALLACE: Q: And I went on to ask you that last
8 year before the Alberta Commission you were asked to
9 measure the riskiness of the Long Canada Bond relative
10 to the Canadian market in an Information Request CAPP
11 McShane ROE 17(d), and do you recall our discussion
12 there?
13 MS. McSHANE: A: I do.
14 MR. WALLACE: Q: And at that point I asked you if your
15 estimate was that the risk, the Long Canada Bond was
16 35 to 38 percent as risky as the TSX?
17 MS. McSHANE: A: You did ask me that, yes.
18 MR. WALLACE: Q: And you at that point said you'd like
19 to see the IR response. I gather you've now had an
20 opportunity to see that response?
21 MS. McSHANE: A: I have.
22 MR. WALLACE: Q: And do you agree that your estimate of
23 the Long Canada Bond was 35 to 38 percent as risky as
24 the TSX?
25 MS. McSHANE: A: What the response to the question was
26 was that the relative risk factor for government bonds

is in the approximate range of 0.1 of bond income returns over the periods for which the data were provided, and 0.4 which was the relative standard deviation of bond total returns. So the two, if -- you had passed out a -- I don't know if we could look at this piece of paper that you had provided me this morning, it might be clearer.

MR. WALLACE: Q: Okay, then I think I should make it available to everybody in the room.

Mr. Chairman, I think this should probably be marked as an exhibit. It, I'm told, would be Exhibit C6-18.

THE HEARING OFFICER: C6-18.

(DOCUMENT "AUC 2011 GCOC IR RESPONSES - CAPP-MCSHANE-ROE ATTACH 17(d)(2).XIX, 1 OF 1", MARKED EXHIBIT C6-18)

MR. WALLACE: Q: Okay, Ms. McShane, you were going to point out something here.

MS. McSHANE: A: So on this table, which was an attachment to an information request which I was asked to look at the Long Canada Bond in the same fashion as I had looked at the utility market returns, I looked at the standard deviation of the bond income return as a percent of the ten sector indices, and you can see over to the very right column, just in the section at the bottom of the table, ratios of standard deviations

for the bond income return, the ratio of standard deviations was approximately .1. And then when it was done using the total return it was approximately, as you said, .38 to .41.

MR. WALLACE: Q: All right. And isn't that the appropriate return to use, the 38 -- or the appropriate measure of riskiness over the long term?

MS. McSHANE: A: Not within the context of the capital asset pricing model where we're trying to see what the premium over the risk-free rate is, and so that the bond income return is the more appropriate measure of the risk-free rate.

Proceeding Time 8:46 a.m. T3

MR. WALLACE: Q: Well, I'm sorry, but you were asked, I think you said, to calculate the riskiness of the long-term Canada Bond as total return as a comparison to the TSX over -- in the same manner that you had calculated it in Schedule 11 with respect to the sub-indices for the utilities.

MS. McSHANE: A: The question was, can I provide the same exact data for the return on the Long Canada Bond and similarly calculate the ratio to the mean in the median, which I did because that was what was asked of me. And I also provided it on an income return basis.

MR. WALLACE: Q: Fair enough, but can we conclude that incrementally over the Long Canada Bond, the increased

1 risk involved in investing in the utilities is going
2 from the 35 to 38 percent of the TSX to the 65 to 72
3 percent of the TSX that we discussed yesterday?
4 MS. McSHANE: A: Well, I guess it depends what they're
5 trying to measure. What I was trying to do initially
6 was to develop a relative risk adjustment in the
7 context of the capital asset pricing model which looks
8 at the premium over a risk-free rate, and so I was
9 using the bond income return as the best measure of a
10 risk-free rate. So in that context, if one were going
11 to do this type of calculation, it should be done on
12 the basis of the income return.
13 MR. WALLACE: Q: I suggest to you that surely, and we
14 went through it yesterday and I won't go through it
15 again, but that the Long Canadas is not a risk-free
16 rate, and you agreed with that.
17 MS. McSHANE: A: I agreed that it's not a risk-free
18 rate. But the objective is in the CAPM to develop a
19 premium in relation to a risk-free rate. So therefore
20 you would need to come up with the best measure of the
21 risk-free rate.
22 MR. WALLACE: Q: And isn't the best measure of the
23 risk-free -- or the increased risk the difference
24 between the risk level of the Long Canadas and the
25 risk level of the Utilities Index?
26 MS. McSHANE: A: It depends what you're trying to

measure. If you're trying to measure the incremental risk over the Government of Canada Bond as opposed to a notional risk-free rate, then yes, I agree with you.

MR. WALLACE: Q: And you would agree with me then that incrementally we have an increase in utility risk of about 30 to 34 percent of the TSX when we see the TSX ratio go from the 35-38 -- nobody's going to understand that. I think I'll leave it where I am. I think we understand the numbers. Thank you.

I'd like to then turn back to DCF estimates, and yesterday we discussed them at some point. I'd like you now to turn to page -- well, and yesterday I think you pointed out to me that you used two methods for estimating growth. One is of analysts' forecasts and the other is a sustainable growth method?

MS. McSHANE: A: I don't think we started that discussion.

MR. WALLACE: Q: Okay. I thought we had got to the point that we agreed there were two methods, but we hadn't gone further. I'm not following up in the sense that I'm going on a separate branch of DCF than what I did yesterday.

MS. McSHANE: A: Oh, well, what we started -- what I thought we were talking about yesterday was the fact that I have a discounted cash flow based risk premium

1 test which we discussed. And then in addition to that
2 I have discounted cash flow tests.
3 **Proceeding Time 8:51 a.m. T04**
4 MR. WALLACE: Q: Okay. And we'll go to your DCF test
5 now, then. I think that's right.
6 MS. McSHANE: A: Okay.
7 MR. WALLACE: Q: Thank you for the clarification. And
8 your DCF estimates involve directly taking the
9 expected dividend yield and then adding growth? And
10 you used two methods for estimating growth. One is
11 the use of analyst forecasts, and the other is the
12 sustainable growth method that Dr. Booth also uses in
13 his Appendix D.
14 MS. McSHANE: A: I have three different approaches.
15 One is to use analysts' earnings growth forecasts.
16 One is to use estimated sustainable growth, and the
17 third is a three-stage model which incorporates
18 analyst growth rates and a long-term estimate of
19 growth based on long-term -- forecast long-term GDP
20 growth.
21 MR. WALLACE: Q: Okay. Can we turn to page 113 of your
22 evidence, please?
23 MS. McSHANE: A: I have that.
24 MR. WALLACE: Q: And you use analysts' growth forecasts
25 to provide a DCF estimate of 9.3 percent?
26 MS. McSHANE: A: For the U.S. utility sample, yes.

1 MR. WALLACE: Q: But that's Table 30 on page 113.
2 MS. McSHANE: A: That's correct.
3 MR. WALLACE: Q: Thank you. And that -- that assumes
4 the analyst's growth goes on forever, whereas the
5 three-stage model assumes that it gradually reduces to
6 that of the GDP.
7 MS. McSHANE: A: That's correct.
8 MR. WALLACE: Q: And that's why the three-stage
9 estimate is slightly lower at 9.2 percent.
10 MS. McSHANE: A: Because the GDP growth rate was
11 slightly lower than the average of the analysts'
12 forecasts, correct.
13 MR. WALLACE: Q: And the sustainable growth forecast
14 assumes reinvestment of retained earnings at the
15 forecast ROE plus an amount that comes out about by
16 selling stock at a market-to-book ratio over 1?
17 MS. McSHANE: A: That's right.
18 MR. WALLACE: Q: And if the utility traded at a market
19 to book of 1, this latter amount would not exist.
20 MS. McSHANE: A: That's true.
21 MR. WALLACE: Q: So if we could turn, then, to Schedule
22 19, where you have the analyst's growth estimates.
23 MS. McSHANE: A: I have that.
24 MR. WALLACE: Q: Thank you. And if we -- I'd like to
25 look at the variability within them. If you look at
26 the first one, AGL Resources Inc., you see that the

growth forecasts range from 4 percent for Bloomberg up to 5.5 percent for Value Line?

MS. McSHANE: A: Correct.

MR. WALLACE: Q: Why is there such a large discrepancy between these estimates?

MS. McSHANE: A: Different number of the analysts. Value Line is a single analyst. The other ones are a number of analysts.

MR. WALLACE: Q: Okay. And if we look at the second company, the range is from 5.8 to 6.2 percent.

MS. McSHANE: A: Yes.

MR. WALLACE: Q: And again, the analysts are very different. If you look for Piedmont, for example, the range is from 2.5 to 5.2 percent.

MS. McSHANE: A: Right. Again, I mean, the Value Line is a single analyst, and the Bloomberg writers and Sachs are the mean of a number of analysts.

MR. WALLACE: Q: Okay. Now, obviously there is a variation of 100 percent there from Value Line to Reuters. Which do you think is correct?

MS. McSHANE: A: Which do I think is correct?

MR. WALLACE: Q: Yeah.

MS. McSHANE: A: I don’t have a view on which is correct. These are different analysts’ anticipated growth rates, which investors would look at. If I had to say which one would I tend to put more emphasis on,

if -- you know, if I were asked to choose, I would say the ones, you know, the ones that had multiple analysts involved.

MR. WALLACE: Q: Okay. And the result of the variation is significant, if you were calculating the DCF based on one. You could -- for example, on Piedmont, range in a DCF from 6.6 to 9.3.

MS. McSHANE: A: If you just used one of those alone, that's true. You would have variability. That's why we try to use samples, not single companies, because there will be, you know, individual companies that -- where the growth rate doesn't necessarily match the dividend yield.

Proceeding Time 8:56 a.m. T14

MR. WALLACE: Q: Well, given that variability, how is this process any more accurate than using betas?

MS. McSHANE: A: I'm not sure what you mean, how is it any more accurate? I mean it's a different methodology. It gives a different perspective.

MR. WALLACE: Q: And subject to at least the same variability.

MS. McSHANE: A: Do you mean by variability it's subject to similar range of -- I don't know what the word is. I guess you'd think of it in terms of a possible range of estimates from the data that you have. So I mean there is a possible range of estimate

1 that comes out of any test.
2 MR. WALLACE: Q: Okay. In terms of these forecasts do
3 you have any evidence that they're not optimistic
4 forecasts?
5 MS. McSHANE: A: I looked at that for these companies
6 to see whether there is any evidence of optimism, and
7 I concluded that there was not.
8 MR. WALLACE: Q: Okay. Now, before the AUC last year,
9 you were asked in CAPP Information Request McShane ROE
10 21(i) to provide the growth rate in the U.S. GDP and
11 earnings and dividends for your U.S. utilities from
12 1990 to 2010. Do you recall that?
13 MS. McSHANE: A: No.
14 MR. WALLACE: Q: You've seen the response?
15 MS. McSHANE: A: I see a table.
16 MR. WALLACE: Q: Okay.
17 MS. McSHANE: A: I don't have the question.
18 MR. WALLACE: Q: Okay, was the table provided by you?
19 MS. McSHANE: A: It looks like something I would have
20 provided but I don't know what the question was, and
21 so I don't quite have the context.
22 MR. WALLACE: Q: Okay. I would -- what I'd like to go
23 through is ask you the questions with respect to this
24 table, and if you find that's in any way inappropriate
25 when you do see the full question, I would suggest
26 that you can come back and augment it in any way you

see. Would that be appropriate?

MS. McSHANE: A: That's fine.

MR. WALLACE: Okay. I think, Mr. Chairman, I should also distribute that table.

THE CHAIRPERSON: Thank you.

MR. WALLACE: Mr. Bemister seems to disappear every time I have a table. Mr. Chairman, that should be marked as the next exhibit, which I believe is C6-19.

THE CHAIRPERSON: Thank you.

(DOCUMENT "AUC 2011 GCOC IR RESPONSES - CAPP-MCSHANE-ROE ATTACH 21(1).XIS, 1 OF 1", MARKED EXHIBIT C6-19)

MR. WALLACE: Q: Ms. McShane, I understand this table was prepared by you in response to an IR. As I've said, if you find out differently and wish to correct the record later, that is fine.

This table apparently shows your sample. Do you recognize it there for Consolidated Edison and going down from the AUC proceeding?

MS. McSHANE: A: It looks familiar, yes.

MR. WALLACE: Q: Thank you, and it shows the growth in -- or the U.S. GDP over the period 1990 to 2010?

MS. McSHANE: A: I guess that's what's at the bottom.

MR. WALLACE: Q: And it shows that as compound 4.7 and arithmetic 4.8 percent.

MS. McSHANE: A: That's what's on the table, yes.

MR. WALLACE: Q: And at the same time it shows the

earnings of your U.S. utilities grew by 4 percent, and dividends by 2.7 percent?

MS. McSHANE: A: That's what that shows for that period, so you've got the -- in the compound growth rate, for example, it's dependent on the beginning year and the end year.

MR. WALLACE: Q: Yes, I understand that, but this is a 20-year period?

MS. McSHANE: A: Yes.

MR. WALLACE: Q: And so the historic record for your U.S. utilities over that period was that they were not able to grow their dividends anywhere close to the growth rate in the GDP?

Proceeding Time 9:01 a.m. T06

MS. McSHANE: A: No, they hadn't grown their dividends as fast as the GDP. The earnings per share numbers and the book value for share numbers were closer.

MR. WALLACE: Q: Closer but, again, below.

MS. McSHANE: A: Yes, they were slightly below.

MR. WALLACE: Q: And so in your Schedule 19, analysts' forecasts, you have an average growth rate of 4.9 to 5 percent for DCF equity cost at 9.3.

MS. McSHANE: A: I do.

MR. WALLACE: Q: And if instead we use the actual dividend growth rate achieved under similar GDP growth rates, we would use 2.7? And get an equity cost

1 estimate of 7.1 percent?
2 MS. McSHANE: A: I wouldn't do that. I mean, I would
3 use -- I wouldn't use the historic dividend for share
4 growth rate as a measure of investor expectations.
5 MR. WALLACE: Q: Okay. But if you adjust your -- if
6 you were to reduce your investor expectations going
7 forward by the amount it appears they have fallen
8 short of the GDP here, you would be substantially
9 lower.
10 MS. McSHANE: A: If you're talking about just the
11 dividends per share.
12 MR. WALLACE: Q: Well, let's put it simpler. Isn't
13 this evidence that shows that the analysts' estimates
14 are optimistic? That the utilities that you use do
15 not manage to keep up with the GDP over a long period
16 of time?
17 MS. McSHANE: A: They did not over this period, that's
18 true. I mean, and there are good reasons that that
19 wouldn't have been the case, because we did have a
20 decline in interest rates, a very major secular
21 decline, which would have meant that you had declining
22 allowed returns, which would have made it very
23 difficult over this period to have kept up with GDP
24 growth rate, just because of the specific situation.
25 MR. WALLACE: Q: Okay. And the historic record, again,
26 to put it simply, is 2.7 percent growth, and the

1 analysts that you are using are forecasting almost
2 twice as much going forward.
3 MS. McSHANE: A: But those are earnings. Not
4 dividends.
5 MR. WALLACE: Q: Okay, thank you. And we agree that
6 the investors receive the dividends.
7 MS. McSHANE: A: Investors receive the dividends and
8 capital appreciation, which comes from earnings.
9 MR. WALLACE: Q: Okay. During the hearing last year
10 before the Alberta Commission, they came to a
11 conclusion and I wish to put it on this issue, in
12 paragraph 86, if you have that decision.
13 MS. McSHANE: A: I do not.
14 MR. WALLACE: Q: Oh. The 2011 decision? I can --
15 you're familiar with that decision?
16 MS. McSHANE: A: I am.
17 MR. WALLACE: Q: And at paragraph 86 on page 18, if you
18 could turn to that.
19 MS. McSHANE: A: Sorry, what page?
20 MR. WALLACE: Q: It's page 18, paragraph 86.
21 MS. McSHANE: A: Oh, 18. Sorry, I was on page 86. I
22 have that.
23 MR. WALLACE: Q: And in the decision the Commission
24 stated:
25 "In 2009, the Commission expressed concern
26 about potential upward bias in analysts'

1 growth estimates. However, Ms. McShane
2 argued that as long as investors believed
3 the optimistic forecast, they would price
4 the securities lower, resulting in a lower
5 dividend yield, and the DCF test would still
6 be an unbiased estimate of investor-required
7 returns. She indicated that this
8 proposition had been successfully tested and
9 described three tests, including the fact
10 that such growth estimates have averaged
11 less than GDP growth."
12 And that's your position in this proceeding?
13 **Proceeding Time 9:06 a.m. T7**
14 MS. McSHANE: A: That there were three tests and they
15 described one, and the Commission in Alberta said from
16 their perspective that didn't resolve the issue. One
17 of the tests was -- which they didn't refer to here,
18 was the comparison of the analysts' growth rates from
19 sources that some have indicated might have conflict
20 of interest in comparison of those to Value Line, to
21 see whether there was any indication of bias in those.
22 That was the particular test that this Commission
23 looked at last time and was convinced that there was
24 no evidence of analyst bias or optimism.
25 MR. WALLACE: Q: Okay, I understand. Okay, thank you.
26 I'd like to go back. However, I should have broken my

1 question up a little more, I guess. The text of the
2 decision is:
3 "However, Ms. McShane argued that as long as
4 investors believed the optimistic forecasts,
5 they would price the securities lower,
6 resulting in a lower dividend yield and the
7 DCF test would still be an unbiased estimate
8 of investor required returns."
9 I understand that's your evidence in this case also.
10 MS. McSHANE: A: I still hold that position, yes.
11 MR. WALLACE: Q: Okay.
12 MS. McSHANE: A: But that wasn't the basis for my
13 conclusion that they weren't optimistic.
14 MR. WALLACE: Q: And they go on to say:
15 "She indicated that this proposition had
16 been successfully tested and described three
17 tests, including the fact that such growth
18 estimates have averaged less than GDP
19 growth."
20 And that's similar in this case.
21 MS. McSHANE: A: Yes.
22 MR. WALLACE: Q: And then the Commission stated:
23 "In the Commission's view this line of
24 reasoning…"
25 and you went to it,
26 "…does not resolve the issues because there

1 is no evidence that the investors believe
2 optimistic forecasts. Therefore the
3 Commission remains concerned with the
4 potential upward bias in analysts' growth
5 estimates."
6 MS. McSHANE: A: I see that.
7 MR. WALLACE: Q: That was their conclusion after
8 hearing similar evidence.
9 MS. McSHANE: A: Sorry?
10 MR. WALLACE: Q: That was their conclusion after
11 hearing similar evidence.
12 MS. McSHANE: A: That was their conclusion.
13 MR. WALLACE: Q: Thank you.
14 I'd like to turn to just a few loose ends
15 then that I have. We've referred to the 2011 decision
16 and if you keep it handy for a moment. Can you turn
17 to paragraph 63 on page 13 and we're looking there at
18 what the Commission had to say about the CAPM
19 methodology?
20 MS. McSHANE: A: I see that.
21 MR. WALLACE: Q: And the Commission stated:
22 "The utilities also noted that Dr.
23 Fernandez, whose work had been cited by Dr.
24 Booth, had provided evidence that CAPM does
25 not work and had concluded that the
26 historical betas are useless to estimate

1 expected return of companies."
2 And I think you are familiar with that work also?
3 MS. McSHANE: A: I am.
4 MR. WALLACE: Q: And the Commission went on to say:
5 "However, the Commission continues to hold
6 the view that CAPM is a theoretically sound
7 and useful tool, among others, for
8 estimating ROE."
9 So the Commission heard the testimony about
10 the Fernandez article criticizing CAPM, and still went
11 on to give CAPM a sound endorsement.
12 MS. McSHANE: A: They said, as you correctly read, that
13 they held -- continue to hold the view that it's
14 theoretically sound, a theoretically sound and useful
15 tool, among others, for estimating ROE.
16 MR. WALLACE: Q: Thank you.
17 Can I now turn to your schedules, first
18 Schedule 2, page 1, which is entitled Trend and
19 Interest Rates, Dividend Yields, and Out -- I'm having
20 trouble reading the small size here -- Outstanding
21 Bond Yields.
22 MS. McSHANE: A: I have that. Goodness the numbers are
23 small.
24 MR. WALLACE: Q: Okay, Schedule 2, page 1 of 2. And
25 what I'm interested in looking at is the yield data
26 and I'd like to go through the differences between the

U.S. Long Canada yield and the U.S. long treasury yield? Between -- yeah. In June, 2012, we have 250 -- 2.5 percent, I'm sorry, for the Canadas.

Proceeding Time 9:12 a.m. T08

MS. McSHANE: A: Yes.

MR. WALLACE: Q: And 2.99 percent for the U.S.

MS. McSHANE: A: For the 30-year, yes.

MR. WALLACE: Q: And so the Canada is basically 50 basis points lower -- 49 basis points.

MS. McSHANE: A: On the 30-year. On the 10-year, the Canada is slightly higher than the U.S. And on other types of long-term rates, they are very, very similar. A-rated corporates, triple-B rated corporates.

MR. WALLACE: Q: But you use 30 for cost of capital purposes generally?

MS. McSHANE: A: For the CAPM. And for this premium test, yes.

MR. WALLACE: Q: And there is a 50 basis -- 49 basis point difference there.

MS. McSHANE: A: Right. But I don't use the U.S. long-term treasury yield, I use the long Canada.

MR. WALLACE: Q: No, and I think the only point I'm making is that for similar bonds, similar duration, there is a lower yield in Canada than there is in the U.S., in June, 2012.

MS. McSHANE: A: For the 30-year Canada. Not for all

bonds across different types. The triple-B corporates have been approximately the same, the A corporates long-term have been approximately the same.

MR. WALLACE: Q: Okay.

MS. McSHANE: A: Ten years have been -- ten-year Canada has been lower than the U.S.

MR. WALLACE: Q: I understand that. I come back to the fact that we're using 30 years for ROE purposes.

MS. McSHANE: A: For applying a test. Correct.

MR. WALLACE: Q: Yes. And in 2011, the Canadas are 60 basis points lower?

MS. McSHANE: A: The 30-year?

MR. WALLACE: Q: Yes.

MS. McSHANE: A: I think that's probably true.

MR. WALLACE: Q: Okay. And in 2010, I have 47 basis points lower, for 30 years.

MS. McSHANE: A: On the 30 years. Yeah. The ten-years have been pretty much consistently either the same or slightly higher in Canada.

MR. WALLACE: Q: Okay. And in 30 years, for 2009, it's 25 basis points lower.

MS. McSHANE: A: Oh, that could be true.

MR. WALLACE: Q: And when I look at this table, I have to go all the way back to 2004 to get higher rates in Canada on the 30-years.

