Référence : ACIG-7, Document 1, Written evidence of Michael Gorman for IGUA, Exhibit MPG-5

Préambule : Mr. Gorman provides data from and references to U.S. regulatory decisions. Gaz Métro seeks clarification regarding the references.

Demandes : 1.1 Please provide and exact reference to the decision in line 3 re “AZ American” including the Arizona Corporation Commission’s Decision No.

Response 1.1

A copy of the order is provided in Vilbert Attachment 1.1.

1.2 Please provide the equity percentage allowed in each of the referenced decisions.

Response 1.2

The equity percentage in each of the referenced decisions is as follows:

1. CA Water 53.00%
2. CA American 42.00%
3. Golden State 51.00%
4. PG&E 48.00%
5. SDG&E 49.00%
6. SoCal Not stated in the order
7. AZ American 36.70%
8. WEPCO 54.36%

1.3 Please confirm that the decisions / orders referenced in lines 1, 3, and 5 pertain to water or wastewater utilities and that those referenced in lines 2 and 4 pertain to electric utilities.

Response 1.3

The orders referenced in lines 1, 3 and 5 pertain to water/wastewater utilities. The order referenced in line 2 pertains to electric utilities. The order referenced in line 4 is a joint application of Wisconsin Electric Power Company and Wisconsin Gas LLC for Wisconsin Electric Power Company to increase its electric, natural gas, and steam rates and for Wisconsin Gas LLC to increase its natural gas rates.

Préambule : Mr. Gorman states that Dr. Vilbert's ATWACC estimates are “flawed because he [Dr. Vilbert] assumed a constant tax rate across all utility companies.” Gaz Métro seeks clarification with regard to this statement.

Demandes :

2.1 Please confirm that the only assumption in the use of the marginal statutory tax rate in calculation of the ATWACC is that the company in question can make use of its interest tax shields at the marginal statutory rate.

Response 2.1

Mr. Gorman agrees.

2.2 Please confirm that some form of calculation of the income tax allowance for a particular rate regulated company is necessary to calculate the revenue requirement under existing regulatory procedures.

Response 2.2

The income tax calculation, based on the utility's actual income tax rates, is to provide recovery of income tax expense via utility revenue requirements and rates.

2.3 Please confirm that some form of calculation of the income tax allowance for a particular rate regulated company is necessary to calculate the revenue requirement under existing regulatory procedures.

Response 2.3

The income tax calculation, based on the utility's actual income tax rates, is to provide recovery of income tax expense via utility revenue requirements and rates.

2.4 Please confirm that the “tax shield” for Gaz Métro derived from the tax deductibility of interest expense is based upon its corporate income tax rate?

Response 2.4

Mr. Gorman agrees.
2.5 Please confirm that the tax shield considered in calculation of the ATWACC is the interest tax shield, not the depreciation tax shield.

**Response 2.5**

Mr. Gorman agrees.

2.6 Please confirm that Dr. Vilbert uses Gaz Métro's marginal corporate income tax rate in all of the ATWACC calculations in his analysis including any adjustments for differences in capital structure between the samples and Gaz Métro's regulatory capital structure. If not, please explain why not.

**Response 2.6**

Dr. Vilbert uses Gaz Métro's corporate income tax rate as a proxy for the tax rates for the proxy companies to calculate the ATWACC for each sample company. Dr. Vilbert did consider the market weight of debt and equity for each sample company in this ATWACC calculation.

2.7 Please confirm that Dr. Vilbert relied on Canadian benchmarks for the market risk premium and risk-free rate used in the CAPM and ECAPM model for both the Canadian utilities and the U.S. gas LDC samples.

**Response 2.7**

Mr. Gorman agrees.

2.8 Please confirm that the only U.S. parameter relied upon in the estimation of the CAPM and ECAPM models for the U.S. gas LDC companies was the beta estimate provided by Value Line.

