M-32

FAIR RETURN AND CAPITAL STRUCTURE FOR TRANSÉNERGIE

EVIDENCE OF

Laurence D. Booth
Michael K. Berkowitz

BEFORE THE
Régie de l'énergie du Québec

November 2000

TABLE OF CONTENTS

1.0 *INTRODUCTION*

Q. PLEASE DESCRIBE YOUR NAMES, QUALIFICATIONS AND EXPERIENCE.

A. Laurence Booth is a professor of finance and finance area co-ordinator in the Rotman School of Management at the University of Toronto, where he holds the Newcourt Chair in Structured Finance. Michael Berkowitz is a professor of economics and finance, holding a cross appointment in both the Department of Economics and the Rotman School of Management at the University of Toronto. Professor Berkowitz is the chair designate of the Department of Economics and Director of the Financial Economics Program.

Professors Booth and Berkowitz have both presented testimony on the capital structure and fair rate of return for regulated utilities before most of the major regulatory boards in Canada, including the CRTC, the National Energy Board, and the public utility 'boards' in Alberta, British Columbia, Manitoba, Quebec and Ontario. Their testimony has been presented on behalf of a wide range of organisations including, but not limited to, the Province of Ontario, the Consumers Association of Canada, the Consumer Advocate of the Province of Newfoundland, the National Anti-Poverty Organisation (NAPO), the Canadian Association of Petroleum Producers (CAPP), the Industrial Gas Users Association (IGUA) and the Industrial Power Consumers Association of Alberta (IPCAA).

Detailed resumes are included as Appendix A.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The Québec Association of Industrial Electricity Users (AQCIE), the Québec Forestry Industry Association (AIFQ) and the Association of Private Electricity Producers (AQPER) have asked us to provide an independent assessment of the fair rate of return on common equity and the appropriate capital structure for TransÉnergie. We have also been asked to comment on various financial issues and to critique the evidence provided by the company witness, Dr. Roger Morin, (Appendix B).

We last appeared before the Regie in 1996 presenting similar evidence on GMI. Since then major changes have occurred in the capital markets that have forced us to modify our basic testimony. In particular, several companies have disappeared. The merging of the eastern regional Telcos into Aliant Telecom and the merger of BC Tel with Telus into BCT.Telus Communications has deprived us of a significant part of our "pure play" regulated sample. This has removed a significant fraction of the pure regulated utility sample that we relied on to draw inferences for pipelines, Telcos and gas and electric companies. As a result, we have discontinued both our discounted cash flow (DCF) and our preferred stock risk premium testimony.[1] The latter is no longer feasible, whereas the former is now subject to significantly greater estimation risk.

To compensate for the loss of these models we have developed a new multi-factor model to complement our standard CAPM based risk premium model. Further, the increasing globalization of capital markets and the development of innovative financing vehicles to circumvent portfolio restrictions in tax deferred savings plans has lead us to examine in more detail the statistical evidence on the US market risk premium.

Q WHAT OVER-RIDING PRINCIPLES HAVE GUIDED YOUR TESTIMONY?

A. In our judgement capital structure decisions should be "long lived" as they are primarily a function of the business risk of the firm. In particular, it is not standard practise to change equity ratios on an ongoing basis. The fair ROE, in contrast, constantly changes with capital market conditions. Consequently, we would recommend that the Régie sets TransÉnergie's allowed ROE in the future

[1] By agreement between the parties in 1996 we did not present our normal testimony focussing instead on our risk premium evidence.

based on a formula adjustment based on its ROE determination in this hearing. We would recommend adopting a similar formula to that chosen by the National Energy Board, the BC Utilities Commission, the Manitoba PUB and the Ontario Energy Board. This approach fixes the allowed ROE and then alters it each year in line with changes in the long Canada rate. The actual implementation differs slightly from jurisdiction to jurisdiction, but we would have no objections to changing the allowed ROE by 75% of the change in the long Canada rate as projected from the Consensus Economics forecast of ten year Canadas for the test year. Although such an approach is primarily an administrative convenience with little grounding in financial theory, it seems to have worked quite well in practise.

Q. WHAT ARE YOUR CONCLUSIONS?

A. The major conclusions of our analysis are:

- A fair return on equity of 8.25% is appropriate for transmission assets for 2001. This is slightly under a 300 basis points risk premium over current long Canadas and a 225 basis point risk premium over our forecast long Canada rate of 6.00%;

- Since the transmission assets are the lowest risk part of the electricity business, we recommend a common equity ratio of 30%, the same as that of mainline gas transmission assets;

- The excellent job done by Mr. Paul Martin in solving the endemic deficit problems of the federal government has reduced the significant risk premium that was embedded in long term Canada bonds, reducing the market risk premium to 4.5%, and

- Canada is poised for at least another year of good economic growth, combined with relatively low inflation. Although the risk of an economic slowdown is increasing, from our analysis of current capital market conditions, it is our judgement that the Transmission assets have sufficient financial flexibility with a 8.25% ROE on a 30% equity component to provide service.