MS. McSHANE: A: That could be correct.

1 MR. WALLACE: Q: Now, if we check the A utility bonds,
2 which is column 12, between Canada and the U.S., we
3 have -- comparing column 12 to column 9, for June,
4 2012, we have 4.26 in the U.S. and 4.09 in Canada.
5 So, Canada A bonds were -- utility bonds were yielding
6 17 basis points less.
7 MS. McSHANE: A: That looks right.
8 MR. WALLACE: Q: And in 2011 and 2010, the difference
9 was 18 basis points.
10 MS. McSHANE: A: Yes.
11 MR. WALLACE: Q: And in 2009, yields were 11 basis
12 points higher in Canada.
13 MS. McSHANE: A: In Canada?
14 MR. WALLACE: Q: Yes. It reversed there.
15 MS. McSHANE: A: Okay. I see that.
16 MR. WALLACE: Q: 2008, 25 basis points lower in Canada.
17 MS. McSHANE: A: That looks right.
18 MR. WALLACE: Q: And similarly 2007, 54 basis points
19 lower in Canada.
20 MS. McSHANE: A: That looks right.
21 MR. WALLACE: Q: And again, by my calculations, you
22 have to go back to 2003 to get a higher utility A bond
23 yield in Canada before they start to get lower again.
24 MS. McSHANE: A: Yeah. The differences recently
25 haven't been very large.
26 MR. WALLACE: Q: And so my conclusion from this A bond

yield data is that Canadian A-rated utility bonds have consistently sold on lower yields than U.S. A rated utility bonds. That is, the market regards them as lower-risk. Is that right?

Proceeding Time 9:17 a.m. T9

MS. McSHANE: A: I'm not sure you can conclude that, because you do have to look at what the underlying yield is in the country. So if they're being priced off a 30-year U.S. Government Bond, and the long-term U.S. Government Bond is slightly higher than -- you know, that would be taken into account as well. I think you also have to look at the spread between the 30-year Treasury and the A Utility Bond to see whether they are viewed as a lower risk or not.

MR. WALLACE: Q: But the fact is that the investors were satisfied with lower returns on utility bonds in Canada than they were in the U.S.

MS. McSHANE: A: Slightly, yes.

MR. WALLACE: Q: Thank you.

One final area of questions with respect to the automated adjustment mechanism. In 2008, Hydro One requested a fair ROE determined by the Ontario Board, and you -- with an automated adjustment mechanism, and you supported that request?

MS. McSHANE: A: I didn't represent Hydro One in 2008.

MR. WALLACE: Q: Okay, thank you. We appear to be in

1 error there. And in 2007, with Union and EGDI -- or
2 in 2007 Union and EGDI entered into a five-year PBR
3 agreement which you have mentioned previously?
4 MS. McSHANE: A: I believe they did, yes.
5 MR. WALLACE: Q: And that had a -- that was a voluntary
6 settlement?
7 MS. McSHANE: A: Yes, which would have involved a
8 number of factors, including the allowed return.
9 MR. WALLACE: Q: And the allowed return was then based
10 on the Ontario Board's ROE formula?
11 MS. McSHANE: A: I believe that's correct.
12 MR. WALLACE: Q: So companies, in the past at least,
13 have been quite willing to enter into automated
14 adjustment formulas.
15 MS. McSHANE: A: Well, they didn't enter into an
16 automatic adjustment formula. When they entered into
17 the PBR -- except very indirectly, I guess, they
18 accepted in their base rates the ROE that was produced
19 by the formula, and that base ROE stayed in place for
20 the term of the PBR. They also were indirectly
21 subject to the formula over the period of the PBR by
22 virtue of the fact that they had an earning sharing
23 mechanism that was based off of what the automatic
24 adjustment mechanism would have produced in each year.
25 MR. WALLACE: Q: I'm going to go back to my question on
26 Hydro One that I did -- in 2008 did Ontario Power

1 Generation request a fair return on equity determined
2 by the OEB ROE formula?
3 MS. McSHANE: A: No. They requested a fair ROE based
4 on evidence supporting that. They didn't ask for the
5 ROE produced by the formula. I've forgotten what the
6 requested ROE was, but it was something significantly
7 higher than what underpin the formula results. But
8 they did request that then the board apply the formula
9 to their requested return.
10 MR. WALLACE: Q: Okay, I think that's the key element
11 and thank you again for your precision. They did
12 request a fair ROE and they did request that the
13 formula be applied going forward.
14 MS. McSHANE: A: Correct.
15 MR. WALLACE: Q: And you testified on their behalf at
16 that time?
17 MS. McSHANE: A: I did, for Ontario Power Generation,
18 correct.
19 MR. WALLACE: Q: Yes. And your supported Ontario Power
20 Generation in that request?
21 MS. McSHANE: A: I did.
22 MR. WALLACE: Q: Thank you.
23 That completes my questions for this panel.
24 Thank you. Thank you, Ms. McShane.
25 THE CHAIRPERSON: Thank you, Mr. Wallace.
26 MR. WALLACE: Actually I should be careful. That

1 completes my non-confidential questions.
2 THE CHAIRPERSON: I understand, yes.
3 MR. FULTON: British Columbia Pensioners' and Seniors'
4 Organization.
5 THE CHAIRPERSON: Thank you.
6 **CROSS-EXAMINATION BY MS. WORTH:**
7 MS. WORTH: Q: Good morning, Mr. Chair, members of the
8 Panel, Ms. McShane.
9 MS. McSHANE: A: Good morning.
10 **Proceeding Time 9:22 a.m. T10**
11 MS. WORTH: A: I'm sure it comes as no surprise that
12 the volume of my cross-examination is going to be
13 somewhat less than Mr. Wallace, and actually far less
14 than I had originally planned. Mr. Wallace has amply
15 covered a lot of the areas I was intending to, so I
16 will be rather brief this morning.
17 I'd like to just begin by asking for a
18 clarification. When I was reading through your
19 evidence and the IRs, I didn't see an overt statement
20 indicating whether you were considering FEI as a pure-
21 play gas distribution utility. Would you mind putting
22 that on the record right now?
23 MS. McSHANE: A: Well, I would consider FEI to be, for
24 all intents and purposes, a pure-play gas utility. I
25 think the company on Wednesday very comprehensively
26 described their operations. For my purposes, what

we're trying to do is to set the return that applies to gas distribution operations. And that is what FEI is, a gas distributor.

MS. WORTH: Q: Okay. So, all of the considerations that went into the evidence that you put forward regarding the appropriate capital structure and the ROE was based on your assumption, and your reliance upon, FEI's pure-play gas distribution utility activities. Is that correct?

MS. McSHANE: A: That's correct.

MS. WORTH: Q: Okay. Can you explain, then, why on page 55 of your evidence you refer to FEI activities focusing on new initiatives, subject to regulatory oversight entailing more frequent, protracted, and contentious proceedings as a regulatory risk?

MS. McSHANE: A: I think -- I tried to clarify what I had in mind in response to BCUC IR 45. Yes, which would be B1-20. And the response to that question -- sorry? Oh, it's number 45, and it's page 105 in B1-20.

And my real objective was to indicate that there is a higher uncertainty because of the effective energy policies, and that FEI's initiatives are being developed to address its declines in throughput in its distribution business. Which those efforts are in large part driven by the effects of energy policy.

1 And those areas where there is increasing complexity
2 and uncertainty in the regulatory environment.
3 MS. WORTH: Q: Okay. Now, on Wednesday there was an
4 exchange between Mr. Dall'Antonia and Mr. Hobbs, where
5 Mr. Dall'Antonia confirmed that the utilities'
6 evidence in Appendix H, in regards to regulatory risk,
7 and in particular Mr. Dall'Antonia said that the
8 greatest one that they faced, greater than supply,
9 price, or volatility on the gas supply side, was
10 regulatory risk. Do you agree with that?
11 MS. McSHANE: A: Well, I think what he was trying to
12 say is that when you look at a regulated business, it
13 truly is regulation that has the ability to either
14 mitigate or enhance the fundamental risks that the
15 utility faces. So, I agree with him that the
16 regulatory framework and regulatory risk is the most
17 important for a regulated company.
18 **Proceeding Time 9:27 a.m. T11**
19 MS. WORTH: Q: Okay. More specifically, Mr.
20 Dall'Antonia went on to say that the regulator can
21 have the single biggest impact by denying a fair
22 return. And I gather that's what you're indicating in
23 your response to my last question.
24 MS. McSHANE: A: Well, not specifically. I mean,
25 that's certainly an element of it. Maybe he meant it
26 in the broader sense, and I just don't recall, of the

Commission regulator being able to take decisions that would make it more difficult for a utility to earn a reasonable return, rather than the Commission actually being able to set a return that's lower than fair. But in the broadest sense, I would agree that a regulator does have the -- has the most influence, I guess, on the utility's ability to earn a fair return and achieve the return of capital.

MS. WORTH: Q: So during that exchange between Mr. Hobbs and Mr. Dall'Antonia, Mr. Dall'Antonia actually said that part of his assessment of the risk associated with regulation was that the utility could go believing that the fair return is a 10 percent ROE and a decision could come back at 6. So, you don't see as a material risk in a utility operating and it's something that needs to be taken into consideration when structuring their capital and their ROE?

In other words, you don't see that there is a significant risk that a regulator would come back with a decision that was so significantly disconnected from what was the fair ROE in the utility's assessment.

MS. McSHANE: A: Well, what -- obviously there are degrees, right? I would say that there is some risk that the regulator will allow a return that's lower than fair. I mean, I think the risk that there will

be a disconnect of the size that you mentioned is probably relatively small. But I think it's broader than just saying that there is a risk that the -- you know, the company believes it should be 10 percent, and the Commission or the regulator comes back and says it should be 6. I mean, I think it's something that in terms of regulatory risk, it's what decisions are taken that either enhance or make it more difficult for a utility to earn a return that's fair and reasonable. And to be able to recover their capital.

MS. WORTH: Q: So it's your evidence that there is actually no significant risk that this or another BCUC panel will refuse to approve a fair and reasonable return for Fortis. Is that correct?

MS. McSHANE: A: I always proceed on the assumption that I -- you would expect the regulator to approve what's fair and reasonable. There is risk that the return will be lower than either -- than investors expect.

MS. WORTH: Q: Okay. The response to Exhibit B1-10, BCPSO IR 1.9.1, indicates your evidence that the potential customer switching to electricity poses a business risk for Fortis's electricity distribution utility as well as its natural gas distribution utility. Is that your recollection of your answer in

that IR?

MS. McSHANE: A: Sorry, could you repeat the question? I was just re-reading my response.

Proceeding Time 9:32 a.m. T12

MS. WORTH: Q: Certainly. Basically it's whether your evidence is that a switch of natural gas customers to electricity poses a risk for both Fortis Gas as well as Fortis Electricity as utilities. It's my understanding that your answer in BCPSO IR 1.9.1 indicates that there is a business risk for Fortis's electricity distribution utility as well as for the gas.

MS. McSHANE: A: I'm having trouble seeing where we're talking about -- so the answer is talking about the risks of FortisBC Electric due to smaller size in ownership of electric generation assets, and the fact that if customers switch to electricity that can create challenges for the utility which, because they have to add more generation capacity or acquire capacity.

MS. WORTH: Q: Okay. That's a very helpful clarification. Thank you.

Okay, thank you, those are my questions.

THE CHAIRPERSON: Thank you.

MR. FULTON: Industrial Customers Group.

CROSS-EXAMINATION BY MR. HOBBS:

MR. HOBBS: Q: Mr. Chair, Commissioners, Ms. McShane, good morning.

MS. McSHANE: A: Good morning.

MR. HOBBS: Q: Ms. McShane, I would like to start by referring you to Dr. Safir's evidence, which is Exhibit C4-9, and I'll also take you to your evidence, A1-9-6, tab F of page 82.

COMMISSIONER GIAMMARINO: To Ms. McShane's -- could you repeat the reference?

MR. HOBBS: Q: Yes. To Ms. McShane's evidence. It's page 82. I'll be getting there in a moment. I just thought I would bring that to your attention.

COMMISSIONER HARLE: What page for Safir?

MR. HOBBS: Page 12. It's Table 1 on page 12. Thank you.

Q: I'd like to begin, Ms. McShane, by perhaps stating the obvious and that is to identify the differences, the key differences between your evidence and Dr. Safir's evidence with respect to the CAPM results. Would it be reasonable for me to conclude that the key differences are the market risk premium and the adjusted beta?

MS. McSHANE: A: Yes.

Proceeding Time 9:38 a.m. T13

MR. HOBBS: Q: Thank you. With respect to the risk-free rate, you're using 4 percent and Dr. Safir is

using 4 percent. And my question to you is, have you had an opportunity to review how Dr. Safir concluded the risk free rate was 4 and if so, whether or not you agreed with his conclusion, or his reasons rather than his conclusion. And I can take you to that, where he provides his opinion in that regard if that's helpful, and it's in yet another exhibit. It's Exhibit C4-11 and it's IR 4.1 on page 5. I'll give you a moment to read that response, Ms. McShane, if you need to, to answer my question.

And I must say I'm really just interested in your opinion with respect to the portion of the answer that appears above Figure 1. However, the balance of it may be useful for you too, so don't let me curtail your reading.

MS. McSHANE: A: So what I understand he's basically done is used what appears to be a forecast 30-year Canada for the next five years based on data he got from the Canadian Department of Finance in October 2012. I mean, my estimate was based on three years, his was based on five, slightly different sources, but it's not inconsistent. It's not an inconsistent approach.

MR. HOBBS: Q: Thank you. And just then to make sure the record is clear, you agree with his use of the five-year period and his reasons for doing so because

that takes us beyond the quantitative easing period.

MS. McSHANE: A: Well, yeah, my understanding is he's basically saying that long-term Government Bond yields today are well below what you'd consider to be normal levels.

MR. HOBBS: Q: So you make an adjustment.

MS. McSHANE: A: Well, I can make an adjustment. I guess Dr. Booth has done. He's made several adjustments to his CAPM, or you can base your CAPM on a longer-term forecast of long-term Canada Bonds.

MR. HOBBS: Q: I had some difficulty in understanding how you arrived at the 4 percent, and it's in your evidence on page 77. Mr. Fulton has already flagged this footnote during the cross-examination of the first panel. It would appear that your 4 percent that you're using for the three-year period 2013 to 2015 is based on a 2013 number of 3.2, 2014 of 4, and 2015 of 4.6. Can you tell me how you calculated the 4 percent, or is it a calculated number?

MS. McSHANE: A: It is a calculated number.

MR. HOBBS: Q: Can you provide the calculation?

Proceeding Time 9:27 a.m. T14

MS. McSHANE: A: You want me to tell you how I did it? Or would you prefer that I provided you a piece of paper with it written out? I could explain it to you.

MR. HOBBS: Q: Which would you prefer?

1 MS. McSHANE: A: It's your question.
2 MR. HOBBS: Q: I'm giving you the option as to how
3 you're answering this question.
4 MS. McSHANE: A: Well, you --
5 MR. HOBBS: Q: My question is going to stand, I can
6 indicate a preference, but why don't you choose?
7 What's your preference?
8 MS. McSHANE: A: I'll write it out for you.
9 **Information Request**
10 MR. HOBBS: Q: Okay. That would be fine.
11 Now, I'd like to turn to the question of
12 the market risk premium. And in order to do this, you
13 know, I tried to avoid some flipping around, and I see
14 I haven't been able to manage that. But I'm back at
15 page 82 in your evidence, Ms. McShane.
16 Am I correct that Table 12 is the essence
17 of your conclusion that at different risk-free rates,
18 you need to use a different market risk premium?
19 MS. McSHANE: A: I don't know that I would say it's the
20 essence. But this table is the basis for the specific
21 choice of risk premium at a given interest rate. I
22 mean, the need to take into account the level of
23 interest rate when determining the risk premium is
24 based on -- the general proposition is based on
25 broader considerations than this, but the specific
26 data are essentially captured in this table.

1 MR. HOBBS: Q: All right. And the broader propositions
2 are, if you will, reflected in the data.
3 MS. McSHANE: A: The specific numbers.
4 MR. HOBBS: Q: The specific numbers.
5 MS. McSHANE: A: Yes.
6 MR. HOBBS: Q: All right. This table is cumulative in
7 the sense that you looked at the observation points
8 below 4 percent, then below 5, through to 9.
9 MS. McSHANE: A: That's right.
10 MR. HOBBS: Q: All right. If you were to group them,
11 so establish a group zero to four, four to six, et
12 cetera, would you expect to see different results?
13 MS. McSHANE: A: You might, yes.
14 MR. HOBBS: Q: All right.
15 MS. McSHANE: A: Because you will have variability
16 within the groups. I wouldn't expect it would be
17 quite as -- the word "need" isn't probably the right
18 word, but I think you would see a lot more variability
19 because you've got fewer observations in each sub-
20 group.
21 MR. HOBBS: Q: Has that analysis been something that
22 you've done?
23 MS. McSHANE: A: I may have that somewhere.
24 MR. HOBBS: All right. I'm going to propose to you
25 groupings for you to do that for me. For Canada, I
26 would like you to group at 0 to 4 -- I'll put these on

the record, and actually I don't think anybody needs to write them down.

MS. McSHANE: A: Okay.

MR. HOBBS: Q: 0 to 4, 4 to 8, 8 to 12, 12 to 16, and above 16. And for the U.S., 2 to 4, 4 to 6, 6 to 8, 8 to 10, and greater than 10.

Is that something that you can do for me?

MS. McSHANE: A: I can. I'm just curious why they're different for the two countries.

MR. HOBBS: Q: I'll leave the option open to you. I would like those results.

MS. McSHANE: A: Okay.

MR. HOBBS: Q: But I'll leave the option to you to put it -- an additional -- I'd like it in the table format that you've presented on Table 12, and then Table 15, which is the same format. But give you the option in your answer to choose different groupings, if you wish.

MS. McSHANE: A: Okay, thank you.

Information Request

Proceeding Time 9:48 a.m. T15

MR. HOBBS: Q: Now, if I turn to -- I want to find your rebuttal evidence, which is B1-32, page 10, and I'm interested in the Q&A that appears from lines 242 to 258.

MS. McSHANE: A: I have that.

1 MR. HOBBS: Q: And is it correct to say that that's
2 your theoretical basis, sort of these other
3 propositions, if you will, that you mentioned earlier,
4 to support your conclusion that market risk premiums
5 need to change before bond income returns?
6 MS. McSHANE: A: Well, that's certainly one basis for
7 it, yes.
8 MR. HOBBS: Q: That's one of the propositions.
9 MS. McSHANE: A: Right, because Dr. Safir said that
10 there was no theoretical basis for it, as I recall.
11 MR. HOBBS: Q: Right. In that regard, your answer,
12 does it assume that bond holders will hold to
13 maturity? And I think you've said that at line 250.
14 MS. McSHANE: A: In this particular case, yes.
15 MR. HOBBS: Q: Right. But in the market, that's not a
16 reasonable assumption, is it? Bond holders if they
17 see inflation coming, they can quickly -- it's a very
18 liquid market. They can quickly make changes to their
19 portfolio.
20 MS. McSHANE: A: Yes, they can make changes to their
21 portfolio, but -- so if interest rates -- so if
22 inflation is higher than anticipated, and a bond
23 holder -- well, let me back up. So inflation is
24 higher than anticipated. The yield on the bonds in
25 the market is going to go up. If you have of a --
26 holding a bond that has a coupon below the market

yield, you're going to sell it at a capital loss.

MR. HOBBS: Q: Right, and you're going to make that adjustment on a -- as you make decisions with respect to --

MS. McSHANE: A: Right.

MR. HOBBS: Q: -- where inflation is, you're going to make those adjustments.

MS. McSHANE: A: Right. So if you're afraid that inflation is going to be higher than expected from the get-go, you're going to incorporate into the return you require compensation to protect you.

MR. HOBBS: Q: Right. And there are other factors at play here other than inflation. So those decisions that are being made are being made for reasons that may include inflation but may very well include a number of other factors.

MS. McSHANE: A: Are we still talking about bonds specifically?

MR. HOBBS: Q: Yes. Yeah, I'm talking about that. A bond holder who reaches a different conclusion with respect to whether or not to hold -- there are other factors at play other than just inflation in their decision making. Isn't that a reasonable assumption?

MS. McSHANE: A: Well, there are always a multitude of factors and bond holders may sell bonds because they want to reallocate to equities.

MR. HOBBS: Q: Right.

MS. McSHANE: A: But this was all about, and this theoretical basis was all about the relationship between, you know, what determines the riskiness of a bond relative to the riskiness of equities.

MR. HOBBS: Q: Right, and there's more at play than inflation. Your answer focuses on inflation and expected inflation. But there is more at play than just inflation.

Proceeding Time 9:27 a.m. T16

MS. McSHANE: A: I would agree with that. Keeping in mind that we are here talking about -- basically about government bonds. And we're not talking about things like, you know, changes in default risk that would affect corporate bonds. We're simply talking about what can affect government bonds.

MR. HOBBS: Q: Right. Is it also true that, as you say, in some cases equity holders are going to have the opportunity to adjust prices but in other cases they're not?

MS. McSHANE: A: The underlying companies.

MR. HOBBS: Q: Yes.

MS. McSHANE: A: Sometimes they will not have the ability to adjust prices, that's true.

MR. HOBBS: Q: Okay.

MS. McSHANE: A: It depends on the specific

1 circumstances in the economy at the time. But the
2 idea is that the underlying companies, all other
3 things equal, can have -- they have a better potential
4 to adjust the prices for goods and services that they
5 sell and thus, you know, have equities to provide a
6 better hedge against inflation than is available in
7 bonds.
8 MR. HOBBS: Q: All right. Turning to the issue of
9 betas, and I want to do this in the context of a
10 discussion you had with Ms. Worth just moments ago.
11 You spoke to concerns about regulatory risk. Isn't it
12 equally the case that there are significant benefits
13 that flow to a utility from regulation?
14 MS. McSHANE: A: Regulation does protect companies. I
15 don't disagree with that.
16 MR. HOBBS: Q: And because regulation protects
17 companies, isn't it also true that you would not
18 expect betas for utilities to ever trend towards 1?
19 MS. McSHANE: A: To trend towards 1. I guess I don't
20 disagree with that. I never said that they would.
21 MR. HOBBS: Q: All right. You take exception to Dr.
22 Safir's use of the Fernandez study. Because, my
23 understanding is, 85 percent of the people who respond
24 to his requests -- and you'll agree there are a lot of
25 them, I am sure -- 85 percent of them rely on their
26 opinions that they receive from others. Is that

fundamentally your concern with the Fernandez study?