**Response 2.8**

Mr. Gorman agrees.
2.9 Please provide all studies and data that Mr. Gorman has that shows that beta estimates are materially affected by the tax rate.

Response 2.9

Mr. Gorman has not performed the requested study.

2.10 Under the ATWACC methodology and for a constant ATWACC, does Mr. Gorman agree that the change in the ROE required to maintain a constant ATWACC for different capital structures is smaller for a lower corporate income tax rate? If not, why not?

Response 2.10

Yes.

2.11 If the market value capital structure of the sample has a lower debt percentage relative to the book value capital structure of the regulated company, does Mr. Gorman agree that the use of a lower corporate income tax rate, as used by Dr. Vilbert in his analysis, results in a lower estimate of the ROE for the regulated company at its regulatory capital structure than would a higher estimated corporate income tax rate? If not, why not?

Response 2.11

No. Dr. Vilbert estimated the ROE separately from his ATWACC calculation. The use of a lower tax rate resulted in a higher ATWACC, for companies with higher tax rates.

Préambule :
« […] The ATWACC methodology measures the overall rate of return using "market" value capital structure weights. In comparison, the traditional method uses the "book value" capital structure weights to estimate an overall rate of return. »

Demandes :

3.1 By the quoted statement, does Mr. Gorman intend to imply that Dr. Kolbe and Dr. Vilbert recommend using a market value rate base instead of a book value rate base?

Response 3.1

No.

3.2 If the answer to part 3.1 is other than an unqualified “no” please explain fully with references to Dr. Kolbe's or Dr. Vilbert's evidence where they advocate use of other than book value rate base to set rates.

Response 3.2

Not applicable.

3.3 Does Mr. Gorman acknowledge that the DCF models and the risk positioning models, i.e., CAPM, ECAPM, Fama-French, etc., all rely upon market information to estimate the cost of equity, and in particular market prices and market returns? If not, please explain fully.

Response 3.3

Mr. Gorman agrees.
3.4 Does Mr. Gorman acknowledge that the cost of equity estimates from the DCF models and the risk positioning models, i.e., CAPM, ECAPM, Fama-French, etc., reflect both the business risk and the financial risk of the sample companies? If not, please explain fully.

Response 3.4

The risk positioning models reflect risk that cannot be diversified away if the security is held in a diversified portfolio. The DCF model generally reflects total investment risk. However, theoretically, the market price is set by the market assuming only non-diversifiable risks are relevant.

3.5 Does Mr. Gorman acknowledge that the ATWACC is an estimated rate of return not an estimate of market value? If not, please explain fully.

Response 3.5

The proposed ATWACC is an estimated market value rate of return.

3.6 Does Mr. Gorman acknowledge that the rate of return represented by ATWACC would be applied to the rate base as measured by book value if the recommendations of Dr. Kolbe and Dr. Vilbert were followed? If not, please explain fully.

Response 3.6

Mr. Gorman agrees.
4. Référence : ACIG-7, Document 1, Written evidence of Michael Gorman for IGUA, pages 6-7

Préambule : « The ATWACC methodology does not meet the Rate Fixing or Modification standards outlined in the Régie's rules. First, the ATWACC does not develop an overall rate of return based on the original cost less depreciation value of the utility assets. Rather, the rate of return will be developed based on the market value of the utility assets. Second, the ATWACC will not establish the debt interest expenditures based on the utility’s actual interest rate multiplied by the amount of debt used to invest in utility plant. Rather, the ATWACC will develop debt interest expense based on the market value of utility debt and prevailing debt interest cost. This is true even with Dr. Kolbe's proposed adjustment to the ATWACC methodology to adjust for embedded debt interest rate. Finally, the ATWACC methodology also does not meet the regulatory standard to ensure financial ratios are reasonably maintained, consistent with the Régie's rules. For all these reasons, the ATWACC methodology is inconsistent with the Régie's rules for Rate Fixing or Modification. »

Demandes :

4.1 By the quoted statement, does Mr. Gorman intend to imply that Dr. Kolbe and Dr. Vilbert recommend using a market value rate base instead of a book value rate base?