MS. McSHANE: A: Well, the section of my testimony that you're referring to, which is at page 10 of the rebuttal, and I don't know the exhibit number. I apologize.

THE CHAIRPERSON: B1-36.

MS. McSHANE: A: Was speaking about the problematic nature of this survey, where you have essentially 85 percent of the respondents, you know, saying that -- just as an example. They will say, "Well, my estimate of the risk premium comes from Ibbitson's book," or "My estimate of the risk premium comes from the Damadorn website." So, you don't have people in this -- most people in this survey actually estimating their own risk premium. They're just -- they're saying, "Well, I rely on somebody else's estimate." So there is a lot of circularity in that.

MR. HOBBS: Q: Right. And it's beneficial, if you will, to have the benefit of analysis of others. One would expect somebody who's offering an opinion of Fernandez's to have considered the views of others. It's a reasonable expectation.

MS. McSHANE: A: Oh, absolutely, that one would expect people to look at and consider what other people have done, and what other people have said. My point was simply that it appears that people are just choosing

1 the numbers of a small number of other sources.
2 **Proceeding Time 9:59 a.m. T17**
3 MR. HOBBS: Q: Okay. I want to turn now to page 113 on
4 the DCF estimates, and Mr. Wallace has already asked
5 you a number of questions with respect to this page.
6 And this may be in the record, Ms. McShane, so you may
7 need to be patient with me. But I would like to know
8 -- or would like you to confirm for me that you, in
9 your DCF analysis, give equal weight to your U.S.
10 results and your Canadian results. And then you also
11 give equal weight to your costs and growth and your
12 three-stage model results.
13 MS. McSHANE: A: That's correct.
14 MR. HOBBS: Q: Thank you. And at the conclusion of the
15 paragraph at line 2862, so this is page 113 of Ms.
16 McShane's evidence, line 2862, you land, I think, on
17 what your conclusion is and that's 9.4.
18 MS. McSHANE: A: Yes.
19 MR. HOBBS: Q: Right. This may just be a typo, but
20 when I look at Table 1 on page 6 of Ms. McShane's
21 evidence, sorry. Ms. McShane's evidence, page 6,
22 Table 1, I see 9.6 there. It is only 20 basis points
23 but is that, just to tidy it up, is that -- should
24 those numbers be the same?
25 MS. McSHANE: A: Oh, I think we're talking about two
26 separate tests.

MR. HOBBS: Q: Are we?
MS. McSHANE: A: Yes. So in Table 1 on page 6, I believe the 9.6 you're talking about is the second number in the table?
MR. HOBBS: Q: Yes.
MS. McSHANE: A: Oh yeah, that's the discounted cash flow based --
MR. HOBBS: Q: Equity --
MS. McSHANE: A: -- and if you come down to the bolded number --
MR. HOBBS: Q: Yes. Yes.
MS. McSHANE: A: -- 9.4, that's the 9.4 that corresponds to what's on page 113.
MR. HOBBS: Q: Yes. Obviously. Thank you.
Now, I would like to take you to Schedule 3 of your evidence, and you have provided --
THE CHAIRPERSON: Excuse me, Mr. Hobbs, from page 1 or 2.
MR. HOBBS: Thank you. Page 2 of 2.
THE CHAIRPERSON: Thank you.
MR. HOBBS: Q: Schedule 3, page 2 of 2. And I'm going to ask a question about the line item Ontario Electricity Distributors, and this is really just for the purposes of the record. But the 9.42 that you have for 2012.
MS. McSHANE: A: Yes.
MR. HOBBS: Q: Would you agree that that was changed to

9.12 on May the 1st, 2012?

MS. McSHANE: A: The 9.42 was the number, the ROE that was for rates effective January 1st, 2012, and then there would have been another cost of capital parameter letter issued after that for rates effective May 1st, 2012, and I've forgotten what the numbers -- 9.12 I think perhaps was the new number.

MR. HOBBS: Q: That's what I think it is.

MS. McSHANE: A: And I believe that it's sitting on Schedule 3, page 1 of 2.

MR. HOBBS: Q: It is. All right. And then we do now have numbers for January 1st, 2013. Correct? I can help you with this. I think --

Proceeding Time 10:04 a.m. T18

MS. McSHANE: A: I believe that's right. I don't recall what they are, but I believe that's right.

MR. HOBBS: Q: All right. Subject to check, we'll assume they're 8.93.

MS. McSHANE: A: Actually, that sounds right, yes.

MR. HOBBS: Q: Okay. And if it's not, just for the purposes of the record, if you could get back to me. Or just correct it on the record.

And then that's true -- the exercise that we just went through is true for each of the preceding years. So, for example, in 2012 where you indicated it was 9.42, that was only for the first quarter.

1 Well, pardon me. That was only until May the 1st,
2 which is the adjustment date by the OEB.
3 MS. McSHANE: A: Not exactly. So, if you're a company
4 that has rates that are effective January 1st in a
5 particular year, then your ROE for that year will be
6 based on -- the OEB will issue a letter, I think it's
7 in November. Three months before rates become
8 effective. And that will be your number for the year.
9 If your rates are effective May 1st of a particular
10 year, then your ROE for your rate year beginning May
11 1st will be the number that's determined for rates
12 effective May 1st.
13 MR. HOBBS: Q: Right. And I'm more concerned about the
14 trend in the rates. And the January 1st and the May 1st
15 dates, or rates, change -- those are the change dates
16 in Ontario if the OEB's calculations change their
17 rates. Then you haven't captured this in these
18 numbers for the years 2007, let's say, till 2011.
19 You've just put the January the 1st dates down.
20 MS. McSHANE: A: Right. So they're consistent with all
21 the other -- I think they're consistent, at least,
22 with all of the other companies that are on the table.
23 But I understand what you're saying, that I haven't
24 put all the various intermediate periods on the table.
25 When I redo this schedule for, you know, to add --
26 when I have returns for 2013, for the affected

1 companies, then the number that would show up here for
2 the Ontario electricity distributors will be the 893.
3 MR. HOBBS: Q: Right. I guess if you would -- the only
4 additional number that I'd like you to put down in
5 that is -- I'm not sure that you were consistent in
6 your numbers with what you just told me, that these
7 are all effective January the 1st. If I look at 2011,
8 the 9.58, I'm not sure is the number effective January
9 the 1st, 2011. I'll ask you to check that number and
10 if it's not correct, change it on the record.
11 So that we are seeing consistency from year
12 to year in your application of the numbers. So we can
13 assume -- I'm hoping that when you're finished, we
14 will have for 2011, 2012, and 2013 the numbers
15 effective January the 1st, and May the 1st, of each of
16 those years. Except, of course, 2013, which we only
17 have for January the 1st.
18 MS. McSHANE: A: So -- sorry, go ahead. I was going to
19 say, so really what you would like is, if I understand
20 correctly, from the time the Ontario Energy Board
21 issued its new cost of capital policy in December,
22 2009, you'd like to see every number that they've
23 actually published as an official ROE for some period.
24 MR. HOBBS: Q: That will do it. I was only looking for
25 2011 on, but yes, that makes sense, what you just
26 suggested.

MS. McSHANE: A: Well, I think the first one would have been effective January 1st, 2010, and then there would have been one in May, 2010, and then --

MR. HOBBS: Q: Yeah, I have the one from --

MS. McSHANE: A: -- May and January for each other -- each subsequent year.

Proceeding Time 10:09 a.m. T19

MR. HOBBS: Q: Yeah, that sounds fine. I am hesitating only because I think you are going to find that your 9.85 for 2010 is in fact the May the 1st number.

MS. McSHANE: A: It could be. I could have been inconsistent --

MR. HOBBS: Q: When you did that.

MS. McSHANE: A: But not on purpose.

MR. HOBBS: Q: No, and I am not suggesting that, and I really just am after you to correct the table of --

MS. McSHANE: A: I will take a look at it.

Information Request

MR. HOBBS: Q: All right, thank you. I'd like to now turn to --

THE CHAIRPERSON: Mr. Hobbs, is this an appropriate time to break?

MR. HOBBS: It is, yes. Thank you.

THE CHAIRPERSON: Let's do that for 15 minutes, coming back at slightly after 20 after 10.

(PROCEEDINGS ADJOURNED AT 10:10 A.M.)

1 **(PROCEEDINGS RESUMED AT 10:29 A.M.)** **T20/21**
2 THE CHAIRPERSON: Please be seated.
3 MR. HOBBS: Mr. Chair and Commissioners, the next exhibit
4 that I wish to turn to is Exhibit A2-11 and it's one
5 that has been filed by Commission Staff. And I do
6 have, although a very limited number of copies, I do
7 have copies if that's going to be helpful.
8 THE CHAIRPERSON: We should have it.
9 MR. HOBBS: Okay. And I do have an exhibit and it's a
10 copy of the testimony of Ms. McShane and I think it'll
11 be most efficient if I simply file it, as long as
12 there are no objections for me to do it in that
13 manner. I believe it's Exhibit C4-14.
14 THE HEARING OFFICER: C4-14.
15 **(DOCUMENT HEADED "TAB 2, TESTIMONY OF KATHLEEN C.**
16 **MCSHARE", PAGE 50, MARKED EXHIBIT C4-14)**
17 MR. HOBBS: Q: Ms. McShane, I'd ask you to first turn
18 to Exhibit A2-11 and the first page of -- well, the
19 second page of A2-11 which is marked page 4, which the
20 note indicates at the top of the page that it's
21 evidence that was filed in the 2005 proceeding, and it
22 provides -- which I'm interested in, the weighted
23 equity return component for Terasen as compared to
24 comparables, and you can do the arithmetic. If you do
25 the arithmetic the difference between Terasen and the
26 average of the comparables is 0.49.

1 MS. McSHANE: A: Sorry, so that the difference between
2 the 289 and 338, is that --
3 MR. HOBBS: Q: Yeah.
4 MS. McSHANE: A: And what was the number you said?
5 MR. HOBBS: Q: 0.49.
6 MS. McSHANE: A: That looks right.
7 MR. HOBBS: Q: And if I turn to Exhibit C4-14, do you
8 -- and I wouldn't expect you to, this isn't a memory
9 test, but do you remember this conclusion from your
10 testimony in that proceeding? And even if you don't
11 remember, that --
12 MS. McSHANE: A: Well, it's -- I remember it now that
13 I've seen it.
14 MR. HOBBS: Q: Okay, all right. I was hoping it would
15 at least do that for you.
16 Can you tell me whether or not, in your
17 last sentence in Exhibit C4-14, whether or not that
18 sentence is in reference to the difference between the
19 3.38 and the 2.89 in Exhibit A2-11? Is that you
20 describing what we're seeing in Exhibit A2-11?
21 MS. McSHANE: A: It could be. Wasn't there another
22 page after this that had a table on it?
23 MR. HOBBS: Q: I'm sorry, I can't answer that.
24 MS. McSHANE: A: Because the second paragraph on the
25 page that you handed me says, "As indicated in the
26 following table," so I would have assumed that there

was a table that followed and could have looked at it and determined whether it was the same thing.

MR. HOBBS: Q: Yeah. Yes. Thank you. I appreciate that and I ought to have done that for you.

MS. McSHANE: A: So, but my recollection is that I did do something similar to what was in the company's testimony.

Proceeding Time 10:34 a.m. T22

MR. HOBBS: Q: Right. Your point is a good one. For the purposes of my questions now -- I do not have the table. So, the purposes of my questions now, and you can correct the record, let's assume that the table will provide evidence as presented in A2-11. You do refer to the weighted equity return component of the allowed return on rate base. So I am assuming that is the weighted equity return component that is shown in A2-11?

MS. McSHANE: A: Right, I mean that is what it says on the table on page 4 in the right hand column, weighted equity return component.

MR. HOBBS: Q: Right, and so one would expect them to be the same. If they are not, I'd ask you then to correct me.

MS. McSHANE: A: Will do.

MR. HOBBS: Q: Assuming that it is the same, your description of that difference was that compared to

the peer group, the weighted equity return component was materially lower? Those are your words, materially lower?

MS. McSHANE: A: Right.

MR. HOBBS: Q: All right. Now, I'd like you to turn to Exhibit B1-20, and this is BCUC 1.4.1 on page 7, and I am actually interested in the table that appears on page 8.

MS. McSHANE: A: Sorry, what was the question number again?

MR. HOBBS: Q: 1.4.1, so 4.1.

MS. McSHANE: A: I have it.

MR. HOBBS: Q: All right. You will see in the table that really doesn't have a heading, but it is on page 8, the weighted return components appear, and I think you can confirm this by looking at the comparable ROEs that we are talking about 2012 numbers. And there we have, if you will, FEI as compared to the comparables being higher and being higher by 0.57.

MS. McSHANE: A: Sorry, I am just trying to make sure I understand what's in this table. So FEI had an allowed return for 2012 that was a continuation of the ROE that was set in 2009. And so ATCO Gas had had a return set specifically for 2011 and '12 in 2011. But the Enbridge gas and the Union gas numbers were the values that sort of carried over from their PBR plans,

from 2007. So, it is kind of a bit of a mixtures of numbers.

MR. HOBBS: Q: Well, let's -- if this helps, if you look at schedule 3, page 2 of 2 in your evidence, I think you are going to see that the numbers that appear as the allowed ROEs for 2012 match your numbers.

MS. McSHANE: A: Oh yes. No, I don't disagree that those are the numbers. It is just that -- I guess what I was saying is they weren't all necessarily determined for 2012 per se, some of them were and some of them weren't. So, yes, yes, FEI for 2012 is higher. Now FEI's ROE is set for 2013, and beyond, so --

Proceeding Time 10:40 a.m. T23

MR. HOBBS: Q: We'll get to 2013 and beyond.

MS. McSHANE: A: I'm not sure how much this really tells us.

MR. HOBBS: Q: Well, all right. Would you agree that it tells us that FEI as compared to the comparables that are there, is materially higher -- that the weighted return component for FEI is materially higher than the comparables. Would you agree?

MS. McSHANE: A: It was materially higher for 2012.

MR. HOBBS: Q: All right. Now, let's get to -- so we have gone from 2005, where compared to its peer group

1 it was materially lower, to now where it's materially
2 higher. Is that correct?
3 MS. McSHANE: A: Yes. Some of it, I think, is timing.
4 But for 2012 it was higher.
5 MR. HOBBS: Q: Okay. You haven't answered my question.
6 MS. McSHANE: A: Okay, I'll try again.
7 MR. HOBBS: Q: I think it's on the record already, but
8 just, I suppose, to make sure that there is no dispute
9 about this. From 2005 to 2012, FEI has gone from
10 being materially lower to materially higher than its
11 peer group.
12 MS. McSHANE: A: Yes, for 2012 and with the caveat
13 that, due to specific circumstances with the timing of
14 the way returns were set.
15 MR. HOBBS: Q: Well, let's deal with the issue of
16 timing, then. If your concern is that this is not
17 reflective of 2013, can you update any of these
18 numbers for numbers that you know for 2013?
19 MS. McSHANE: A: Well, Enbridge Gas for sure. Union
20 Gas for sure. The other ones are still in flux,
21 because ATCO Gas will have a 2013 number set in a
22 generic proceeding. Gaz Metro will have a return set
23 for 2013 somehow, you know, either because they have a
24 formula or because they file for a new return.
25 TransCanada is in the middle of a proceeding. The
26 reason that they had 808 for 2012 was because they

were in a long-term agreement, which kept them under the National Energy Board's formula.

MR. HOBBS: Q: All right.

MS. McSHANE: A: So there are a couple that will be -- that are already determined, and there are the rest of them will be.

MR. HOBBS: Q: Would you like to update this table? I'll give you the option. If that addresses your concerns about timing, I'll give you the option. Would you like to --

MS. McSHANE: A: I don't see any particular need to update it. I just thought it was important to recognize that there were some timing differences.

MR. HOBBS: Q: But it doesn't change the conclusion that you've just --

MS. McSHANE: A: No, for 2012 --

MR. HOBBS: Q: Right.

MS. McSHANE: A: -- FEI was higher than what the allowed returns were for this group of companies.

MR. HOBBS: Q: Materially higher.

MS. McSHANE: A: Well, compared -- yes. I mean, I think it would only be fair to say that, based on the conclusion, you know, the difference, when we said that they were lower.

MR. HOBBS: Q: That's why I took you there first. Thank you.

1 You have -- I want to turn to comparable
2 earnings, but very briefly. You testified yesterday
3 that you have appeared in cost of capital proceedings
4 as many as 200 times.
5 MS. McSHANE: A: Sad but true.
6 MR. HOBBS: Q: And I think you also testified, and
7 perhaps equally sad from your perspective, that you
8 haven't been able to achieve traction on your
9 comparable earnings test.
10 MS. McSHANE: A: It's been a difficult slog. I think,
11 you know, this Commission has been the most open to
12 comparable earnings, or open to comparable earnings,
13 whereas other regulators have really not been.
14 MR. HOBBS: Q: That's why I found it particularly
15 surprising, Ms. McShane, that you chose to
16 characterize Dr. Safir's evidence with respect to
17 comparable earnings as meaningless. It seems to me
18 that you're trying to be helpful to the Commission,
19 and Dr. Safir was also trying to be helpful to the
20 Commission. Would you agree?
21 **Proceeding Time 10:45 a.m. T24**
22 MS. McSHANE: A: I agree we're all trying to be helpful
23 to the Commission, yes. That doesn't take away from
24 my conclusion that I think the numbers he's produced
25 don't mean anything.
26 MR. HOBBS: Q: All right, but you haven't been able to

1 convince anyone yet that your numbers mean anything
2 either, have you?
3 MS. McSHANE: A: Well, I think they have meant
4 something to this Commission because they interpreted
5 them and determined from them what they believed the
6 -- they believed they indicated as a fair return.
7 MR. HOBBS: Q: In 2006 they said, "Yeah, maybe."
8 MS. McSHANE: A: Right. They said, "Yeah, maybe."
9 They expressed a concern. The concern was did we need
10 to apply a market-to-book ratio adjustment? I
11 addressed that concern. And in 2009 they looked again
12 at the numbers and said they were prepared to give
13 some small weight to those numbers and assess them and
14 said, "This is," -- I don't recall the exact values
15 but, "This is what these comparable earnings numbers
16 indicate to us is a fair return for the benchmark B.C.
17 utility."
18 MR. HOBBS: Q: In that sense your evidence may be
19 equally as helpful or as unhelpful as Dr. Safir's
20 evidence with respect to comparable evidence.
21 MS. McSHANE: A: Well, I wouldn't agree with that, but
22 you know, the Commission has before it the evidence
23 and it's up to them to, you know, assess how helpful
24 each piece of evidence is. I gave my view on Dr.
25 Safir's comparable earnings and hopefully, you know,
26 that evidence is of assistance to them.

1 MR. HOBBS: Thank you, Mr. Chair, Commissioners.
2 THE CHAIRPERSON: Thank you, Mr. Hobbs.
3 MR. GHIKAS: Before we move on, Mr. Chairman, I just
4 wanted to -- I had checked -- my friend Mr. Hobbs was
5 referring to A2-11 and the table there. It doesn't
6 appear exactly like that in Ms. McShane's testimony
7 from 2005 on page 51. The information that is on A2-
8 11, page 4 is part of the information that is
9 presented by Ms. McShane on page 51 of her evidence in
10 2005. It is not the entirety of the evidence that's
11 in the table.
12 THE CHAIRPERSON: Okay.
13 MR. GHIKAS: Thank you.
14 THE CHAIRPERSON: We don't have it. You have it we
15 don't.
16 MR. GHIKAS: I do have a copy, which I'm prepared to
17 file. I only have one copy for myself, but if it's
18 useful to the Commission I can have copies run.
19 MR. HOBBS: The challenge, Mr. Chair, is if I have misled
20 Ms. McShane, that's not fair to Ms. McShane. So my
21 suggestion would be that Ms. McShane have an
22 opportunity to review the table that I did not provide
23 to her and see if it draws different conclusions.
24 THE CHAIRPERSON: Fair enough. That sounds like a fair--
25 MR. HOBBS: Thank you.
26 **CROSS-EXAMINATION BY MR. FULTON:**

MR. FULTON: Q: Good morning, Ms. McShane.

MS. McSHANE: A: Good morning.

MR. FULTON: Q: I'd like to begin with a follow-up of a question that I had asked of Panel 1 yesterday, and they indicated that you were the individual who should answer the question, and it related to your use of the 2013-2015 three-year period forecast for 30-year Canada Bonds of 4 percent at the risk-free rate. If you've got transcript Volume 3 close at hand, I would ask you to turn to page 323.

MS. McSHANE: A: I have that.

MR. FULTON: Q: And the discussion began at line 14 -- or at line 8 on page 323, and I want to focus on the question that I asked at page 324, lines 1 to 4, which Mr. Dall'Antonia did defer to you and that was

> "…given that the 2013 thirty-year Canada Bond yield forecast is 3.2 percent and a three-year period is based on 4 percent, shouldn't the ROE for the one-year period be lower by 80 basis points?"

Proceeding Time 10:50 a.m. T25

MS. McSHANE: A: And the answer is "No." For the following reasons. First of all, there are several tests that are done to estimate the fair return. Only the risk premium tests are based on the long Canada bond yield. So if you think about the various weights

that were given to the tests, only, say, 37 and a half percent weight was given to tests that are using the long Canada bond yield forecast. And even within those tests that use the long-term Canada bond yield forecast, there is not a one-for-one relationship between the change in the long-term Canada bond and the change in the ROE.

So, for discussion's sake, if we proceed on the premise that the ROE changes by about 50 percent of the change in the long-term Canada bond yield -- I mean, it's going to be different at different points in time. But if you look at it on a weighted average basis, if you looked only at the 3.2 percent, you'd be talking about maybe a 20 basis point difference.

MR. FULTON: Q: All right. So, some difference, but the difference is not 80 basis points but 20 basis points.

MS. McSHANE: A: That was an approximation based on how much weight was given to the risk premium test and the essential relationship between long-term government bond yields and the ROE.

MR. FULTON: Q: Thank you.

If you were only looking at the risk premium test, would the estimate then be 40 basis points rather than 20 basis points?

MS. McSHANE: A: So, if I were only using risk premium

tests to estimate the ROE --

MR. FULTON: Q: Yes.

MS. McSHANE: A: -- and then you asked me to basically re-estimate the ROE at 3-2 versus 4 percent.

MR. FULTON: Q: Right. For the -- just for one year. So there's only a one-year period.

MS. McSHANE: A: Correct. And then, you mean if that were the way I were doing it, then that would follow.

MR. FULTON: Q: Thank you. Now, there was another area that was deferred to you as well, and it related to the standalone principle. And that discussion that I had yesterday with Mr. Dall'Antonia was at transcript 329. And beginning at line 4, I referenced a statement in your evidence at page 10, beginning at line 257, about the nature of the standalone principle, and what it encompassed. And then I asked the question beginning at line 13, in reference to that statement of principle,

> "…do I understand that to mean, then, that on the basis of the stand-alone principle, one wants, then, to derive a cost of capital for FEI that reflects the characteristics and circumstances of FEI as opposed to a utility that has different characteristics or circumstances?
>
> And if it helps you in terms of clarity,

1 what I am focusing on precisely is the gas
2 distribution side of FEI's business.
3 **Proceeding Time 10:56 a.m. T26**
4 MS. McSHANE: A: Right. The idea, the standalone
5 principle is attempting to capture the idea that you
6 are focusing on the risks of the investment, or the
7 business, and the return should reflect the
8 opportunity cost related to that business. What the
9 returns you could get or achieve if you invested in a
10 business of similar risk. And the idea is to separate
11 the use of the funds, the opportunity cost of the
12 funds as opposed to the source of the funds.
13 MR. FULTON: Q: Yeah, so we are looking at specifically
14 at FEI as opposed to a utility that has different
15 characteristics, or circumstances? Implying the stand
16 alone principle.
17 MS. McSHANE: A: I am hesitant to go that far, and this
18 is why. I would say yes, that in principal you are
19 trying to determine a fair return for FEI with its
20 characteristics. Having said that, when you look at
21 comparable companies in order to figure out what the
22 opportunity -- what FEI's opportunity cost of equity
23 or capital is, I mean, you have to recognize that you
24 are never going to find a company that is identical to
25 FEI. So, your comparable or proxy companies are
26 almost by definition going to be somewhat different

1 than FEI.
2 But maybe if I gave you an example from --
3 just from history which may explain a bit why the
4 standalone principle really evolved in the first
5 place, in Canada, and that was because, particularly
6 with pipelines that were regulated by the National
7 Energy Board, they were becoming more diversified. I
8 mean, TransCanada at one point, I think they were
9 owned by Dome Petroleum. So the National Energy Board
10 was trying to make sure that when they looked at the
11 cost of capital for the pipelines, they were looking
12 at just the pipeline operations. They weren't trying
13 to give them a return that reflected the fact that
14 they were involved in oil and gas exploration. So
15 that is sort of the genesis, and that is really, when
16 we talk about the standalone principle for FEI, that
17 is the same idea.
18 MR. FULTON: Q: Would you agree with me that you want to
19 be looking at comparables of a similar companies as
20 you can find, so that you wouldn't want to be looking
21 at companies that are involved in the oil and gas
22 exploration business, for example?
23 MS. McSHANE: A: I think the focus certainly is on
24 companies that are in similar lines of business that
25 you know that investors would view as similar risk to
26 FEI. I don't think it necessarily needs to be limited

1 to companies that are in the utilities sectors,
2 because investors do have options to put their money
3 in other sectors that are of relatively low risk. And
4 that would be viewed as potential alternative
5 utilities.
6 **Proceeding Time 11:01 a.m. T27**
7 MR. FULTON: Q: Would you agree with me though that if
8 there are different components, you need to adjust for
9 different levels of risk?
10 MS. McSHANE: A: If the comparable or the proxy
11 companies are different total risks than in principle,
12 yes, you need to make adjustments.
13 MR. FULTON: Q: Thank you. If I could ask you to move
14 forward to page 35 of your evidence, and also have in
15 front of you Exhibit C6-15, which is the response of
16 AMPC to BCUC IR 1.11, page 16. So Exhibit C6-15, AMPC
17 response to BCUC IR 1.11, page 16.
18 MS. McSHANE: A: Yeah, I have that.
19 MR. FULTON: Q: Okay. And in your evidence on page 35,
20 lines 872 to 877, you talk about what is required for
21 Fortis to attract debt capital on reasonable terms and
22 conditions and to maintain its creditworthiness and go
23 on to say:
24 "FEI should provide the basis for standalone
25 investment grade debt ratings in the A
26 category. Debt ratings in the A category

1 ensure that a utility would be able to
2 access the capital markets on reasonable
3 terms and conditions during both robust and
4 difficult or weak capital market
5 conditions."
6 And bearing that answer in mind, if you
7 then look at the response of AMPC to the Commission's
8 question in Exhibit C6-15, towards the end of the
9 first paragraph of the answer the statement appears:
10 "When Canada went into recession, utility
11 debt traded as if it was at least one
12 category higher than non-utility debt.
13 Until Bloomberg started the synthetic
14 utility series there was no way of updating
15 the CVRS data and SMPC's publishing it after
16 they took over CVRS. However, the point is
17 that when conditions get bad and the market
18 does recognize the value of the regulatory
19 protection so that utilities can access
20 credit on better terms than the ratings
21 indicate, currently some Canadian utilities
22 are now issuing 40 and 50-year debt at rates
23 of barely 4 percent, indicating the
24 incredible financial strength of Canadian
25 utilities."
26 If Dr. Booth is -- first of all, do you

1 agree with Dr. Booth that utilities can access markets
2 easily when market conditions are good?
3 MS. McSHANE: A: Utilities that have investment grade
4 debt ratings can access the capital -- access the debt
5 markets fairly easily when debt market conditions are
6 good.
7 MR. FULTON: Q: And do you also agree with them that
8 the market recognizes the value of regulatory
9 protection when times are tough?
10 MS. McSHANE: A: I think that's fair to say, that the
11 capital markets and the equity -- sorry, the debt
12 markets attribute some value to regulation.
13 MR. FULTON: Q: Okay. So if utilities can access
14 markets easily when market conditions are good, and
15 markets recognize the value of regulatory protection,
16 when times are tough, why should the Commission be
17 concerned about ensuring an A credit rating for FEI?
18 **Proceeding Time 11:06 a.m. T28**
19 MS. McSHANE: A: Because if they are downgraded into
20 the triple-B rating category, there will be less
21 market for the debt, because there are limitations on
22 holdings of triple-B rated debt by pension funds, for
23 example. Because if the Commission takes a decision
24 which expressly indicates that it doesn't view it to
25 be important to maintain the A rating, then the effect
26 will be, in my view, double. First of all, if there

is a downgrade, there will be a higher cost of debt. And there will be the effect that existing bond investors will say, "You, the Commission, have negatively impacted the value of our debt. We are going to be a lot less willing to buy any future issues of FEI." Plus, if conditions are bad, it's not like FEI can turn around on a dime and say, "Oh, we want our A credit rating restored so that we now have market access."

So that's -- those are the reasons I think the Commission should be concerned about. Making sure that the company has the ability to maintain its A rating, so it can access markets.

MR. FULTON: Q: Thank you. Page 49 of your evidence.

MS. McSHANE: A: I have that.

MR. FULTON: Q: Actually, if you go to C-10, it's the reference that I want. So, page C-10 of your evidence.

MS. McSHANE: A: Oh, page C-10 of my evidence. Yes.

MR. FULTON: Q: Yes, I'm sorry, I took you to page 49 and I should have taken you to C-10.

MS. McSHANE: A: I'm on page C-10.

MR. FULTON: Q: Okay. And there you discuss the three-stage model. And say that as applied to the sample of U.S. low-risk utilities relied on the average of the four sources of analysts' earnings forecasts for the

first five years, which is stage 1. The average of stage 1 forecasts, and the forecast long-term growth in the economy for the next five years, stage 2, and the long-term growth in the economy thereafter, which is stage 3.

Now, when you speak of average, are you talking about the mean that appears in Schedule 23 to your evidence?

MS. McSHANE: A: Well, there are -- I guess there are two references to "average" in what you've read me.

MR. FULTON: Q: All right. So --

MS. McSHANE: A: So the first reference to the average --

MR. FULTON: Q: Yes?

Proceeding Time 11:11 a.m. T29

MS. McSHANE: A: The average of the four sources of analysts' earnings forecasts. So that would be on Schedule 19. So that's referring to the average in column 8, where it says "Average of all EPS estimates".

MR. FULTON: Q: Yes, that's there -- they are both mean and median that are referred to.

MS. McSHANE: A: I apologize. I sometimes am inconsistent with my terminology. If it says "mean" it means "average". They mean the same thing.

MR. FULTON: Q: Okay. And so just so that you're at

1 least consistent in your terminology in the two
2 schedules, “mean” means “average” in Schedule 19 and
3 “mean” means “average” in Schedule 23.
4 MS. McSHANE: A: Yes.
5 MR. FULTON: Q: Thank you. And the means, or the
6 averages, are annual growth percentages. Is that
7 correct?
8 MS. McSHANE: A: They are annualized growth, yes. So
9 if the number, for example, when we’re looking on
10 Schedule 19, was the first one under Column 8 was 4.6,
11 then that would be growth per year.
12 MR. FULTON: Q: And is that also, then, if you move
13 forward to Schedule 23, is the 7.5 also a growth-per-
14 year average?
15 MS. McSHANE: A: Yes.
16 MR. FULTON: Q: And equally so are the 5.9, 4.3 of
17 stage 2 and stage 3 growth. Those are growth-per-year
18 averages?
19 MS. McSHANE: A: Yes.
20 MR. FULTON: Q: Now, returning to the standalone
21 principle, what I want to discuss with you is a growth
22 rate that is reflective of FEI rather than utilities
23 that may have different characteristics or drivers.
24 And Enbridge, which is one of the companies on
25 Schedule 23, has a stage 1 growth rate of 10.4
26 percent.

1 MS. McSHANE: A: Yes.
2 MR. FULTON: Q: And are you able to confirm for me that
3 in the case of Enbridge, the gas distribution segment
4 was responsible for 16 percent of the net adjusted
5 income reported in December, 2011?
6 MS. McSHANE: A: I haven't done that calculation, but
7 that sounds approximately right.
8 MR. FULTON: Q: Would you agree with that, subject to
9 check?
10 MS. McSHANE: A: I would.
11 MR. FULTON: Q: And then for Canadian Utilities
12 Limited, you show it as having a growth rate of 6.2
13 percent. Would you agree with me that it owns a
14 significant power generation assets in Canada and also
15 owns operations in Australia?
16 MS. McSHANE: A: It owns a gas distribution system, I
17 think, in Australia. It may own some power in
18 Australia. It owns power plants in Alberta, which
19 are, I guess -- what they're called is quasi-rate of
20 return regulated.
21 **Proceeding Time 11:16 a.m. T30**
22 MR. FULTON: Q: Would you classify FEI as a mature
23 utility?
24 MS. McSHANE: A: Yes.
25 MR. FULTON: Q: And if we are looking at a growth rate
26 for FEI, shouldn't we be looking at the prospects for

a mature utility with virtually no growth prospects based on the issues that -- the business risk issues that have been raised in the proceeding today?

MS. McSHANE: A: Well, a couple of comments or responses. The ROE should be determined by reference to as comparable entities as possible. One of the criticisms that I have seen of my evidence is too much emphasis placed on American data. I have tried to remedy that by looking at Canadian regulated companies to the extent possible.

So, these are the Canadian regulated companies that are publically traded. So this is the data that we have available.

There are no companies in Canada which have the precise characteristics, in terms of growth, that FEI has. So, it is not possible to focus simply on companies that have relatively limited growth. Having said that, when you look at a DCF estimate for companies, there will be -- the dividend yield part of the equation should match, if you will, with the growth expectation. So, you would expect a company like Enbridge, which has relatively good growth prospects mostly in the pipeline area, to have a relatively low dividend yield. So, the pieces tend to offset each other.

MR. FULTON: Q: Thank you. I'd like to take you for a

moment, and I am going to take you back to it again later as well, the rebuttal evidence, which is exhibit B1-32.

MS. McSHANE: A: This is my rebuttal evidence?

MR. FULTON: Q: Actually, it is the rebuttal evidence of Mr. Engen, which is pages 5 and 6. So that rebuttal evidence follows the companies evidence. So there are 13 pages of companies evidence, followed by the rebuttal evidence of Mr. Engen?

THE CHAIRPERSON: Is there a page number?

MR. FULTON: Page 5 and 6.

Q: And beginning at line 9 where Mr. Engen references the *Calgary Herald* newspaper article --

MS. McSHANE: A: Sorry, I am not quite there yet, I apologize.

MR. FULTON: Q: Okay, I am sorry. So, in Exhibit B1-31, if you go through the 13 pages of Fortis rebuttal -- or B1-32, I'm sorry. And then you'll come to Mr. Engen's rebuttal?

Proceeding Time 11:22 a.m. T31

MS. McSHANE: A: I'm there.

MR. FULTON: Q: Thank you. And what I'll do is I'll let you read his comments on Dr. Booth's reference to the *Calgary Herald* newspaper article which begin on line 5 and continue over to line 12 on page 6. And actually you can read to page 12 -- or line 12, but I

1 want to focus on that part of the response that ends
2 at line 4. That begins on line 5 on page 5 and ends
3 at line 4.
4 MS. McSHANE: A: I've read it, yes.
5 MR. FULTON: Q: Do you agree with Dr. -- or Mr. Engen's
6 comments about TransCanada and Enbridge that are
7 referred to in that rebuttal evidence?
8 MS. McSHANE: A: So -- sorry, I hadn't really had an
9 opportunity to focus on this before. So Mr. Engen
10 says that the TransCanada raised these funds, which
11 were partially to fund the Keystone Pipeline system,
12 wasn't undertaken to fund assets subject to cost of
13 service regulation. So that seems to be just factual.
14 I don't have any reason to disagree with that.
15 So then the next paragraph says that Dr.
16 Booth referred to comments made by Mr. Daniel about
17 the low-risk model of pipelines in general, and I
18 guess most of the pipelines are not subject to strict
19 cost of service regulation, so I don't have any reason
20 to disagree with that.
21 And then he goes on to say that the equity
22 financing and the low-risk pipeline model were related
23 to assets not subject to the same kind of regulations
24 here. I think that's right. Canadian assets subject
25 to cost of service regulation have seen a steady
26 decline in allowed ROEs. That's true. And the

1 success of firms in growing earnings and strong share
2 performance has had precious little to do with assets
3 subject to cost of service regulation, and I think
4 that's also true.
5 MR. FULTON: Q: Do I take it that you would consider
6 FEI a low-growth pure play natural gas utility?
7 MS. McSHANE: A: On a standalone basis it has
8 relatively low growth, that's true.
9 **Proceeding Time 11:27 a.m. T32**
10 MR. FULTON: Q: And the references in the *Calgary*
11 *Herald* newspaper article to the comments of the CEOs
12 of TransCanada and Enbridge, Inc., can you tell me how
13 the comments of those -- of the CEOs would not be
14 applicable regarding pipelines -- I think I'll just
15 leave it.
16 Let me try it this way. Why should the
17 Commission dismiss the attributed views of the CEOs of
18 pipelines but at the same time recognize that you've
19 included the pipelines in your evidence, in your
20 Schedule 29, as being germane to the growth rates of
21 Fortis?
22 MR. GHIKAS: Just before Ms. McShane addresses that,
23 perhaps it would be useful to ask Ms. McShane whether
24 she had actually seen the *Calgary Herald* article that
25 the comments are coming from. It might be useful,
26 because I don't want Ms. McShane to be in a position

of trying to interpret an article she hasn't seen before.

MR. FULTON: Thank you.

Q: Let me try it this way then, if you haven't read the article. If you go to the statement at lines 3 and 4 of page 6 of 9, where Mr. Engen says, "Mr. Daniels' comments were directed at his pipeline's business, which is not comprised of assets subject to cost of service regulation." And so, if that is the case, why wouldn't the -- why would the growth rate of Enbridge sill be important as a comparable to that of a low-growth natural gas utility such as Fortis?

MR. GHIKAS: I'm not trying to be difficult, Mr. Chairman, but I think the question still does require reference to what Mr. Daniel is saying. If Mr. Fulton is asking -- assuming that these companies have a non-cost of service regulated portion of the business, why is it a relevant comparator, if that's the simple question that Mr. Fulton is getting at, I think that's something Ms. McShane can answer.

MR. FULTON: Right. Thank you, yes.

THE CHAIRPERSON: I think that's the question for you.

MS. McSHANE: A: So, back to what I had said earlier, which was that the availability of publicly traded companies in Canada with regulated operations is limited. I mean, we obviously rely on them to -- when

we look at the capital asset pricing model in the betas, but these are the best comparables that we have for regulated utilities. And just because, as I said, a company might have better growth prospects than the subject company for whom the cost of equity is being estimated, doesn't make that company not an appropriate proxy. For two reasons. One, it's an alternative potential investment, and two, there will be a tendency to have -- if you have low growth, you'll have a high yield, and if you have high growth prospects, you'll have a lower dividend yield.

Proceeding Time 11:32 a.m. T33

MR. FULTON: I've provided your copy with -- or your counsel with a copy of some pages from Attachment 47.2 of Exhibit B1-20 which was an electronic version of a Standard & Poors report, and I gave them that this morning. I'm not sure whether you would have had an opportunity to look at it.

MS. McSHANE: A: I -- this morning. I haven't seen this one.

MR. GHIKAS: Mr. Chairman, somewhere along the line Mr. Fulton and I got our wires crossed in terms of getting the document to Ms. McShane, so she hasn't seen this one yet.

THE CHAIRPERSON: Do you want to take a few minutes and let her read the document, or --

MR. GHIKAS: I'll leave it to Mr. Fulton depending on what he's asking. It would be good for -- if he's asking the details of it, she's going to need some time.

MR. FULTON: Q: I just wanted to focus on one paragraph and that's -- well, at this time one paragraph and that was on page 9, the paragraph under Aggressive Growth Profile. And if you don't feel comfortable answering the question now, we can come back and I can ask it. I'll do that after lunch. But I'll try the question and then you can see.

MS. McSHANE: A: That's fine.

MR. FULTON: Q: Okay.

MS. McSHANE: A: So under the heading Aggressive Growth Profile, the statement appears:

> "The company consistently has a large capital program…"

and it's talking about Enbridge,

> "…a large capital program, although we believe the track record of executing large projects on time and on budget and consistently investing in assets characterized by long-term commercially secured contracts with relatively low risks, stable cash flows mitigates this."

Do you agree with that, those comments

about the growth profile of Enbridge that are made in the Standard & Poors report?

MS. McSHANE: A: I agree that they've had a large capital program. They had a successful track record of executing those projects. They've been investing in relatively low-risk assets with stable cash flows, and the bulk of their capital program is for their four businesses. So I have no reason to disagree with S&P.

MR. FULTON: Q: Would you agree with me that that doesn't sound like a profile that's comparable to Fortis?

MS. McSHANE: A: To FEI?

MR. FULTON: Q: Yes.

MS. McSHANE: A: No, they have larger growth prospects than FEI as a standalone gas distribution utility.

MR. FULTON: Q: Thank you.

If that could be marked the next exhibit, Exhibit A2-36.

THE HEARING OFFICER: A2-36.

(PAGES 7 TO 10 FROM STANDARD & POORS REPORT, MARKED EXHIBIT A2-36)

MR. FULTON: Q: Would you agree with me that in looking at the growth rate for FEI, given the demand challenges that natural gas presents, FEI probably isn't looking at a large capital program?

1 MS. McSHANE: A: I wouldn't disagree with that, based
2 on the business risk profile of its standalone gas
3 distribution business.
4 **Proceeding Time 11:37 a.m. T34**
5 MR. FULTON: Q: Now, if we can turn back in your report
6 to page 28, and your comments beginning at line 703 to
7 708, relating to the Bank of Canada's June 2012
8 Financial System Review, and I'd just like to focus on
9 the first point at line 705 to 708.
10 MS. McSHANE: A: Yes.
11 MR. FULTON: Q: And in terms of growth rates then, is it
12 your view that the economy will recover from the low
13 and sluggish growth mode that the Bank of Canada
14 describes both globally and in Canada?
15 MS. McSHANE: A: That would be my expectation, yes.
16 That the recovery has been drawn out, but that it will
17 recover.
18 MR. FULTON: Q: Thank you. Page 93 of your evidence.
19 MS. McSHANE: A: I'm there.
20 MR. FULTON: Q: Okay. And on page 93, you discuss the
21 intercept to estimate component of the utility return,
22 that is incremental to what the CAPM would predict?
23 MS. McSHANE: A: Yes.
24 MR. FULTON: Q: And if I could ask you to read the
25 paragraph that begins at line 2347 and concludes at
26 line 2355?

1 MS. McSHANE: A: I've read that.
2 MR. FULTON: Q: IN the middle of the paragraph you say,
3 "The intercept in the equation should in
4 principle represent the risk free rate."
5 Can you tell us what you mean by that statement?
6 MS. McSHANE: A: What I meant by that statement is if
7 the CAPM held, then the intercept should equal the
8 risk free rate. And the risk free rate over that
9 period was 7 percent, and the intercept was higher
10 that by a significant margin.
11 MR. FULTON: Q: Okay, and further down on page 93, and
12 particularly at lines 2363 to 2364, you state that, or
13 you expand the regression to include government bond
14 returns -- that when you expand the regression to
15 include government bond returns, somewhat more of the
16 volatility IN the stock prices is explained in your
17 view, correct?
18 MS. McSHANE: A: Correct.
19 MR. FULTON: Q: Now, given the statement or your
20 evidence on page 93, can one conclude that in the
21 first regression, if the R'd squared is only 28
22 percent, the remaining unexplained 72 percent contains
23 everything else. And that would include the risk free
24 rate, errors, and other factors such as the movement
25 in long term Canada bonds, in order to explain the
26 volatility in utility returns?

Proceeding Time 11:42 a.m. T35

MS. McSHANE: A: It includes -- it does include everything that's not in the market beta.

MR. FULTON: Q: Okay. And that therefore might explain the volatility in the returns.

MS. McSHANE: A: You mean the other stuff?

MR. FULTON: Q: Yes.

MS. McSHANE: A: Right. I mean, it's other -- it's things other than the equity market itself, and in the second regression, other than the equity market and the bond market.

MR. FULTON: Q: Okay. And that being so, would you agree with me, then, that of the 3.9 percent difference between the calculated intercept and the average 90-day treasury bill return, the risk-free rate is only one component.

MS. McSHANE: A: We've already accounted for the risk-free rate in the 7 percent.

MR. FULTON: Q: Okay.

MS. McSHANE: A: So it's the difference between the two.

MR. FULTON: Q: But am I correct in understanding that the 3.9 percent includes everything? All the stuff that you talked about?