Response 4.1

Mr. Gorman did not assert that the witnesses proposed a market value rate base, but rather they proposed a rate of return derived from the market value of the assets to apply to rate base and, thus, include a market value return in revenue requirement.

4.2 If the answer to part a) is other than an unqualified please explain fully with references to Dr. Kolbe's or Dr. Vilbert's evidence where they advocate use of other than book value rate base to set rates.

Response 4.2

Not applicable.

4.3 Isn't it true that Dr. Kolbe provides an adjustment to the ATWACC methodology that recovers the actual embedded cost of debt as opposed to the market cost of debt?

Response 4.3

No. Dr. Kolbe’s adjustment is to the embedded interest rate, not the actual embedded cost of debt interest expense.
4.4 If the ATWACC is adjusted to recover the embedded cost of debt as recommended by Dr. Kolbe, in what way would the embedded cost of debt not be recovered in rates? In other words, please explain in detail exactly how the adjustment proposed by Dr. Kolbe fails to result in a revenue requirement based upon the embedded cost of debt instead of the market cost of debt.

Response 4.4

The embedded debt interest expense is the product of embedded debt interest rate multiplied by the book value of debt. This produces the utility’s actual debt interest expense. Dr. Kolbe’s methodology adjusts the ATWACC which is tied to market value of debt to total capital and not the book value of debt to total capital. Hence, it does not properly derive a return that will recover the actual debt interest expense.

Préambule : « The maintenance of proper financial ratios include (sic) the proper maintenance of debt and equity components of the book value capital structure. A reasonable capital structure will help maintain the financial integrity of the utility at the lowest cost to customers. Under the proposed ATWACC, management and/or the regulatory authority would not have any control over the variations in the capital structure financial ratios because these components would be driven entirely by changes to market value of stock and corresponding changes to market capital costs. Setting rates that do not reflect appropriate ratios of capital do not meet the Régie's rate modifications rules. »

Demandes :

5.1 Please specify where in Dr. Kolbe’s or Dr. Vilbert’s written evidence it is suggested or recommended that the capital structure of the regulated entity would not be either under the control of the regulated company’s management or under the control of the regulator.

Response 5.1

Under Dr. Kolbe’s and Dr. Vilbert’s recommendations, the capital structure weights would be based on the market value of the utility securities. Hence, the capital structure financial ratios would be determined by the market, and not the capital management decisions of the utility. Therefore, these capital structure weights would not be managed by the utility management. Therefore, the Régie’s ability to judge the reasonableness of management’s action would be impaired. Mr. Gorman is not aware of any place in Dr. Kolbe’s or Dr. Vilbert’s written evidence where they recognized the need for proper management and regulatory oversight of the utility’s capital structure.

5.2 Please explain in detail how setting the allowed rate of return on rate base equal to the ATWACC affects either the dollar amount of the regulated company’’s rate base or the capital structure selected by the regulated entity’s management.

Response 5.2

Setting the rate of return at the ATWACC affects the operating income which is the product of the rate of return times the utility’s rate base, and hence, will affect the revenue requirement and actual opportunity to produce an earned return on common equity actually invested in utility plant. The proposed ATWACC would establish capital structure weights by the market and would not develop an overall rate of return based on a capital structure that is managed by the regulated entity’s management as necessary to support financial integrity and to maintain its overall cost structure in a competitive manner.
5.3 Please explain in detail how variations in the market value capital structures of the sample companies under the ATWACC methodology affects either the dollar amount of the regulated company’s rate base or the capital structure selected by the regulated entity’s management.