MS. McSHANE: A: Well, it's everything that wasn't captured in the risk-free rate, the market, equity

1 market beta, and the bond market, and the beta on the
2 -- sorry. On interest rates.
3 MR. FULTON: Q: Right. So just so I'm clear in terms
4 of stuff, it's the errors and other factors such as
5 the movement in the long-term Canada bonds.
6 MS. McSHANE: A: That's captured in the second
7 variable.
8 MR. FULTON: Q: Okay.
9 MS. McSHANE: A: The relative volatility in the equity
10 market is accounted for. The risk-free rate is
11 accounted for, because that's in the intercept. And
12 it's the difference between what the actual return was
13 over that whole period and what this equation on page
14 93 would have predicted, given the market returns, the
15 spread between the long Canada and T-bills over that
16 period, and the average level of the risk-free rate is
17 measured by the treasury bills.
18 MR. FULTON: Q: Can I distill that down to an essence
19 that the 3.9 percent is a reasonable approximation?
20 MS. McSHANE: A: Of what, please?
21 MR. FULTON: Q: Of the difference between the
22 calculated intercept and the average 90-day treasury
23 bill return.
24 MS. McSHANE: A: Yes, that is the difference between
25 the treasury bill return and the return that the rest
26 of the equation captures.

MR. FULTON: Q: It's a reasonable approximation of the component of the utility return incremental to what the CAPM would predict.

MS. McSHANE: A: Right. Well, the CAPM with the two different -- it's not really the CAPM *per se*, it's the two variable model 1 -- one variable being the equity beta, if you will, and the other variable being the interest rate beta.

Proceeding Time 11:47 a.m. T36

MR. FULTON: Q: Page C-6 of your evidence.

MS. McSHANE: A: I have that.

MR. FULTON: Q: And on the second line in the first paragraph you discuss the issue of reliability and explain why it arises. So if you could read to yourself that paragraph beginning the second line down to the end of the paragraph, I'll ask you some questions.

MS. McSHANE: A: I've finished that.

MR. FULTON: Q: Okay. When investors are assessing whether to invest, or where to invest, are they restricting their analyses to, one, the growth expectations, or two, the growth and dividends, or three, are they looking at the total return that they can expect?

MS. McSHANE: A: Total return.

MR. FULTON: Q: Okay. And in terms of how they base

their expectations, are their expectations then based on all the information that they have available to them?

MS. McSHANE: A: Yes.

MR. FULTON: Q: And you would agree with me that analysts adjust their forecasts periodically?

MS. McSHANE: A: Yes.

MR. FULTON: Q: The next paragraph of your evidence talks about analysts' optimism?

MS. McSHANE: A: Yes.

MR. FULTON: Q: And you discussed analysts' optimism with Mr. Wallace this morning?

MS. McSHANE: A: I believe it was this morning.

MR. FULTON: Q: Yes. And you talk of, in that second paragraph, of analysts' optimism becoming a high-profile issue during the irrational exuberance phase of the tech boom during the 1990s. Would you agree with me that if in a period of irrational exuberance, investors' expectations are wildly unrealistic, those expectations are not the correct ones to use in a model?

MS. McSHANE: A: Not necessarily.

MR. FULTON: Q: Okay. Why not?

MS. McSHANE: A: Because -- first of all, when we're talking about just as a caveat, we're not talking about utilities when we're talking about irrational

1 exuberance. But if -- and I should say that for the
2 companies that would have been most affected by
3 irrational exuberance, it would have been difficult to
4 apply a discounted cash flow model in any effect
5 because most of them wouldn't have been paying
6 dividends. So the model really wouldn't have been
7 applicable. But when I quickly said yes to your
8 proposition, if the price of a stock reflects
9 irrational expectations, or overly exuberant
10 expectations, if I'm trying to figure out what the
11 return that investors expect is, for me to say, well,
12 I don't think those expectations are rational, I'm
13 just going to cut 10 percent out of them, I won't be
14 estimating the return that investors expect. I'll be
15 estimating what I think should be reasonable. But if
16 the price doesn't reflect that, then the number that
17 I've come up with for an investor-expected return will
18 be incorrect.
19 **Proceeding Time 11:53 a.m. T37**
20 MR. FULTON: Q: Thank you. Now, I want to move to the
21 topic of counter-cyclical stocks, and that is a topic
22 that I don't think we've had so far in this
23 proceeding. I'm going to provide you with the
24 definition that I understand comes from Investipedia,
25 for counter-cyclical stock, and you can tell me if you
26 agree with it or if you have another --

MS. McSHANE: A: Investipedia, the fount of all knowledge.

MR. FULTON: Q: Yes. So, it defines “counter-cyclical stock” as "a type of stock in which the underlying company belongs to an industry or niche with financial performance that is negatively co-related to the overall state of the economy. As a result, the stock’s price will also tend to move in a direction that is opposite to the general economic trend, meaning appreciation occurs during times of recession and depreciations in value occur in times of economic expansion."

Would you agree with that definition of a counter-cyclical stock?

MS. McSHANE: A: It sounds about right.

MR. FULTON: Q: Okay. Now, if we go back to your Schedule 23, in Exhibit B1-32, you will agree with me that it shows the stage 1 growth at 7.5 percent, dropping to 5.9 percent in stage 2 for years 6 to 10, and dropping further for stage 3 to 4.3 percent.

MS. McSHANE: A: Right. So, reflecting the fact that these companies have at this point in time all relatively good growth prospects.

MR. FULTON: Q: Okay. You’ll agree with me, though, that at the present time FEI is experiencing low growth?

MS. McSHANE: A: Yes.
MR. FULTON: Q: There is -- and there is a sluggish economic climate.
MS. McSHANE: A: Yes.
MR. FULTON: Q: Okay. So, given those two factors, doesn't Schedule 23 suggest that FEI is a counter-cyclical stock insofar as you're predicting high growth in the near term and slower growth further out?
MS. McSHANE: A: Sorry, I didn't follow that.
MR. FULTON: Q: Okay. Well, you've agreed with what the definition of counter-cyclical stock is. Right?
MS. McSHANE: A: Okay. FEI is not a stock, so --
MR. FULTON: Q: All right. Well, would you agree with me that FEI, then, appears to be a counter-cyclical company?
MS. McSHANE: A: No.
MR. FULTON: Q: Why not?
MS. McSHANE: A: So, FEI and Schedule 23 -- wait a minute. We're not talking about Schedule 23 right now. We're talking about definition of counter-cyclical and whether FEI is consistent with that definition.
MR. FULTON: Q: No, but we are talking about Schedule 23 because it does show on the median numbers what's happening in terms of stage 1, stage 2 and stage 3 growth, which all appear to be -- which are all

1 defined.
2 MS. McSHANE: A: I'm sorry, I'm not trying to be
3 difficult, but -- so we have five companies on
4 schedule 23. None of which are FEI. These five
5 companies have, over the next five years, good growth
6 prospects because they need to build infrastructure.
7 **Proceeding Time 11:58 a.m. T38**
8 MR. FULTON: Q: Yes, but -- I'll let you finish, Ms.
9 McShane.
10 MS. McSHANE: A: I would not call them in principle
11 counter-cyclical stocks, but at this point in time,
12 given infrastructure requirements in North America
13 they have good growth prospects. But that really
14 doesn't have much to do with whether they are
15 effectively counter-cyclical or not. It's sort of a
16 function of, you know, what's required in terms of
17 infrastructure investment at this point in time. FEI,
18 within the context of what you read me as far as what
19 constitutes counter-cyclical and FEI would be
20 cyclical. I mean it's following the economy. Low
21 growth, low growth. Low growth in the economy. FEI
22 has low growth. Due to a number of factors, mind you,
23 not all that have to do with the economy *per se* but --
24 MR. FULTON: Q: But in your model results on Schedule
25 23, aren't you showing high growth in Stage 1 for
26 those companies, trailing off into Stage 3?

1 MS. McSHANE: A: Correct, but that -- the trailing off
2 doesn't have anything to do with cyclicality. The
3 trailing off has to do with the recognition that you
4 can't maintain above normal growth rates into
5 infinity. As I said, the high growth today for these
6 specific companies reflects the fact that
7 infrastructure is required. It's not to me reflective
8 of them being counter-cyclical stocks. Yes, at this
9 point in time they have good growth prospects because
10 of infrastructure requirements and relatively speaking
11 their growth prospects might be better than in the
12 economy as a whole, but I don't see that as making
13 them counter-cyclical stocks.
14 MR. FULTON: Q: All right, thank you. Pages C-6 and C-
15 7 of your evidence.
16 MS. McSHANE: A: I have that.
17 MR. FULTON: Q: And at the bottom of page C-6 you refer
18 to an article by Michael Keene and David Runcle titled
19 "Are Financial Analysts' Forecasts of Corporate
20 Profits Rational?"
21 MS. McSHANE: A: Yes.
22 MR. FULTON: Q: And you state that when the authors
23 eliminated observations from their data sample based
24 on the size of the negative special items, nearly
25 eliminate evidence of mean optimism in their sample.
26 MS. McSHANE: A: Yes.

MR. FULTON: Q: Now, do I take it that what this means in simple terms is that the authors looked back at analysts' forecasts and the actual earnings of the sample companies, eliminated those with negative special items over a certain size, and based on the remainder of the sample the evidence of mean optimism was almost eliminated?

MS. McSHANE: A: That's my understanding, yes.

MR. FULTON: Q: And would you agree that on a hindsight basis for a study of analyst bias, such observations can be eliminated because the earnings have been reported?

Proceeding Time 12:03 p.m. T39

MS. McSHANE: A: Sorry, because they're been recorded? Reported?

MR. FULTON: Q: Reported.

MS. McSHANE: A: Yes, I'm not sure if I'm following exactly what you're asking. You have -- in order to do a study of optimism you have to have something to compare the forecast to. So it has to be something that's supported.

MR. FULTON: Q: Right.

MS. McSHANE: A: And so it depends how you interpret their reported data.

MR. FULTON: Q: On a forecast basis when the earnings are not known, would you agree that the negative items

cannot be eliminated and may or may not be included in the analysts' earning forecast?

MS. McSHANE: A: So when you're -- when you're forecasting, you're forecasting essentially a normalized operating earnings over a period of time. So, you wouldn't be including special negative items anyway.

MR. FULTON: Q: Right. And so to the extent that you're not including those special negative items, that the forecasts may be optimistic.

MS. McSHANE: A: I am not following that connection. The point about the elimination of the special negative items was that when you -- when you test for whether there was optimism, you have to look at what the forecast were and then you have to look at what the actuals were. And how you determine whether or not those actuals indicate optimism, pessimism or neutrality, depends on how you interpret the reported earnings. And if the reported earnings, you know, have a -- of some companies have a couple of special negative items in them that basically determine the outcome of your study, which appears to be what this article has suggested, that if you remove them, these special negative items, there's no longer any evi -- that's over stating it.

The evidence of optimism is, you know,

1 almost gone.
2 MR. FULTON: Q: Okay, and to the extent that they are
3 not removed, optimism remains.
4 MS. McSHANE: A: Well, that's -- I mean, that's what
5 these people were testing. They were testing to see,
6 you know, what effect these particular items had on
7 the results of the study, and concluded that, you
8 know, this seemed to be the item that was driving the
9 study results. And removing those negative special
10 items basically changed the results.
11 THE CHAIRPERSON: Ms. McShane, could I just clarify the--
12 MS. McSHANE: A: Sure.
13 THE CHAIRPERSON: When you say special negative items or
14 items that couldn't have been predicted by the
15 analysts, so then when you remove all those, you go
16 right back to a fair result relative to forecast or
17 what --
18 MS. McSHANE: A: Exactly.
19 THE CHAIRPERSON: Yes, okay.
20 MR. FULTON: This would be a good time to take the lunch
21 break.
22 THE CHAIRPERSON: Let's do that. It's -- why don't we
23 come back at 1:30.
24 **(PROCEEDINGS ADJOURNED AT 12:08 P.M.)**
25 **(PROCEEDINGS RESUMED AT 1:37 P.M.)** **T39/40**
26 THE CHAIRPERSON: Please be seated.

Mr. Ahmad?

MR. AHMAD: Mr. Chairman, I have two undertakings for filing. The first one is FortisBC Utilities' Undertaking Number 10. The transcript reference for this is page 333, lines 14 to 16. It was a request for an update of a table in the AMPCBC UC FBCU IR 1.4.1. I believe this should be B1-45.

THE HEARING OFFICER: B1-45.

(RESPONSE - "FORTISBC UTILITIES UNDERTAKING NO. 10", PAGE 333, LINES 14 TO 16, MARKED EXHIBIT B1-

MR. AHMAD: And the second filing is FortisBC Utilities' Undertaking Number 11. Transcript reference for this is Volume 3, page 328, lines 4 to 14, and it was a request to provide a forecast of capital additions for the next five years, broken down into the categories of natural gas, NGT and biomethane. I believe that should be B-46.

THE HEARING OFFICER: B-46?

MR. AHMAD: B1-46. I apologize. The document itself says "B-46", but it should be B1-46.

(RESPONSE - "FORTISBC UTILITIES UNDERTAKING NO. 11", VOLUME 3, PAGE 328, LINES 4 TO 14, MARKED EXHIBIT B1-46)

MR. GHIKAS: And before we move back to Mr. Fulton, Mr. Chairman, there was the issue that arose during my friend Mr. Hobbs's cross-examination of Ms. McShane

about her 2005 evidence, and the table that followed page 50 that he was referring to. What we're going to do is file page 51. And as I indicated before, the numbers that Mr. Hobbs was referring to are the same on both documents. There is just more. So in terms of reading the transcript, the numbers in the transcript are not going to change.

THE CHAIRPERSON: Okay.

MR. GHIKAS: But just for the purpose of clarity, my friend Mr. Hobbs and I, we have determined that it's fine to just file the document. And as I understand it, Ms. McShane doesn't need to make any further comment on the document.

THE CHAIRPERSON: Okay, that's terrific.

MR. GHIKAS: Thank you. So, in filing this one, this will be -- and I believe it's included in the documents you have before you. This would be B1-47. And that's page 51 of Ms. McShane's testimony. It's titled at the top "Testimony of Kathleen C. McShane".

THE CHAIRPERSON: Oh, I see that.

MR. GHIKAS: And there's a Table 7 on it, and it's marked at the bottom, page 51. So B1-47. And this relates -- so, just for context, this relates to Exhibit C4-14 filed by Mr. Hobbs earlier today.

THE CHAIRPERSON: Thank you, Mr. Ghikas.

MR. GHIKAS: Thank you.

1 THE HEARING OFFICER: B1-47.
2 **(DOCUMENT HEADED "TAB 2, TESTIMONY OF**
3 **KATHLEEN C. MCSHARE", PAGE 51, MARKED EXHIBIT B1-47)**
4 THE CHAIRPERSON: Mr. Fulton?
5 MR. FULTON: Thank you, Mr. Chair.
6 **CROSS-EXAMINATION BY MR. FULTON (Continued):**
7 MR. FULTON: Q: Good afternoon, Ms. McShane.
8 MS. McSHANE: A: Good afternoon.
9 MR. FULTON: Q: I'd like to begin with Schedules 19 and
10 21 to your evidence.
11 MS. McSHANE: A: I have those.
12 MR. FULTON: Q: And specifically the line entry for
13 Piedmont Natural Gas on both those schedules. Would
14 you agree with me that the estimate in Schedule 19 for
15 the Bloomberg -- for Piedmont Natural Gas is based on
16 a Bloomberg forecast that has two analysts' estimates?
17 MS. McSHANE: A: The Bloomberg has two estimates?
18 MR. FULTON: Q: Yes.
19 MS. McSHANE: A: That --
20 MR. FULTON: Q: I've provided your counsel --
21 MS. McSHANE: A: I'm not positive.
22 MR. FULTON: Q: -- prior to lunch today with attachment
23 24B of Exhibit B1-9, which was from -- oh, it's from
24 B1-19, I'm sorry. Yes.
25 MS. McSHANE: A: Yes, that's right. I can see that on
26 this table.

1 **Proceeding Time 1:42 p.m. T42**
2 MR. FULTON: Q: So you would agree with me then that
3 the Bloomberg forecasts for the Piedmont Natural Gas
4 estimate is based on two analysts' estimates.
5 MS. McSHANE: A: Correct.
6 MR. FULTON: Q: Okay. And does that cause you any
7 concern about the accuracy of the estimates when
8 they're based on such a low number of analysts'
9 estimates?
10 MS. McSHANE: A: Obviously it would be preferable to
11 have more than less, but that's why I have various
12 sources rather than just Bloomberg or just Value Line
13 or just Reuters.
14 MR. FULTON: Q: Now, in terms of those other forecasts,
15 Bloomberg, Reuters, Value Line and Sachs, to what
16 extent would you expect any of those analysts'
17 forecasts to duplicate any of the other analysts'
18 forecasts within that group?
19 MS. McSHANE: A: There may be some duplications.
20 Certainly not in Value Line. Value Line is separate.
21 The Value Line forecasts as far as I know don't appear
22 in any of the others, but there may be some overlap
23 where analysts contribute to both sources.
24 MR. FULTON: Q: And based on your expertise would you
25 expert there to be some real likelihood of overlap in
26 some of the cases?

MS. McSHANE: A: I would say that's fair because there are only a limited number of utility analysts.

MR. FULTON: Q: Okay. Now, given that there is that potential for overlap, would the growth forecast be potentially biased one way or the other due to the double weighting of a particular analyst's earnings estimate?

MS. McSHANE: A: I don't see any reason why there should be any systematic bias one way or the other.

MR. FULTON: Q: Okay, and why not?

MS. McSHANE: A: Because there's no reason to believe that an analyst who happens to be high or low is going to be systematically double represented.

MR. FULTON: Q: Okay. But certainly the estimates, if they include estimates of the same analyst twice, isn't that a cause for concern from a weighting standpoint? So if the Bloomberg's estimate is relying on an estimate of one of the Sachs estimates and vice versa, isn't there a concern in terms of what the numbers ultimately are -- the numbers that are ultimately being derived?

MS. McSHANE: A: I don't think so. I mean, because I don't believe that there's any particular, as I said, you know, systematic bias one way or the other in terms of where a particular analyst stands relative to the median or the mean value.

MR. FULTON: Q: All right, well while there may not be systematic bias, might there be some unsystematic then issues that arise in terms of the ultimate numbers that are derived?

MS. McSHANE: A: My personal view is that it's better to have all of the sources rather than just one. I understand that what you are suggesting, but I don't see that when you've got four different sources that there's any real reason for concern that there's -- I'm not sure, we don't like the word "bias" but that there's really a concern with double counting.

MR. FULTON: Q: If you could turn to Exhibit B1-20, the response to BCUC IR 1.52.1 and it's at page 120

Proceeding Time 1:47 p.m. T43

Mr. Chairman?

MS. McSHANE: A: I have that.

MR. FULTON: Q: Yes. And the part of the response that I want to focus on is the last half of the response, where it's stated:

> "In the absence of inflation and technological gains, the market value of assets should approximate its book value. However, those caveats do not reflect reality particularly in the case of public utilities, where persistent inflation over time results in the book value of the assets

1 understating their true economic value.
2 When the regulatory paradigm is based on
3 historical cost of the assets, but the
4 allowed return represents a capital market
5 derived return applied to the book value of
6 the equity, with the underlying premise for
7 the allowed return is that the utility
8 market value should equal book value, the
9 resulting prices will understate the real
10 economic costs of providing utility services
11 and send price signals to customers that
12 encourage overconsumption of scarce
13 resources."
14 Is it your view that if a utility is
15 purchased for a premium over book value, in order to
16 reflect the real economic costs of providing utility
17 services, the new rates should be based on a rate base
18 that includes the acquisition premium?
19 MS. McSHANE: A: I think I was asked that question in
20 an Information Request. And my response to that was
21 that it really depends. To the extent that there are
22 benefits that are brought to bear from the
23 acquisition, I think a case could be made for that.
24 But that -- I mean, that's not the regulatory model
25 that -- typically that is used in North America. So,
26 acquisition premiums are to the account of the

1 shareholder.
2 MR. FULTON: Q: Thank you. If you could move forward
3 in the responses in Exhibit B1-20 to the response to
4 BCUC IR 1.60.1, at page 143. And that response cites
5 lines 2266 to 2267 of your evidence, where you say
6 "Once the capital is committed it cannot be withdrawn
7 and redeployed elsewhere." And then it goes on to
8 talk about the focus of the capital asset pricing
9 model, and I'll let you read the rest of that answer
10 and then I'll ask my question when you're finished.
11 MS. McSHANE: A: I've finished.
12 MR. FULTON: Q: Okay. Would you agree with me that the
13 response appears to highlight the view that utility
14 investments are very secure investments?
15 MS. McSHANE: A: I'm not sure that's what that response
16 says. It says that they are single-use assets, and
17 unlike assets of some other firms, they basically
18 can't be used anywhere else.
19 MR. FULTON: Q: Right. All right. Would you agree
20 with me that once capital in real utility assets has
21 been allowed into rate base by regulators, there is
22 little risk that the asset will not continue to earn a
23 return in comparison to a company that assets are
24 prematurely rendered obsolete due to competition or
25 new technological advances.
26 **Proceeding Time 1:52 p.m. T44**

MS. McSHANE: A: Relatively speaking that's true. The utility assets are of lower risk than an average -- the assets of an average risk company in the economy.

MR. FULTON: Q: Okay. And I'd like next to turn to Exhibit B1-24, which are the responses to BCUC IR 2, and I would ask you to turn the response to question 2.194.5 which is at page 107. Page 107.

MS. McSHANE: A: I have that.

MR. FULTON: Q: Now, can we agree that that response discusses how you came up with your long-range GDP forecast in Schedule 21?

MS. McSHANE: A: Yes.

MR. FULTON: Q: And the response shows a table of nominal GDP growth for the years 1989 to 2011.

MS. McSHANE: A: Well, that's part of the response but that doesn't have anything to do with how I came up with the 4.9 percent. So the first -- the question had multiple requests. The first request was: What are the assumptions used to estimate the long-term nominal GDP growth rate of 4.9 percent in Schedule 21? So the first paragraph of the response says that it came from a consensus forecast of blue chip economic indicators, which is the consensus of forecasts of more than 50 business economists.

And then the second part of the question is: What were the associated assumptions of inflation

in real growth that were incorporated in the 4-9? And I provided those in the second paragraph. And then it asks if that forecast had changed and I gave enough update and said that it was based on October it was 4-8. And then the table down below was a response to the question: What's the actual experience of GEP been in recent years? So that's what the table represents.

MR. FULTON: Q: And would you agree with me subject to check that the average rate of growth that's shown in the table is 4.7 percent?

MS. McSHANE: A: I haven't done that calculation, but it's possible.

MR. FULTON: Q: Okay.

MS. McSHANE: A: I will take that subject to check.

MR. FULTON: Q: Okay. And that would be the nominal average rate of growth.

MS. McSHANE: A: Correct.

MR. FULTON: Q: Now, I produced to your counsel a copy of the TD Economics Long-Term Economic Forecast dated September 18th, 2012. Have you had a chance to review that document?

MS. McSHANE: A: I did look at it, yes.

MR. FULTON: And I see that Mr. Wallace is not alone in being abandoned by the Hearing Officer when it comes time to --

1 THE CHAIRPERSON: Thank you. Do you have an exhibit
2 number on there?
3 MR. FULTON: Yes. A2-37 please.
4 THE CHAIRPERSON: 37?
5 THE HEARING OFFICER: A2-37.
6 **("LONG-TERM ECONOMIC FORECAST, TD ECONOMICS, SEPTEMBER**
7 **18, 2012", MARKED EXHIBIT A2-37)**
8 **Proceeding Time 1:57 p.m. T45**
9 MR. FULTON: Q: You would agree with me that through
10 the period covered by the table, the annual U.S.
11 growth rate forecast for the years 2012 to 2016 ranges
12 from 2 to 3.5 percent in real terms?
13 MS. McSHANE: A: Correct. So this forecast goes out to
14 2016, right?
15 MR. FULTON: Q: Yes.
16 MS. McSHANE: A: That's what I understand.
17 MR. FULTON: Q: Yes. And that in terms of the Canadian
18 growth forecast on an annual basis, the forecast is
19 1.8 to 2.5 percent in real terms in the same period.
20 MS. McSHANE: A: Right. That's what the TD forecast
21 shows.
22 MR. FULTON: Q: Okay. And then it falls out
23 mathematically, then, that the Canadian growth rate in
24 real terms is approximately 0.2 to 1 percent lower
25 than the U.S. growth rate over that period of time.
26 MS. McSHANE: A: Correct.

MR. FULTON: Q: Okay. I now have some questions on your rebuttal evidence. We're on to rebuttal evidence, your part of it. If you turn to page 12.

MS. McSHANE: A: Yes, I have that.

MR. FULTON: Q: And I'll just give you the line number. Line 314 to 315, you state,

> "Investor return expectations are likely to be formed by the returns that they have achieved historically."

Are those historical achieved returns observable at any point, given point in time?

MS. McSHANE: A: Yes. Over various periods, yes.

MR. FULTON: Q: And does it follow, then, as well that the growth in historical achieved terms is observable?

MS. McSHANE: A: Sorry, is -- I didn't hear exactly what you said.

MR. FULTON: Q: Does it follow, then, that the growth in historical achieved terms is observable? So you can observe the historical achieved returns at any given point in time. You've agreed with me on that.

MS. McSHANE: A: Yes.

MR. FULTON: Q: And so can you also observe the growth in the achievable returns -- or in the achieved returns, I should say.

MS. McSHANE: A: Do you mean, can you observe whether the trend in the returns has changed? Is that what

1 you mean?
2 MR. FULTON: Q: Yes.
3 MS. McSHANE: A: Yes, you can look at the trends in
4 returns and see if there is a change in trend.
5 MR. FULTON: Q: Okay. In your evidence, though, you
6 base your near-term growth forecasts on analyst
7 estimates, correct?
8 MS. McSHANE: A: Now we're talking about the -- we're
9 back talking about the discounted cash flow test?
10 MR. FULTON: Q: Yes.
11 MS. McSHANE: A: Yes.
12 MR. FULTON: Q: Okay.
13 MS. McSHANE: A: There have been a lot of studies that
14 have shown that analysts' forecasts are better
15 predictors of future growth than historic growth
16 rates.
17 MR. FULTON: Q: And you don't need to turn to it, but
18 you can take this subject to check that at page C-4 of
19 your evidence, you say "The consensus earnings
20 forecasts are reflective of the analysts' community
21 views, and there fore are reasonable proxy of
22 unobservable investor growth expectations." Do you
23 recall giving that evidence?
24 **Proceeding Time 2:03 p.m. T46**
25 MS. McSHANE: A: Yes.
26 MR. FULTON: Q: And if investor return expectations are

likely to be formed by achieved historical returns, and you can observe achieved historical returns, wouldn't it be more direct to base the growth expectations on the growth of historical -- on the growth that's shown in achieved historical returns?

MS. McSHANE: A: So just to make sure I understand what you're asking, are you asking me that isn't it in the context of the discounted cash flow test to combine a forward-looking dividend yield with a historic growth rate?

MR. FULTON: Q: If investors' expectations are based on the historic growth rate, why can't you use that in your DCF?

MS. McSHANE: A: The investors' expectations will be in part informed by history. To the extent that history is relevant they should be -- that history should be reflected in the forward-looking analysts' forecasts. Analysts' forecasts have been shown to be better predictors of growth than historic numbers, so I think it is best to use, in the context of the DCF, the analysts' forecasts as the best measure of investor expectations.

MR. FULTON: Q: Would you agree with me that one doesn't know the extent to which those historic achieved returns are embedded into the analysts' forecasts.

1 MS. McSHANE: A: You can't be sure the extent to which
2 investment analysts are embedding, to use the term you
3 used, history into their expectations, but it would be
4 reasonable to expect that they have looked at what the
5 companies have been able to do in the past to assess
6 what they should reasonably be expected to achieve in
7 the future.
8 MR. FULTON: Q: Thank you. Page 17 of rebuttal
9 evidence, your rebuttal evidence, and beginning -- the
10 paragraph beginning at line 452 and concluding at 459.
11 MS. McSHANE: A: I have that.
12 MR. FULTON: Q: So it's page 17.
13 MS. McSHANE: A: Yes.
14 MR. FULTON: Q: And I want to focus on the statement
15 that the earnings growth forecast for the companies in
16 the index is approximately 11 percent arterially
17 higher than the 6.3 percent sustainable growth rate as
18 estimated by Dr. Booth.
19 In the current economic climate, and given
20 recent historical achieved returns, does an annual
21 growth forecast of 11 percent seem reasonable to you?
22 MS. McSHANE: A: For those companies for the next five
23 years?
24 MR. FULTON: Q: Yes.
25 MS. McSHANE: A: Yes, I would say it's not
26 unreasonable. But it's only for the next five years.

It's not supposed to be a perpetual growth rate. The point really is that what we have is a dividend yield for the composite of approximately 3 percent. Which is -- which represents the yield of 249 individual companies, which have their own individual outlooks for growth. And that growth will not be constant in perpetuity. But what Dr. Booth has done is to basically assume that, for what are really specific companies, there is a single constant growth rate that investors expect, which represents the return on equity for corporate Canada, not for the 259 companies in the S&P Composite Index.

Proceeding Time 2:08 p.m. T47

MR. FULTON: Q: Thank you. Page 25. On that page, you include as Table 3 the interest rate differences between Canada and the U.S. Just to make sure the record is clear, can you confirm that these interest rate differentials are derived by subtracting the U.S. yield from the Canadian yield for each period, and each category?

MS. McSHANE: A: Correct.

MR. FULTON: Q: And what data did you use as the source for your bond yields? And if you can't recall, you can provide this by way of undertaking.

MS. McSHANE: A: I do. It might be easier if I -- and this is my fault. I usually am pretty good about

putting sources under my tables. Maybe it would be -- unless you have some questions you want to ask about them, maybe it would be easier for me just to provide you the sources for each of the series that was used.

Information Request

MR. FULTON: Q: Yes, that would be satisfactory, thank you.

Now, I have some questions about decoupling mechanisms and business risk. And I'd like to begin with Exhibit B1-20, the response to BCUC IR 54.2.1, which is at page 126 of B1-20.

COMMISSIONER HARLE: Could you repeat that?

MR. FULTON: Yes. Exhibit B1-20, IR 1.54.2.1, at page 126.

Q: And in that IR, you were asked to elaborate on some of the major categories of methodologies and mechanisms which may or may not lead to certain outcomes, such as risk reduction or efficiency?

MS. McSHANE: A: Yes, I was.

MR. FULTON: Q: And you indicate on page 127 of the response that -- and this is under the heading "Revenue to coupling and related mechanisms", about two-thirds of the way down, "Risk mitigation is a byproduct of revenue decoupling, but not its primary objective." Correct?

MS. McSHANE: A: Yes.

1 MR. FULTON: Q: Okay. Can you tell us what you mean by
2 "revenue decoupling"?
3 MS. McSHANE: A: What I mean by "revenue decoupling" is
4 that there is a mechanism that would either refund or
5 recover amounts from customers that are due to higher
6 or lower volumes that are -- that arise from changes
7 in customer usage. And it can include weather, as
8 well, or weather may be a separate mechanism.
9 MR. FULTON: Q: Okay. And to put it another way, would
10 you -- or could one say that revenue decoupling
11 removes the link between sales and revenues and
12 therefore makes the utility indifferent as to the
13 effects of conservation and other policy objectives?
14 **Proceeding Time 2:13 p.m. T48**
15 MS. McSHANE: A: I've heard that definition before in
16 exactly those words. Yes, that's exactly what it is.
17 MR. FULTON: Q: Okay, all right, you'd agree with that
18 definition?
19 MS. McSHANE: A: Yes, I would.
20 MR. FULTON: Q: All right, thank you. And would you
21 consider the existence of deferral accounts a type of
22 revenue to coupling mechanism?
23 MS. McSHANE: A: No. I wouldn't consider that to be
24 the same thing. Certain deferral accounts mitigate
25 forecasting risks but the purpose of them is not as
26 you describe revenue to coupling.

MR. FULTON: Q: If you could turn over to page 128 where you talk about rate stabilization mechanisms, on the second line you say:

> "FEI's RSAM is a decoupling mechanism, not a rate stabilization mechanism, despite its name."

Can you tell us what the difference is?

MS. McSHANE: A: So you described what a decoupling mechanism was. When I was referring here to a rate stabilization mechanism which a couple of the utilities in my sample have, the rate stabilization mechanism simply is a way to adjust rates to ensure that the utility can earn its allowed return.

So for example in the case of Piedmont Natural Gas in its South Carolina operations, I don't recall specifically what its allowed return is, but let's say its allowed return is 10 and a half percent, if it looks like their return is going to be 9 and a half percent or 11 and a half percent, then the rates will be changed to bring the allowed return back to -- I'm sorry, to bring the earned return back to approximately the allowed return.

MR. FULTON: Q: If I could return to your statement on page 127 that risk mitigation is a byproduct of revenue to coupling but not its primary objective, would you agree that business risk is mitigated

through the existence of decoupling mechanisms, through the existence of deferral accounts, and -- or through the existence of rate stabilization mechanisms?

MS. McSHANE: A: I don't disagree that all of those things have the effect of reducing short-term year-to-year variability risk. My only point here was just to say that regulators have introduced revenue decoupling for purposes which don't have any -- which are not for the purpose of reducing risk, but that that is one of the effects of that, at least as affects short-term risk.

MR. FULTON: Q: Now, I may not have given this document to your counsel, but it part of the record so I'll pass it to him now and I'll give it to you. It's a slide, Slide 17 from the AVS Consultant study that was filed by Corix and is included in Exhibit B2-9, Attachment 8.2(a). And I apologize for you not getting that in advance, Ms. McShane.

MS. McSHANE: A: That's quite all right.

Sorry, this was -- was this part of a study?

Proceeding Time 2:19 p.m. T49

MR. FULTON: Q: Yes, the ADS Consultants study that was filed by Corix as an attachment to its evidence. And the conclusion in the study is that revenue decoupling

-- sorry. It appears to be that revenue decoupling mechanisms have no impact on the systematic risk of utilities. Would you agree with that?

MS. McSHANE: A: That's not something I've really thought about.

MR. GHIKAS: Mr. Chairman, I'm just rising because I think it's important that without having seen the analysis that leads up to the statement that Ms. McShane not be asked to adopt a conclusion that presumes that she agrees with all of the analysis leading up to it. So if my friend wants to formulate a question that's in the abstract, that would be my preference. Because I think until Ms. McShane sees the context leading up to it, it's difficult to ask her whether she agrees with the simple conclusion.

MR. FULTON: Q: Right. Well, let me ask you a general question, then. Would you agree that revenue decoupling mechanisms have no impact on the systematic risk of utilities.

MS. McSHANE: A: Well, if you think about what systematic risk is intended to capture, which would be, you know, how stocks react to factors like, you know, how the whole equity market moves, how they move in relation to movements in the economy, movements in oil prices, movements in interest rates, those kinds of systematic things. I mean, intuitively I would say

1 decoupling probably had little impact on beta. But I
2 haven't looked at this study, and so, you know, I
3 don't know what -- how the analysis was conducted.
4 And whether it's measuring betas the way they should
5 be measured to capture those kinds of differences. So
6 all I can give you is my intuition.
7 MR. FULTON: Q: All right. Well, thank you, then. And
8 you will have the opportunity to look at the entire
9 study if you wish. And if your view changes, I'm sure
10 that we'll hear that on re-examination.
11 MS. McSHANE: A: Okay.
12 MR. FULTON: So, Mr. Chairman, could we mark that
13 document the next exhibit, if we have not already?
14 A2-38?
15 THE HEARING OFFICER: That's A2-38.
16 MR. FULTON: Which is page 17 of attachment 8.2A.
17 **("ATTACHMENT 8.2(A), PAGE 17 OF 18, RESULTS OF**
18 **DIFFERENCES IN SYSTEMATIC RISK", MARKED EXHIBIT A2-38)**
19 MR. FULTON: Q: Of Exhibit B2-9.
20 If you could turn back to Appendix B of
21 your evidence. Page B-5 and B-6. And these pages
22 relate to details of some of the utilities collected
23 from your sample of low-risk U.S. utilities?
24 **Proceeding Time 2:24 p.m. T50**
25 MS. McSHANE: A: Right.
26 MR. FULTON: Q: And pages B-5 and B-6 relate to Alliant

1 Energy Corp?
2 MS. McSHANE: A: Right.
3 MR. FULTON: Q: About halfway down page 6, B-6, it
4 talks about deferral mechanisms and in particular for
5 IPL, which I understand is Interstate Power and Light?
6 MS. McSHANE: A: Correct.
7 MR. FULTON: Q: And it states that "IPL was authorized
8 to implement a pilot transmission cost recovery
9 mechanism for a three-year term. The rider was
10 implemented in conjunction with a three-year rate-base
11 freeze in reduction and allowed ROE of .40 percent."
12 Would you agree that that provides us with some
13 insight that deferral mechanisms actually reduce
14 risks, and that's why we see a reduction in the
15 allowed ROE? Is that a reasonable inference to draw
16 from that summary?
17 MS. McSHANE: A: Well, the reasonable inference to draw
18 is that at least at some level, that there is a
19 reduction -- viewed as a reduction in risk, yes.
20 Whether there's a particular -- actually with this one
21 or not, I mean, that's a different question. But I
22 mean, this Commission has introduced reductions in ROE
23 for, for example, the implementation of RSAMs.
24 MR. FULTON: Q: I produced yesterday to your counsel an
25 extract from the decision of the Oregon Public Utility
26 Commission, Order No. 09-176. Have you had an

opportunity to review that extract?

MS. McSHANE: A: Yes, I did look at it.

MR. FULTON: Q: Okay, and would you agree with me that the decision related to a proposal by Portland General Electric for decoupling mechanisms related to energy efficiency programs?

MS. McSHANE: A: It's a decoupling mechanism I'm looking for. I mean it is related -- they are all related to energy efficiency, yes, so I agree with you.

MR. FULTON: Q: And then in the introduction the statement appears to be on the second line:

> "Among our conclusions was the determination that because "PGE does have the ability to influence customer usage we believe that a properly constructed decoupling mechanism would promote behaviour by the Company that would be publicly beneficial'."

And then it goes on to say:

> "Among the conditions were an initial limitation on the length of the program, the two years subject to review, and a 10 basis point reduction in return on equity."

Would you agree with me that this appears to be another example of where the introduction of a certain type of decoupling mechanism resulted in a

reduction of ROE?

MS. McSHANE: A: Yes, this was another example of that.

Proceeding Time 2:29 p.m. T51

MR. FULTON: Q: Can we infer from both the Alliant Energy example and the Portland General Electric example that a reduction -- that the reduction in ROE is the result of the decoupling mechanism and decoupling mechanisms actually reduce the level of risk for a utility?

MS. McSHANE: A: Decoupling mechanisms do assist in helping to recover the fixed costs and earn a return from year to year, so they do reduce short-term risk.

MR. FULTON: Q: And depending upon the nature of the deferral accounts, if they have a revenue decoupling aspect, would you agree that the more accounts of that nature a utility has, the lower the level of risk it faces?

MS. McSHANE: A: In terms of the year-to-year variability, the more of the revenue requirement that's assured, I would say that there is less forecasting risk. So there is less short-term risk.

MR. FULTON: Q: And so would the way that you measured the level of the risk be determined by the number of deferral accounts, or revenue decoupling mechanisms, that assist in the reduction -- assist in ensuring what the revenue -- that the utility will get its

return.

MS. McSHANE: A: No, I don't think you would look at the number. You'd be more concerned about what percentage of the costs are recovered by these -- by the mechanisms. And then, of course, you would need to see how that compares to comparable companies. So, from the perspective of a gas utility, for example, and I think that there was a discussion about this the other day with panel 1, a significant amount of their costs are gas costs, and those are recovered through gas cost recovery -- I can't remember what the acronyms are any more. But that, you know, that's basically the same as every other gas utility. And then you have the RSAM, which a lot of gas utilities have RSAM-type accounts and weather normalization accounts. So on that front, FEI is fairly similar to other gas utilities. I think -- so it's a combination of looking at what proportion is covered and how does the utility compare to its peers.

MR. FULTON: Q: Thank you.

Could we mark the extract from the Oregon Public Utility Commission, Order 09-176, the next exhibit, please?

THE HEARING OFFICER: A2-39.

(EXTRACT FROM ORDER NO. 09-176 FROM PUBLIC UTILITY COMMISSION OF OREGON, MARKED EXHIBIT A2-39)

Proceeding Time 2:34 p.m. T52

MR. FULTON: Q: I'd next like to ask some questions on your response to BCUC IR 49.6 in B1-20 which is page 116 of B1-20, and I do have some copies of electronic documents and the first is a rating report of DBRS dated February 29th, 2012. Do you have a copy of that? Okay. And the second is a Moody's investor credit opinion dated July the 21st, 2011. Perfect.

So I will ask first of all that the DBRS report dated February 29, 2012, which is part of Exhibit B1-9-1, tab A-2, be marked the next exhibit please. And then -- which would be A2-40, and then a Moody's report which is part of Exhibit B1-9-1 be marked Exhibit A2-41.

(RATING REPORT, FEBRUARY 29, 2012 FROM DBRS, MARKED EXHIBIT A2-40)

(DOCUMENT HEADED "MOODY'S INVESTORS SERVICE, CREDIT OPINION: FORTISBC ENERGY INC.", MARKED EXHIBIT A2-41)

MR. FULTON: Q: Now, if we begin with the response to the IR, that response shows that under a debt/equity ratio of 40/60, FEI's cash flow from operations interest coverage ratio is 2.6 times and its cash flow from operations pre-working capital debt is 10.8 percent?

MS. McSHANE: A: Yes.

MR. FULTON: Q: And that under an assumed reduction in

1 the deemed common equity of 2 percent, are estimated
2 to be 2.5 times and 10.2 percent. Correct?
3 MS. McSHANE: A: Sorry, can I just have a second to
4 just refresh my memory on this question?
5 MR. FULTON: Q: Absolutely.
6 MS. McSHANE: A: Sorry, go ahead.
7 **Proceeding Time 2:39 p.m. T53**
8 MR. FULTON: Q: So, you'll agree with me that under an
9 assumed reduction the deemed common equity of 2
10 percent, the ratios are estimated to be 2.5 times and
11 10.2 percent.
12 MS. McSHANE: A: At the actual 2011 ROE, I believe.
13 Only a reduction in the common equity ratio.
14 MR. FULTON: Q: Yes. And have you read the rest of the
15 response to 49.6?
16 MS. McSHANE: A: Yes.
17 MR. FULTON: Q: And in that response you speak of -- in
18 the light of the trend toward thicker equity ratios in
19 other Canadian jurisdictions in recent decisions --
20 and then you also talk about Moody's expectation of
21 stronger metrics. I want to focus on the trend
22 towards thicker equity ratios in other Canadian
23 jurisdictions.
24 What do you base your statement on that
25 there is a trend towards thicker equity ratios in
26 other Canadian jurisdictions?

MS. McSHANE: A: There are -- at the National Energy Bard, there have been changes, increases, in the allowed common equity ratios for a number of the Canadian pipelines since the last decision as well as the increases for all the Alberta utilities in 2009, and confirmed in 2011.

MR. FULTON: Q: The OEB, though, did reject Union Gas's application for an increase from 36 to 40 percent, did they?

MS. McSHANE: A: Yes, they did.

MR. FULTON: Q: Okay. Now, if you look at A2-40, which is the DBRS report, the second paragraph of that report, about midway down, states:

> "The regulatory framework in British Columbia is viewed as reasonable in terms of cost recovery, returns on equity, ROE of 9.5 percent, and capital structure 40 percent. Although FEIs, ROE, and capital structure could be affected in 2013 to a regulatory review (see regulation) DVRS does not expect the outcome of the regulatory review to have a material impact on the company's earnings and cash flow."

So, that was DBRS's view as of September the -- as of February the 29th, 2012. Correct?