**Response 5.3**

The ATWACC methodology would impact the product of rate of return times rate base and thus would impact the revenue requirement and the rates developed from the revenue requirement. As such, it will impact the rate of return on the rate base and would prevent the regulated entity’s management from ensuring that the rate of return is based on a capital structure found appropriate by the regulated entity’s management.

Préambule : « Dr. Kolbe’s assertion that the ATWACC methodology has gained wide acceptance outside of North America is at best speculative conjecture. But more importantly, he has not demonstrated that regulatory practices outside North America are superior to those used in North America. »

Demandes :

6.1 Does Mr. Gorman challenge Dr. Kolbe’s statement that the ATWACC methodology is used as the method of setting rates in many jurisdictions in Europe (including in Austria, Belgium, Finland, France, Ireland, Luxembourg, Italy, the Netherlands, Sweden and the United Kingdom) as well as Australia, New Zealand? If so, please provide the basis for the statement that the ATWACC method is not used in the identified countries.

Response 6.1

Mr. Gorman does not challenge this assertion, but simply observes that Dr. Kolbe made certain qualifications in his assertions that it is used in these jurisdictions. Further, Dr. Kolbe has not shown that he is developing an ATWACC in a manner that is consistent with the other jurisdictions noted.

6.2 If Mr. Gorman does not dispute that the ATWACC methodology is used in the countries identified in part a), in what way is it “at best speculative conjecture” to say that the ATWACC method has gained wide acceptance outside of North America based upon the list of countries using the method?

Response 6.2

Not applicable.

6.3 Given the list of deficiencies for the ATWACC method asserted by Mr. Gorman in his direct evidence, how does he explain the use of the ATWACC method by the countries identified in part a)?

Response 6.3

Mr. Gorman is not aware of the regulatory mandates, protocols or rules in those other jurisdictions, nor is he aware of the franchise or monopolistic nature of those utilities. As such, regulatory objectives and protections available to utility shareholders and utility customers in the other jurisdictions have not been shown to be comparable to those included in North America regulations.
6.4 Does Mr. Gorman acknowledge that the listed countries could have chosen to use the “traditional” methods to regulate their utilities given that the traditional methods were in use in the U.S. before these countries adopted the ATWACC method?

Response 6.4

Please refer to response to 6.3. Mr. Gorman has not researched the regulatory mandates, protocols and rules of these other jurisdictions.
7. Référence : ACIG-7, Document 1, Written evidence of Michael Gorman for IGUA, page 6, lignes 4-12

Préambule : « The ATWACC methodology is poor regulatory policy for several reasons.
a. First, it does not produce clear and transparent objectives for management to pursue in order to minimize its overall rate of return while preserving its financial integrity and access to capital, and maintain competitive rates. Therefore, a regulatory commission cannot oversee the reasonableness and prudence of management decisions in managing its capital structure, and determine that it is reasonable. Rather, under the ATWACC, the capital structure weights will be set by the market, and will not be the result of reasonable and prudent management actions. »

Demandes :

7.1 Please explain how the regulated entity’s “capital structure weights will be set by the market, and will not be the result of reasonable and prudent management” for the purpose of setting the regulated revenue requirement under the ATWACC methodology proposed by Dr. Kolbe and Dr. Vilbert.

Response 7.1

Utility management can manage its book value capital structure by issuing debt and equity that maintain capital structure weights that will support its credit rating and financial integrity and preserve its access to capital. Under the proposed ATWACC, the capital structure weights will be based on the market's valuation of the securities, and not the actual amount of funds received from the securities that are used to fund investments in utility plant. Hence, management cannot control the market value of those securities because the market value will be set based on factors far outside of management's control. Further, the market value of the underlying securities can fluctuate significantly in different markets, and the resulting ATWACC return can change significantly. As such, the ATWACC methodology would not be the result of prudent management objectives for setting a revenue requirement that will meet the objectives of maintaining financial integrity, and protecting the interests of both shareholders and ratepayers. Further, it would introduce significant revenue requirement and utility rate volatility.

7.2 Please explain how a regulated entity’s management has less incentive to minimize its overall rate of return while pursuing its financial integrity and access to capital under the ATWACC approach than under the traditional approach to regulation.

Response 7.2

This assertion misrepresents Mr. Gorman’s evidence.
7.3 Does Mr. Gorman recognize that it is at least possible that the capital structure deemed by a regulator is not a capital structure that minimizes the company’s cost of capital? If not, please explain why this possibility is excluded?

Response 7.3

Mr. Gorman’s understanding is that a regulator typically attempts to balance the interests of ratepayers and investors. Hence, if a regulator finds a capital structure is reasonable, it is consistent with its objectives for balancing said interests. As such, Mr. Gorman would agree that departures from minimizing the utility’s cost of capital could be a factor considered by a regulator in exchange for other factors that continue to balance stakeholder interest.

7.4 Does Mr. Gorman understand that the regulated entity’s rate base and capital structure are not affected by the ATWACC approach? If the answer is anything but an unqualified, yes, please explain how Mr. Gorman envisions the ATWACC method to change the rate base or the capital structure selected by management.

Response 7.4

Mr. Gorman agrees that the book value capital structure and book value rate base are not affected by the ATWACC approach. However, the rate of return and revenue requirement and retail rates are affected by the ATWACC. If the earnings and cash flows of the utility are positively impacted through the adoption of the ATWACC, then the market value of the assets included in rate base, could be impacted which could impact the market value of rate base and market value of capital structure.

7.5 Please confirm that the Board could allow the regulated entity the ability to select its own capital structure, as opposed to having it set by the regulator, as one policy decision available to the Board should it decide to use the ATWACC method to set rates? If not confirmed, please explain.

Response 7.5

Mr. Gorman is not aware of any constraints on the Regie’s ability to set just and reasonable rates, including the development of an overall rate of return.
7.6 Please confirm that the Board could deem the regulated entity’s capital structure as one policy decision available to the Board should it decide to use the ATWACC method to set rates?

Response 7.6

Without offering a legal interpretation, Mr. Gorman confirms the assertion in the question.

7.7 Please confirm that the only way that the sample companies’ market value capital structure is used in the ATWACC approach is during the estimation of the ATWACC? If not confirmed, please explain in what other way the market value capital structures of the sample companies are used.

Response 7.7

Mr. Gorman confirms.

Préambule : Mr. Gorman makes a series of assertions in his evidence that seem to be in contration to the ATWACC methodology proposed by Dr. Kolb e and Dr. Vilbert. « b. Second, relying on market value of common stock to establish capital structure weights will likely not ensure that the rates are just and reasonable and fair rate of return standards are met. Indeed, as Dr. Kolbe acknowledges in his evidence, market value of stock determinations are not well understood and are not reliable for setting utility rates. The ATWACC is based on market value capital structure weights which are driven entirely by changes in the market price of stock. Highly unpredictable and volatile stock market prices can result in a rate of return which can be excessive and would unjustifiably inflate tariff rates, or could decline to a level which produces a rate of return which will not maintain the financial integrity of the utility. Therefore, the ATWACC methodology based on market value capital structures will introduce significant volatility in the ratemaking process, and will not ensure that the rate of return meets the fair compensation and financial integrity standards. »

Demandes :

8.1 Does Mr. Gorman acknowledge that the financial markets provide the best available information to estimate the cost of capital for a regulated entity? If not, please explain.

Response 8.1

Mr. Gorman acknowledges that the financial markets establish the current required return on common equity but the cost of debt may be an embedded cost and will not be changed by the market after the debt securities are sold, assuming the debt is a fixed rate debt instrument. As such, the best estimate of the utility cost of plant investment is based on the embedded capital structure weights, embedded cost of debt and preferred stock securities, and the current market cost of equity.

8.2 Please specify where in Dr. Kolbe’s written evidence that Dr. Kolbe “acknowledges in his evidence, market value of stock determinations are …. not reliable for setting utility rates.