MS. McSHANE: A: Well, that says to me that they didn't

1 expect there to be material changes. But that's my
2 interpretation of what they're saying.
3 MR. FULTON: Q: Okay. And then if you turn to Exhibit
4 A2-41, the Moody's Investor Service Report of July
5 21st, 2011, and turn to the third page of that report,
6 under the heading "What could change the rating -
7 down?", and the comment appears:
8 "Notwithstanding FEI's low-risk business
9 profile, its financial profile is considered
10 weak at the A-3 senior unsecured rating
11 level. Accordingly, a sustained weakening
12 of FEI's cash flow interest coverage below
13 2.3 times and CFO pre-W/C debt below 8
14 percent combined with a less supportive and
15 predictable regulatory framework would
16 likely return in a downgrade of FEI's
17 rating. This could occur if gas were to
18 lose its competitive advantage over
19 electricity in British Columbia due to
20 provincial policies favouring non-carbon-
21 emitting energy sources and other factors."
22 Would you agree that on the numbers
23 available to date, it doesn't appear that FEI will
24 lose its competitive edge?
25 **Proceeding Time 2:44 p.m. T54**
26 MS. McSHANE: A: Well, the statement references not

1 prices, but it says gas losing its competitive
2 advantage due to provincial policies favouring non-
3 carbon-emitting energy sources or other factors.
4 MR. FULTON: Q: Well, you'll agree with me that the
5 carbon tax is under review?
6 MS. McSHANE: A: Yes.
7 MR. FULTON: Q: And would you also agree with me that
8 the new natural gas policy is more friendly towards
9 FEI than was previously the case?
10 MS. McSHANE: A: In one specific application.
11 MR. FULTON: Q: Yes.
12 MS. McSHANE: A: That being natural gas transportation,
13 which is, as was discussed, expected to be relatively
14 small impact at least over the next five years.
15 MR. FULTON: Q: I have some questions now about what
16 the change might be in the embedded costs of debt if
17 there was a downgrade to B Double-A. And if you could
18 -- we can begin with your evidence, your rebuttal
19 evidence actually, page 5, footnote 6.
20 MS. McSHANE: A: I have that.
21 MR. FULTON: Q: And can we agree that the marginal
22 costs of long-term debt in the examples is
23 approximately 4 percent and that the current embedded
24 cost of debt is 6.78 percent?
25 MS. McSHANE: A: The 4 percent is basically the rate
26 for an A rated utility for 30-year debt today.

MR. FULTON: Q: The difference between the two numbers is 278 basis points?

MS. McSHANE: A: Yes.

MR. FULTON: Q: And you'll agree with me that the debt rating agencies don't evaluate credit metrics using the marginal costs of debt but they use the embedded costs of debt?

MS. McSHANE: A: Yes.

MR. FULTON: Q: Would you agree with me that the refinancing of embedded debt with new lower cost marginal debt under current conditions is beneficial to the rating agency credit metrics over time, the rating agency base credit metrics over time?

MS. McSHANE: A: If you can -- all other things equal, and that includes your allowed ROE, if you can -- and your capital structure. If you can refinance at lower than embedded costs it will improve your credit metrics. That does assume the same capital structure.

Proceeding Time 2:49 p.m. T55

MR. FULTON: Q: And you don't need to turn to this unless you want to, but will you agree with me that in the rebuttal evidence at page 6, you have raised a concern that a downgrade to B Double-A rating category could significantly raise FEI's costs of new long-term debt?

MS. McSHANE: A: Yes.

1 MR. FULTON: Q: And do I understand your concern
2 correctly to be that it relates to a rise in the
3 marginal cost of debt which is currently assumed to be
4 4 percent?
5 MS. McSHANE: A: Well, it would be -- it's not just
6 what you finance today. But if -- as you go out in
7 time and you need to refinance maturing debt, for
8 example, it will impact those rates as well. And you
9 won't necessarily be, and probably won't be,
10 refinancing a lot of your existing debt at 4 percent
11 if you -- if interest rates do, as is expected,
12 normalize. So I think from my own perspective it
13 would be fairly short-sighted to assume that it's okay
14 to be B Double-A rated now, because interest rates
15 happen to be low in 2013.
16 MR. FULTON: Q: Would a downgrade to B Double-A rating
17 cause the marginal cost of debt to rise more than the
18 278 basis points up towards FEI's embedded cost of
19 debt?
20 MS. McSHANE: A: No. But as you refinance, you would
21 see an increased cost. So, if you get out to when
22 some of the large amounts of debt become due -- I've
23 forgotten what the years are, maybe -- I'm going to
24 say 2016. Then we're talking refinancing at rates
25 that could be significantly higher at a B Double-A
26 than at an A. And this is something that perpetuates

over time.

MR. FULTON: Q: Okay. Would you agree with me that even with a 4 percent number, for Canada, you wouldn't expect the spread to go up 278 basis points? Wouldn't it be more in the range of 190 basis points?

MS. McSHANE: A: I'm sorry, I don't know what the 190 basis points represents.

MR. FULTON: Q: It's the Triple-B spread.

MS. McSHANE: A: Over 30-year Canadas?

MR. FULTON: Q: Yes.

MS. McSHANE: A: I'm not sure how that relates to the 678.

MR. FULTON: Q: No, the 278.

MS. McSHANE: A: So, the difference is 278.

MR. FULTON: Q: Yes.

MS. McSHANE: A: Between what the embedded cost of debt is today and the cost of new debt to an A-rated utility, which is a spread of about -- for an A-rated utility is a spread of about -- is 150 basis points.

MR. FULTON: Q: So if you take the 190 on a Triple-B --

MS. McSHANE: A: Right.

MR. FULTON: Q: -- plus the 4 percent.

MS. McSHANE: A: No, I think that's not right.

MR. FULTON: Q: Why isn't it right?

MS. McSHANE: A: The 4 percent already includes a spread for A-rated utilities of, say, 150 basis

points. So the differential is -- for new debt, could be an additional 40 basis points per issue, or more, if the market views a decision to explicitly cause a reduction in rating to Triple-B.

Proceeding Time 2:55 p.m. T56

MR. FULTON: Q: Your new Canada yield is approximately 4 percent. If you take the --

MS. McSHANE: A: I'm sorry. I think we're talking about two different 4 percents. Maybe that's the problem.

MR. FULTON: Q: All right, so let's try this again so that the record is clear. Your new Canada yield is 4 percent based on the 30-year forecast.

MS. McSHANE: A: Oh, see, that's where we weren't clear. Okay. Because the number that's in footnote 6 that we were talking about is not the 4 percent Canada rate. So we want to discuss -- if over the next couple of years, if the Canada rate, 30-year Canada rate is 4 percent and we have a spread of say 150 basis points for an A-rated utility, then there were about 5 and a half percent for an A-rated utility.

MR. FULTON: Q: And for a Triple-E?

MS. McSHANE: A: And then you would add anywhere from -- I mean it depends. Depends on what the perception of the bond investor is with regard to the downgrade. It could have a more, a greater impact than typical

simply because investors are concerned about the implications from a regulatory support perspective. But let's assume that it's just a typical Triple-B spread versus A-rated utility. So we would add perhaps another 50 basis points to the 550. So we're at 6 percent for a Triple-B at a Long Canada 4 percent, 590, 6 percent. So now the difference in the next three years we're talking about, or five years, is the difference between 6 percent and the embedded cost of 6.78 percent. So that's 78 basis points at that specific point in time, and long-term Canada Bond yields over that period are still relatively low.

So as we move out to the point where FEI's long-term debt starts to become ready to be refinanced, we're back at long-term bond yields that are fairly similar to the embedded rate.

MR. FULTON: Q: You would agree with me, though, that the result of that is that the embedded costs of debt is less than the 6.78 percent. The new marginal costs on the embedded debt -- the new marginal costs on debt are going to be less than the 6.78 percent that's referred to at page 5, footnote 6.

MS. McSHANE: A: At a Triple-B?

MR. FULTON: Q: Yes.

MS. McSHANE: A: For the long term? Or just in the next couple of years?

MR. FULTON: Q: In the near term, in the next couple of years.

MS. McSHANE: A: In the next couple of years because we're at abnormally low interest rates, that's true. Over the long term, no. And I don't think you should be looking at what small benefit you might be able to achieve in the next couple of years at the cost of long-term increased costs to customers.

Proceeding Time 3:00 p.m. T57

MR. FULTON: Q: And what it really depends on is on your forecasts of long-term bond yields.

MS. McSHANE: A: Well, not just my forecasts. It depends on where long-term bond yields end up. And it depends on, you know, what the state of the markets turns out to be, how receptive the markets are in the future to A-rated companies versus lower-rated companies. So it depends on a lot of things.

MR. FULTON: Q: I'd like to talk about comparable earnings next. In Schedule 25 of your evidence, you use a Canadian sample of unregulated industrial companies to estimate comparable earnings. Correct?

MS. McSHANE: A: Yes.

MR. FULTON: Q: And the achieved ROEs presented in Schedule 5 range from negative 43.7 percent in the case of Canadian National Railway in 1995 to a positive 38.8 percent for Ritchie Bros. in 1998.

1 Agreed?
2 MS. McSHANE: A: I haven't looked at the highs and
3 lows, but I'll take that, subject to check.
4 MR. FULTON: Q: And would you also agree subject to
5 check that there are many other companies with large
6 swings in ROE or have recorded negative ROEs in that
7 schedule?
8 MS. McSHANE: A: There are some that have negative, and
9 there are swings, yes.
10 MR. FULTON: Q: And would you agree with me that that
11 schedule appears to show that there is a much higher
12 level of business volatility with those unrelated
13 companies than there are with regulated utilities?
14 MS. McSHANE: A: There is higher volatility in
15 earnings, yes.
16 MR. FULTON: Q: And the majority of those unregulated
17 industrial companies are rated Triple-B?
18 MS. McSHANE: A: The ones that are rated, they're rated
19 Triple-B.
20 MR. FULTON: Q: Yes.
21 MS. McSHANE: A: There are a lot that aren't rated, as
22 I said yesterday, I guess it was. That there are a
23 lot that don't -- a fair number that don't have much
24 debt, and therefore they really don't need a debt
25 rating.
26 MR. FULTON: Q: Would you agree with me that the --

that higher business risks such as economic downturns or competition are a large reason for the ROE variability in those companies?

MS. McSHANE: A: Yes.

MR. FULTON: Q: The risk adjustment that you have made, or estimated, is approximately 125 to 150 basis points to compensate investors for additional business risk?

MS. McSHANE: A: To reflect the differences in total risk as between the unregulated companies and utilities.

MR. FULTON: Q: And -- all right, I think I'll leave that one there.

I'm moving to another topic, Mr. Chairman. I see the time. So --

THE CHAIRPERSON: We'll break for 15 minutes. Back at 3:15.

(PROCEEDINGS ADJOURNED AT 3:04 P.M.)

(PROCEEDINGS RESUMED AT 3:22 P.M.) **T/5859**

THE CHAIRPERSON: Please be seated.

MR. FULTON: Q: Ms. McShane, I'd like to move to the subject of A ratings, and your rebuttal evidence page 28, so Exhibit B1-32, page 28. Now, at page 28 in the answer that appears at lines 763 to 770, you state that the average S&P rating for Canadian utilities is A Minus, which is only one notch higher than Triple-B Plus, and you go on to say that the one notch

difference in debt rating between the two universes of utilities does not support the conclusion that the utility sectors in the two countries are viewed by S&P as a materially different total risk.

Are you implying that a one notch difference moving from A Minus to Triple-B Plus does not represent materially different total risk from S&P's perspective? Is that what I'm to take from your statement?

MS. McSHANE: A: No, I think what you're to take from my statement is that from an equity holder's perspective, Triple-B Plus versus -- a universe of Triple-B Plus versus a universe of A Minus is not so materially different that you can't select sample companies of comparable risk from a universe of Triple-B Plus companies.

MR. FULTON: Q: If you turn back to page 6 of the rebuttal evidence, you state that a downgrade of the Moody's rating from A-3 to the B Double-A category could significantly raise FEI's costs of new long-term debt, and in weak debt market conditions negatively impact its access to capital. I'm trying to reconcile what appears to me to be an inconsistency, but you may say it's not and tell me why it's not. But it seems on the one hand that you're saying that the difference between the two S&P ratings where Triple-B Plus and A

1 -- the difference between Triple-B Plus and A Minus is
2 not material, yet a move of Moody's ratings for FEI
3 could significantly impact its cost or access to
4 capital. Can you help me reconcile what seems to be,
5 to me at least, to be an inconsistent position?
6 MS. McSHANE: A: So what I was trying to convey was
7 that if you have a universe of companies that is
8 within one notch of another universe of companies, I
9 didn't think that that difference was material enough
10 to conclude that the universe that was rated Triple-B
11 on average was so much more risky that you could not
12 select from that universe companies of comparable risk
13 to Canadian utilities. That was really the thrust of
14 what I was trying to say on page 28.
15 **Proceeding Time 3:27 p.m. T60**
16 MR. FULTON: Q: And then the statement on page 6 is
17 then specifically intended for the FEI situation.
18 MS. McSHANE: A: Yes. If FEI was to be downgraded,
19 that there could be a significant increase in its cost
20 of debt, due to that downgrade from A-3 to Triple-B.
21 In a market particularly -- which is particularly
22 small, still, in terms of Triple-B issues, at the
23 long-term end.
24 MR. FULTON: Q: Okay. I'd next like to turn to the
25 issue of regulatory lag. And use the Puget Sound
26 Energy as an example of that.

In IR No. 1, beginning at page 78, there was a discussion about Puget Energy's achieved ROE and allowed ROE over the period 2002 to 2011. And so page 78 -- and in 2010 and 2011, we can agree that the ROEs that were achieved by Puget Sound Energy were less than the allowed ROEs for those years. Correct?

MS. McSHANE: A: I didn't prepare this response, but I assume that those are accurate.

MR. FULTON: Q: Okay. Well, this may be something that I need to ask Mr. Engen, then. Do you know whether that gap was caused by regulatory lag?

MS. McSHANE: A: No, I don't, specifically.

MR. FULTON: Q: Okay. The score for Puget Sound Energy is B Double-A?

MS. McSHANE: A: Yes.

MR. FULTON: Q: And the Moody's score?

MS. McSHANE: A: Score for?

MR. FULTON: Q: Its rating?

MS. McSHANE: A: Are you talking about the Moody's rating?

MR. FULTON: Q: Yes.

MS. McSHANE: A: Based on the piece of paper that I was provided, which I -- no, sorry, this is --

MR. FULTON: Q: Let me take you to page 28 of the IR, and that may help you in terms --

MS. McSHANE: A: Okay.

MR. FULTON: Q: Because you were asked a question at 161.1. And you were unable to speak -- it was noted you were unable to speak for Moody's as you did not know what consideration led to its assignment of the BWA rating.

So maybe I should try this more generally. Is it your opinion that the existence of a regulatory lag is a significant reason for a lower regulatory framework rating?

MS. McSHANE: A: I think it could be one reason that Moody's would assign a lower rating on regulatory framework.

MR. FULTON: Q: Okay. But I take it from that you can't put any weight on how significant that reason might be.

MS. McSHANE: A: No. I can't.

Proceeding Time 3:32 p.m. T61

MR. FULTON: Q: Okay. I next have some questions related to risk adjustments to holding companies. And I'd like to ask you about the risk adjustment that should be made when we look at a holding company versus an operating company. You'll agree that the objective of this proceeding is to find an ROE, a benchmark ROE for an operating company, the operating company FEI and not the holding company.

MS. McSHANE: A: That's correct.

MR. FULTON: Q: And the majority of the public traded equity represents holding company equity for utilities from the evidence that you've provided, correct?

MS. McSHANE: A: Most of the publicly traded companies are holding companies that have one or more utilities as subsidiaries.

MR. FULTON: Q: And back to Schedule 22, would you agree with me that these publicly traded companies are likely to be holding companies? We know --

MS. McSHANE: A: They were all holding companies.

MR. FULTON: Q: Yes, thank you. And in terms of the U.S. sample that you provided, are they also mostly holding companies?

MS. McSHANE: A: They're mostly holding companies.

MR. FULTON: Q: Would you agree with me generally that your market-based test such as the CAPM, beta, historic utility equity risk premium and DCF inform of the costs of equity for publicly trading holding companies and not specifically for operating companies?

MS. McSHANE: A: Yes, the publicly traded and these are holding companies.

MR. FULTON: Q: Yes.

MS. McSHANE: A: For the most part, except for I think Piedmont Natural Gas and Northwest Natural Gas are really not holding companies *per se* in that their

1 operating company sits at the parent company level. I
2 mean they may have some small subsidiaries themselves,
3 but Piedmont and Northwest are not really holding
4 companies.
5 MR. FULTON: Q: So in terms of the universe of
6 companies that you have provided in your samples,
7 there aren't many examples of publicly trade equity of
8 the operating companies, of operating companies, are
9 there?
10 MS. McSHANE: A: No, they're mostly holding companies
11 whose subsidiaries are operating utilities.
12 MR. FULTON: Q: Conversely, there is more information
13 in the bond market because both operating companies
14 and holding companies typically issue bonds. Would
15 you agree with that?
16 MS. McSHANE: A: Sorry, there's more information on --
17 MR. FULTON: Q: On the bond market in which the holding
18 companies and the operating companies are involved
19 because both holding companies and operating companies
20 typically issue bonds.
21 MS. McSHANE: A: Just so I'm clear what you're asking,
22 I can observe what the ratings are for the holding
23 companies and what the ratings are for the operating
24 companies in the bond market.
25 MR. FULTON: Q: Yes, but you can't do that in the
26 equity market.

MS. McSHANE: A: That's correct. You are essentially inferring the cost of equity from information for the publicly traded entity.

MR. FULTON: Q: And the difference in the cost of long-term debt between the holding companies and the operating company subsidiaries of Canadian utilities has been approximately 35 basis points since 2010?

MS. McSHANE: A: I think that's about right.

MR. FULTON: Q: And Mr. Engen provided a graph of the spread between Fortis Inc. and related subsidiaries which showed a similar profile. Do you recall that evidence?

MS. McSHANE: A: Yes.

Proceeding Time 3:37 p.m. T62

MR. FULTON: Q: Can you confirm that you conceptually use bond spreads as a proxy to calculate a portion of the risk adjustment in your comparable earnings test?

MS. McSHANE: A: I did. And I was asked in an Information Request about that. And I said that in that case I did use that difference as well as the beta, where I was -- where there was, to my mind, overwhelming evidence that the unregulated companies were a greater risk than the utilities.

MR. FULTON: Q: And IR 176.3, which is in Exhibit B1-24 at page 56 -- so, B1-24, page 56. You were asked about a hypothetical scenario, and your response was,

1 all other things equal, that is, a single investment
2 by the holding company, and no liquidity premium
3 attached to the 50 percent of the equity owned by the
4 private investor, the equity of the holding company
5 would be riskier due to the higher leverage. Correct?
6 MS. McSHANE: A: In the example that you gave, yes.
7 MR. FULTON: Q: Okay. If equity investors are exposed
8 to more risk than bond investors, and bond investors
9 demand a 35 to 40 basis point risk premium to invest
10 in the holding company bonds, wouldn't it be
11 reasonable to assume that an equity investor in a
12 holding company would also demand at least 40 basis
13 points more than the hypothetical equity investor in
14 the operating company on a standalone basis, all else
15 being equal?
16 MS. McSHANE: A: No. I believe that if you look at the
17 response to BCUC IR No. 1, I think it's question 73.5,
18 which is Exhibit B1-20, and it's page 162, there is a
19 full discussion of this issue and the fact that the
20 reason that there is a premium on the debt of the
21 holding company is because of the subordination of the
22 debt at the holding company level to the debt of the
23 operating company level. Which is a factor that is
24 not the same at the equity level.
25 At the equity level, we should be looking
26 at the -- you know, what the business risks are of the

equity of the holding company. What businesses are there, how much diversification is there. That kind of thing. So, the debt really has to do with the subordination of the parent company debt to the operating company debt.

MR. FULTON: Q: And you're speaking of on a standalone basis.

MS. McSHANE: A: The equity?

MR. FULTON: Q: Yes.

MS. McSHANE: A: Yes.

MR. FULTON: Q: Now, in terms of the U.S. sample of low-risk U.S. utilities that you used to perform the discounted cash flow estimates, can you confirm that 7 of those 12 companies in the sample have Moody's ratings of D Double-A1?

Proceeding Time 3:42 p.m. T63

MS. McSHANE: A: Yes. Which, by the way, is the same rating that Fortis Alberta has, that Newfoundland Power has, that Hydro One has on a standalone basis. So, very similar to the typical rating of a Canadian utility that Moody's rates. So --

MR. FULTON: Q: I provided your counsel yesterday with copies of extracts from the electronic attachments, attachments 47.5b and 47.5c. Have you had an opportunity to review those attachments?

MS. McSHANE: A: Yes.

1 MR. FULTON: Q: And would you agree, from your review
2 of attachments 47.5b and 47.5c, that they display a
3 history of achieved ROEs and allowed ROEs for the
4 companies that are listed in those attachments?
5 MS. McSHANE: A: So, the first page of the attachment
6 that you gave me, these are the returns for the parent
7 companies, the holding companies.
8 MR. FULTON: Q: Yes.
9 MS. McSHANE: A: And then the allowed returns in the
10 years they were granted for whatever subsidiary they
11 were granted for is on the next four pages.
12 MR. FULTON: Q: Okay. Now, on 47.5b, would you agree
13 that the highlighting shows where large declines in
14 ROE -- where there are large declines in ROE or the
15 ROE has fallen short of the allowed ROE?
16 MS. McSHANE: A: The highlighted numbers are -- well,
17 they're all actual ROEs of the parent company. So they
18 don't necessarily show where, for the operating
19 subsidiary, the achieved ROE has fallen short of the
20 allowed ROE. I'm sure that what you've done, for
21 example, for Xcel Energy is to look at the most recent
22 allowed ROEs that are on like page 4 of Attachment
23 47.5c. The number for 2011 for Xcel Energy on 47.50b
24 doesn't necessarily tell you Northern States Power of
25 Minnesota earned its allowed ROE. It just shows that
26 overall the holding company earned 10.1 percent in

2011.

Proceeding Time 3:48 p.m. T64

So there are some -- a few numbers that you've got highlighted on here. For example, in 2002 you show a large negative ROE for Xcel Energy, and you had -- Staff had asked an IR with respect to some of the specific numbers and that was one of them, and that was in response to BCUC IR No. 2-162.3, and that's on page 31 of B1-24. And so each of those was explained and we could talk about those individually if you'd like, but they're all set out in that response.

MR. FULTON: Q: Would you agree with me that in looking at Attachment 47.5b, the U.S. companies have -- U.S. holding companies have much higher earnings risks?

MS. McSHANE: A: They have higher volatility in returns than FEI would have had, yes. And I address that issue in 164 -- sorry, BCUC IR 2-162.4.

MR. FULTON: Q: Thank you. Now, on Attachment 47.5c, the highlighting is of allowed ROEs of the various operating companies relating to recent years.

MS. McSHANE: A: Yes.

MR. FULTON: Q: Now, taking a look at 47.5b again, you'll agree with me that there a number of years where the achieved ROEs had significantly fluctuated.

MS. McSHANE: A: Yes. Yes, that's true.

1 MR. FULTON: Q: And we can just pick AGL for an
2 example, in which its achieved ROE declined from 13
3 point -- 13 percent to 6.7 percent during 2010-2011.
4 MS. McSHANE: A: Yes because they acquired NYCOR and
5 incurred significant merger and acquisition costs.
6 MR. FULTON: Q: Okay, and Alliant Energy Corp achieved
7 an ROE, or its achieved ROE went down from 9 percent
8 to negative .3 percent during 2003-2005, and then more
9 recently moved from 10.5 percent down to 4 percent
10 during 2008-2009.
11 MS. McSHANE: A: Yes, and again all of those situations
12 were described in response to 162.3.
13 MR. FULTON: Q: Okay. Can I infer that it was
14 unregulated business activity that caused a fall in
15 the ROE?
16 MS. McSHANE: A: In which case?
17 MR. FULTON: Q: For some of the companies?
18 MS. McSHANE: A: For some of the companies, yes.
19 **Proceeding Time 3:52 p.m. T65**
20 MR. FULTON: Q: Okay. Did you select most of the
21 companies due to their proportionately large holdings
22 of regulated assets?
23 MS. McSHANE: A: Yes. That was one of the criteria.
24 MR. FULTON: Q: Okay. There are also a number of
25 instances on -- in the attachments where the achieved
26 ROEs were somewhat below the allowed ROE, and those

1 would include Atmos, Integrys Energy, Vectren, and
2 Xcel over the last two to three years?
3 MS. McSHANE: A: I think that's fair to say, that in
4 those examples you've given me that in the last couple
5 of years the achieved ROEs have been lower than the
6 allowed -- allowed returns that have been allowed in
7 recent years.
8 MR. FULTON: Q: And would you also agree with me that
9 attachment 47.5c generally shows that the allowed ROEs
10 and allowed common equity ratios of the U.S. sample
11 companies are generally higher than the allowed ROEs
12 and allowed common equity ratios in Canada?
13 MS. McSHANE: A: That's true. Yes.
14 MR. FULTON: Q: And can you also agree with me that
15 U.S. utility companies, at least those that appear in
16 your sample, often achieve lower returns on equity
17 than allowed while in Canada utility companies usually
18 receive ROEs at the same or higher levels than those
19 allowed.
20 MS. McSHANE: A: Well, two things. One, these returns
21 are for the parent companies, not for the utilities.
22 And also there are situations where they earn below,
23 but there are also situations where they earn above,
24 so that on average the utilities tend to earn their
25 allowed return. I think I can --
26 MR. FULTON: Q: In Canada.

MS. McSHANE: A: -- I have discussed, in that there is more of a tendency to earn more and then less than to earn on average a return equal to the allowed -- there is a bit more volatility in the U.S. achieved returns of utilities than in Canada.

MR. FULTON: Q: But in spite of the higher common equity rates, the U.S. sample still has higher earnings volatility.

MS. McSHANE: A: They do have higher earnings volatility, yes. Now, at the parent company level. Which is the trade --

Proceeding Time 12:14 p.m. T66

MR. FULTON: Mr. Chairman, if we could mark those attachments the next exhibit in the A2 series, I believe that's A2-42.

THE HEARING OFFICER: A2-42.

(FIVE-PAGE DOCUMENT, FIRST PAGE HEADED "RETURNS ON AVERAGE COMMON STOCK EQUITY FOR SAMPLE OF U.S. UTILITIES", MARKED EXHIBIT A2-42)

MR. FULTON: Q: Now, in summary, would you agree that much of your current U.S. sample is rated lower and has much higher profit risk for the various reasons that you have described?

MS. McSHANE: A: They have more variability. I wouldn't say they have higher profit risk in the sense that the expectation that on average the utilities

1 will earn a fair return is similar in the U.S. as in
2 Canada. They may do it with more variability around
3 the average in the U.S., but I don't think that
4 there's a view that there's greater risk that they
5 won't on average earn a compensatory return.
6 MR. FULTON: Q: In terms of looking at the change in
7 risk, would you agree with me that there has been a
8 change in the companies in the sample since 2009 and
9 that since then six companies have been removed and
10 five companies added to the current sample of 12
11 companies?
12 MS. McSHANE: A: I know you're referring to an
13 information request response.
14 MR. FULTON: Q: Yes.
15 MS. McSHANE: A: Could you give me the reference to
16 that?
17 MR. FULTON: Q: Yes, I will.
18 MS. McSHANE: A: Thank you.
19 MR. FULTON: Q: BCUC 47.4, pages 109 and 110 and I'm
20 specifically referring to page 110.
21 MS. McSHANE: A: Sorry, so could you ask your question
22 again now that I have the IR in front of me here?
23 MR. FULTON: Q: Some of the companies that were in your
24 2009 sample are no longer in the 2012 sample, correct?
25 MS. McSHANE: A: Yes.
26 MR. FULTON: Q: And in fact there have been six

1 companies removed and five companies added between the
2 sample dates.
3 MS. McSHANE: A: Yes. Part of that is because the
4 criteria for inclusion were changed. So if we look at
5 the companies that are in the 2012 sample that were
6 not in the 2009 sample, those are all improved in
7 terms of risk. The ones that were in the 2000 sample
8 that aren't in the 2012 sample, like the first two
9 that were in the 2009 sample, I didn't have a -- I did
10 not have a criterion on the Moody's rating. So the
11 reason that Dominion and Duke were in the sample but
12 not now is because I actually included -- well, I
13 insisted that the utilities had to be -- at least be
14 Double-A-1 or Triple-B Plus on both credit ratings.
15 So as a result, these two companies weren't in the
16 sample in 2012. Had the criteria been the same, had I
17 not strengthened the criteria, they would have still
18 been in the sample.
19 **Proceeding Time 4:03 p.m. T67**
20 And similarly, on the New Jersey resources,
21 in the bottom half of the table, it was because the
22 criteria were strengthened, not because of any change
23 in the riskiness of the company. It was because I had
24 determined that if, you know, there was a concern
25 about the relative risk of the sample, let's make the
26 criteria a little bit more strict and so I added this

criterion that you had to have a certain percentage of assets that was regulated, so that that knocked out New Jersey Resources. It wasn't a change in the riskiness of the company. It was just that it didn't meet the criteria.

MR. FULTON: Q: So can I take it from that answer that previously some of the companies were higher-risk and they only recently began to display lower risk, so they don't have a long track record of being low-risk.

MS. McSHANE: A: Well, they would have been maybe one notch lower before. I mean, it's not like somebody changes their risk overnight. It's sort of a continuum. At some point, S&P decided that they should be rated A-minus. So it would have been, I guess, what you might call an evolution.

MR. FULTON: Q: Well, if we return to the earnings -- the issue of earnings variability conceptually, would you agree with me with something with high variability requires higher arithmetic returns to compensate for the volatility?

MS. McSHANE: A: I'm not sure I exactly understand what you're asking. Are you talking about, like, a risk/reward trade-off?

MR. FULTON: Q: Yes.

MS. McSHANE: A: So --

MR. FULTON: Q: And I'm talking conceptually here.

1 MS. McSHANE: A: Conceptually, you would expect or hope
2 that if a company had higher variability of returns,
3 it would have a higher return. To compensate for the
4 higher variability. And that's conceptually what
5 you'd expect.
6 MR. FULTON: Q: I'd next like to turn to a discussion
7 of equity risk premium methods. And the *ex ante* and
8 the *ex post* methods. And am I correct in my
9 understanding that the *ex ante* method starts off with
10 the premise of the expectation of future equity
11 returns as measured by your DCF implied cost of equity
12 in each calendar year from 1998 to 2012, as opposed to
13 the expectations of bond returns as indicated by the
14 bond yields in the calendar year, or income returns?
15 MS. McSHANE: A: So the DCF measures are the dividend
16 yield for their monthly estimates. So you've got the
17 dividend yield plus the growth rate that's published
18 as the expected growth rate during that same month.
19 Essentially the sum of those two numbers gives you the
20 DCF cost. And those DCF numbers are then compared
21 with the coincident month's yield on Government bonds.
22 **Proceeding Time 4:08 p.m. T68**
23 MR. FULTON: Q: All right, so that's the *ex ante*
24 method.
25 MS. McSHANE: A: Yes. So there is a determination then
26 in each month of what the premium was and then there

was an analysis of what the relationship over that period was between equity risk premiums, the level of government bond yields, and also the spread between A-rated utility bonds and government bonds. So then we can estimate based on where we think interest rates are going to be, where I forecast long-term government bond yields and spreads are going to be, what the cost of equity is at that level of long Canada bond yields and A-rated utility spreads.

MR. FULTON: Q: Now, if we turn next to the ex-post method. As I understand it, the *ex post* method is based on the premise of actual returns, and you described this method as the historic utility equity risk premium test?

MS. McSHANE: A: Yes.

MR. FULTON: Q: And for equity returns, this consists of income returns and actual capital gains or losses which combined equal the total return?

MS. McSHANE: A: So there is a total return on the equities and a bond income -- in comparison to bond income returns historically.

MR. FULTON: Q: And the total return includes both anticipated and unanticipated price movements?

MS. McSHANE: A: On the equity return?

MR. FULTON: Q: Yes.

MS. McSHANE: A: It would, yes. Conceptionally.

MR. FULTON: Q: Now, when we experienced market forces that cause simultaneous price moves to both equities and bonds, shouldn't we compare them on a total return basis?

MS. McSHANE: A: Depends what you are trying to do. If you are trying to estimate it in relation to the risk-free rate, then no. This is what I was trying to do here, similar to what I was doing with the capital asset pricing model.

MR. FULTON: Q: Page 107 of your evidence, table 27.

MS. McSHANE: A: I have that.

MR. FULTON: Q: And Mr. Wallace, yesterday afternoon touched on this table with you. That table shows the historic risk premium relative to bond total returns and relative to bond income returns.

MS. McSHANE: A: This is Table 27?

MR. FULTON: Q: Yes.

MS. McSHANE: A: Yes, it does.

MR. FULTON: Q: And the income based bond returns shows the utility risk premium of approximately 60 to 70 basis points higher than the bond total return?

MS. McSHANE: A: Yes, it does.

MR. FULTON: Q: So 60 points for Canadian utilities and 70 basis points for the U.S. gas utilities and U.S. electric utilities.

MS. McSHANE: A: Right, that's how much higher the bond

total returns were than the bond incomes returns over the historical period.

MR. FULTON: Q: And are you able -- is Table 27 telling us that Canadian investors have earned a total return premium of 4.2 percent by investing in utilities versus bonds?

MS. McSHANE: A: If they -- if they had bought and sold bonds each and every year, that's what that 4.2 is telling you.

Proceeding Time 4:13 p.m. T69

MR. FULTON: Q: Okay. Now, we may not have agreed with this completely, but we did have a discussion earlier about investors looking to past experience as a guide to the future. Do you recall that discussion?

MS. McSHANE: A: I do.

MR. FULTON: Q: Okay. And some investors do look to past experience as a guide to the future, correct?

MS. McSHANE: A: They would do.

MR. FULTON: Q: Yes. And those investors might expect a similar 4.2 percent risk premium over bonds going forward rather than your regression model at 6.4 percent?

MS. McSHANE: A: Are you talking about the number that's on page 108?

MR. FULTON: Q: The one on page 28, which I think this is -- it's in Table 28 on 108, yes.

MS. McSHANE: A: I suppose that you could argue that there might be investors that would look at it that way. I have a discussion underneath Table 27 which shows that there really hasn't been any trend in the equity returns of utilities over time. So I would think that investors would look to what they've actually earned as far as returns on the utilities, as well as recognize that these total bond returns are from a period on average that gave rise to a much higher return than they could expect, given where interest rates are today.

MR. FULTON: Q: Now, in terms of how you calculated your DCF costs of equity estimate, there are different variations of using DCFs and a common distinction could be described as using a single-stage or multi-stage model?

MS. McSHANE: A: That's one difference in the way analysts implement the DCF model or models.

MR. FULTON: Q: Yes, and you've read the Brattle report?

MS. McSHANE: A: I did read the Brattle report.

MR. FULTON: Q: Do you have it close by?

MS. McSHANE: A: I don't.

Proceeding Time 4:16 p.m. T70

MR. FULTON: Q: Ah. I'm wondering if Mr. Ghikas could provide you with that report and just take it to page

26.

MS. McSHANE: A: Sorry, Mr. Fulton, what was the exhibit number?

MR. FULTON: Q: Of the Brattle report?

MS. McSHANE: A: Yes.

MR. FULTON: Q: A2-3. And page 26. And if you turn forward to page 30, the top paragraph, the comment appears:

> "The major source of debate for the DCF model is determining the dividend growth rate, particularly for the long term. Unfortunately the forecast growth rate has a major effect on the costs of equity estimated by the DCF method."

Do you agree with that statement?

MS. McSHANE: A: That the forecast growth rate has a major effect on the cost of equity?

MR. FULTON: Q: Yes.

MS. McSHANE: A: Yes, it does. If you're talking about a utility, it could be half of the cost estimate.

MR. FULTON: Q: And you've expressed the view that many investors feel that the long-term growth rate for the utility industry should be similar to the GDP if not lower.

MS. McSHANE: A: I don't think I said anything about if not lower.

1 MR. FULTON: Q: Okay.
2 MS. McSHANE: A: But I mean, I think that's a
3 reasonable assumption for what the terminal growth
4 rate should be in a multi-stage model, for a utility.
5 **Proceeding Time 4:19 p.m. T71**
6 MR. FULTON: Q: Okay. And I apologize, Ms. McShane, I
7 said that you said, "If not lower", and I understand
8 that you didn't say that. So thank you.
9 Now, you have incorporated very high long-
10 term growth estimates in one of your variants of the
11 DCF estimate on schedule 22, correct?
12 MS. McSHANE: A: I am assuming that schedule 22 is the
13 Canadian utility group?
14 MR. FULTON: Q: Yes.
15 MS. McSHANE: A: So this is the group that has very
16 strong forecast earnings growth and that is reflected
17 in the relatively lower dividend yields than compared
18 to the U.S. sample, which has lower expected earnings
19 growth.
20 MR. FULTON: Q: And the single stage constant growth
21 Canadian-based sample shows a long-term mean growth
22 rate assumption of 7.5 percent for those companies?
23 MS. McSHANE: A: That's correct.
24 MR. FULTON: Q: And that is substantially higher than
25 the 4.3 percent GDP used on your Canadian multi-stage
26 variant?

MS. McSHANE: A: Yes, it is.
MR. FULTON: Q: And that fact results in a much higher corresponding DCF cost of equity estimate?
MS. McSHANE: A: The constant growth is higher than the multi-stage growth?
MR. FULTON: Q: Yes.
MS. McSHANE: A: Yes.
MR. FULTON: Q: Now, I think at some point this morning you used the word "infinity", but I can check the transcript over the weekend.
MS. McSHANE: A: "Perpetuity" I think maybe was the word.
MR. FULTON: Q: Perpetuity? Okay.
MS. McSHANE: A: But same difference.
MR. FULTON: Q: Okay, thank you. So that doesn't a 7.15 percent long-term growth rate into perpetuity for the utility sector with a 4.3 percent GDP rate for the whole Canadian economy imply that the utility sector would become a substantially larger portion of the Canadian economy?
MS. McSHANE: A: In principle, if those were -- growth rates were achieved into perpetuity, that would be eventually the logical outcome. And that's why I don't give 100 percent weight to that constant growth model, nor do I give a hundred percent weight to the multi-stage model.

MR. FULTON: Q: Because they would result in unreasonable outcomes.

MS. McSHANE: A: Giving a hundred percent weight? Yeah, I think on its own, for this sample of utilities that the constant growth model overstates the long-term expected return. On the other hand, I think doing it -- when you implement a very low growth rate relatively speaking into the multi-stage model, you end up understating. So the answer is somewhere in the middle.

Proceeding Time 4:23 p.m. T72

MR. FULTON: Q: And because the number is unreasonable, why not just eliminate it?

MS. McSHANE: A: Because I think what I was trying to say is that it's not that you eliminate it. You recognize that there is a range of these -- of values, and it falls in the middle. Similarly, I suppose, you could say, you know, eliminate the three-stage model because it's unreasonably low. And then you've got nothing.

MR. FULTON: Q: Okay. Of the two mechanism options, the single-stage and the multi-stage, which one in your opinion is the more unreasonable?

MS. McSHANE: A: I don't think either of them is more or less unreasonable. I think the answer falls in the middle.

MR. FULTON: Q: Okay.

MS. McSHANE: A: I mean, clearly investors are expecting above-average growth from these companies in the medium-term, and that's reflected in the prices and their yields. So, I believe that to accurately represent expectations that you need to consider the constant growth model, as well as the multi-stage model.

MR. FULTON: Q: Okay. I'd like to turn briefly to Enbridge, and I don't have a transcript reference for this, so it's based on my understanding of your testimony earlier today, I think. That you mentioned that Enbridge Inc., as a growth company, would have lower dividend yield, which offsets the high growth in estimating the cost of equity. Do you remember saying something like that?

MS. McSHANE: A: That, yeah, that there would tend to be a lower dividend yield with higher growth. Not saying that they're going to entirely offset each other, so that you'd get exactly the same answer for two companies with, you know, different growth rates and different dividend yields.

Proceeding Time 4:26 p.m. T73

MR. FULTON: Q: Okay. Well, if we return to Schedule 22 again, it shows that Enbridge Inc.'s dividend yield is 3.2 percent, which is 70 basis points lower than

1 Fortis Inc.'s 3.9 percent.
2 MS. McSHANE: A: Correct.
3 MR. FULTON: Q: And the growth rate of Enbridge is 10.4
4 percent, or 350 basis points higher than that of
5 Fortis Inc.
6 MS. McSHANE: A: Correct.
7 MR. FULTON: Q: And both of them are holding companies,
8 as we have agreed.
9 MS. McSHANE: A: Yes.
10 MR. FULTON: Q: Would it be fair to say that the lower
11 dividend yield of Enbridge is only a partial offset to
12 high growth, relative to Fortis Inc.?
13 MS. McSHANE: A: That's true. I mean, otherwise they
14 would be equal, which the DCFs would be equal, which
15 they're not.
16 MR. FULTON: Q: So perhaps, then, if I could summarize
17 then some of the differences in risk adjustments that
18 could be made to some of your market-based models,
19 including the equity risk premium test and the DCF
20 test. First, the U.S. utility sector in your sample
21 has higher business risk, as the fluctuations and the
22 achieved ROEs show, and the shortfalls from the
23 allowed ROEs show.
24 Second, that --
25 MS. McSHANE: A: So, higher business risk than an
26 operating company?

1 MR. FULTON: Q: Yes.
2 MS. McSHANE: A: They do have higher volatility of
3 achieved returns.
4 MR. FULTON: Q: Yes. And compared to the Canadian
5 operating company, compared to FEI.
6 MS. McSHANE: A: The volatility of those returns is
7 higher than FEI's has been.
8 MR. FULTON: Q: Okay. Many of the companies in your
9 sample are holding companies, which have higher equity
10 risks than their associated operating companies on a
11 stand-alone basis.
12 MS. McSHANE: A: I don't know that I would agree with
13 that, since a lot of the companies have multiple
14 operating companies, and so you get the
15 diversification effect across multiple geographic
16 locations, multiple regulatory jurisdictions, and
17 economic bases.
18 MR. FULTON: Q: Okay. One of the Canadian DCF
19 estimates includes a utility sector long-term growth
20 assumption that is much higher than GDP growth?
21 MS. McSHANE: A: Are you talking about the Canadian
22 Utilities?
23 MR. FULTON: Q: Yes.
24 MS. McSHANE: A: The constant growth? The DCF
25 estimates based on constant growth for the Canadian
26 Utilities is, yes, it's higher than GDP growth,

reflecting the fact that these companies have relatively high growth prospects in the medium term.

Proceeding Time 4:30 p.m. T74

MR. FULTON: Q: And the Canadian estimates rely partially on businesses that are very different than gas distribution, pure play gas distribution, and I'm including in those different businesses, Enbridge Inc. and TransCanada.

MS. McSHANE: A: So Enbridge Inc. is made up of gas distribution and pipelines for the most part, so they would be similar infrastructure type businesses.

MR. FULTON: Q: TransCanada?

MS. McSHANE: A: TransCanada is pipelines and power, I guess.

MR. FULTON: Q: Now, one last question in this area and that is that on pages 20 to 32 of your evidence, there are charts numbered 1 to 4 and tables numbered 2 to 3. And as an undertaking could I ask you to update those charts and tables to the end of November of 2012?

MS. McSHANE: A: Sorry, what pages are these on?

MR. FULTON: Q: They're on pages 20 to 32 of your evidence.

MS. McSHANE: A: So Charts 1 --

MR. FULTON: Q: 1 to 4.

MS. McSHANE: A: -- to 4.

MR. FULTON: Q: And Tables 2 and 3.

MS. McSHANE: A: Yes, I can do that.

Information Request

MR. FULTON: Thank you, Mr. Chairman. I'm moving into a different area now, so this would be a good time to break. I know you're looking like "How much longer are you going to be, Mr. Fulton?"

THE CHAIRPERSON: What a sense of --

MR. FULTON: I've anticipated that question and I'll probably be till the morning break tomorrow. On Monday I should say.

THE CHAIRPERSON: On Monday, okay. I think probably that it's appropriate that we'll break now. And then we have Mr. Wallace following you on Monday, is that right?

MR. FULTON: What will happen on Monday is I will finish.

THE CHAIRPERSON: Yes.

MR. FULTON: The Commission Panel will then ask its questions. Mr. Ghikas will conduct his re-examination to the extent that he has any. Then we will then close the public session of Ms. McShane's evidence and take hopefully just a five-minute break or however long it will take the Hearing Officer to set us up to do an *in camera* session, and Mr. Wallace and anyone else who has questions in the *in camera* session will then ask questions of Ms. McShane. Once that's done we'll close off the *in camera* session. Ms. McShane

will be finished in terms of her evidence, and we will move into the next witness panel, which will be Mr. Coyne.

THE CHAIRPERSON: Mr. Coyne, okay. Well, let's break for today and for the weekend, and back Monday morning 8:30. I think we should anticipate maybe going a little later on Monday, perhaps 5:00.

MR. FULTON: Yes. I've had some discussions with counsel, Mr. Chairman, and we're all agreed that we would like to have a shortened lunch hour. So we can pick up a half an hour there if we break from 12:00 until 1:00, and then in terms of sitting later next week we can see how flexible everyone can be.

THE CHAIRPERSON: Okay, that's reasonable at this point, so we'll deal with that on Monday then.

MR. FULTON: Thank you.

THE CHAIRPERSON: Excellent. Have a good weekend everybody.

(PROCEEDINGS ADJOURNED AT 4:34 P.M.)