Response 8.2

Please see Dr. Kolbe’s Appendix E: Issues Raised in Previous Regulatory Decisions at E-17 and the discussion on lines 1-5 and E-23 on lines 3-6. At that point of Dr. Kolbe’s evidence, he states that in 1984 there were a number of caveats concerning use of market to book ratio to test utility rates. He goes on to state that since that time the market has behaved in ways that are plainly inconsistent with a simple pricing model in which the market to book ratio test rests. He concludes that it is now clear that the market to book ratio test does not work. At page E-23, he recommends the M/B ratio be set aside for better methods. The ATWACC sets capital structure weights based on the same market values that render the M/B ratio test unreliable.
8.3 Does Mr. Gorman acknowledge that noting that the determination of the level of market prices for stocks is not well understood is not the same as saying that market prices cannot be used to set utility rates? If not, please explain.

Response 8.3

No. The ATWACC sets capital structure weights based on poorly understood security market values. Hence, the ATWACC should be rejected for the same reasons as the M/B ratio test. Hence, Dr. Kolbe’s conclusion that a market to book ratio adjustment to a rate of return is not reliable, is equally applicable to his proposed ATWACC methodology.

8.4 Please describe the circumstances that Mr. Gorman has in mind from the following quote: “Highly unpredictable and volatile stock market prices can result in a rate of return which can be excessive and would unjustifiably inflate tariff rates, or could decline to a level which produces a rate of return which will not maintain the financial integrity of the utility. Therefore, the ATWACC methodology based on market value capital structures will introduce significant volatility in the ratemaking process, and will not ensure that the rate of return meets the fair compensation and financial integrity standards.” For purposes of the answer to this question, please assume that neither the amount of the book value rate base nor the capital structures changes as a result of using the ATWACC method. Further assume that the regulator's policy is to allow recovery of embedded costs which are calculated as suggested by Dr. Kolbe.

Response 8.4

There are numerous factors which could cause significant price volatility through use of the ATWACC methodology. The primary issue and concern of Mr. Gorman is that the ATWACC methodology will set the entire rate of return based on current market cost, and security market valuations. As such, it will prevent the utility from hedging any component of the overall rate of return. That is, use of a book value capital structure weights and embedded cost of debt and preferred equity securities, locks in portions of the utility’s total rate of return, and removes these cost elements from cost variations caused by changes to capital market cost and valuations. Under the ATWACC, this hedging of the overall rate of return will not occur. By letting the entire rate of return fluctuate with market prices/valuations, the utility’s revenue requirement and retail rates will become more volatile, because the rate of return is applied to rate base to determine the rate of return that is built into the utility’s revenue requirements and retail rates.

Préambule : Mr. Gorman asserts without proof that revenue requirement using the ATWACC methodology as proposed by Dr. Kolbe and Dr. Vilbert will result in more variable rates. « c. Third, book value capital structure weights permit the utility to hedge or lock-in a large portion of capital market costs in arriving at the rate of return used to set rates. This rate of return cost hedge stabilizes the utility’s cost of service, which in turn helps stabilize utility rates. A stable method of setting rates also allows investors to more accurately assess the future earnings and cash flow outlooks for the utility, which will reduce the business risk of the utility. The ATWACC, on the other hand, will produce an overall rate of return which will change based on both changes to market value capital structure weights and also based on changes to market capital costs. Hence, a major component of the cost structure of the utility (i.e., the overall rate of return and tax expense) will vary based on market forces from rate case to rate case. This rate of return variability will introduce significant instability in the utility’s cost of service and tariff rates. Introducing additional instability in the utility’s cost structure and rates will not benefit either investors or ratepayers. »

Demandes :

9.1 In the context of the quotation listed above, please define what Mr. Gorman means by the term “hedge” a portion of capital market costs.

Response 9.1

Hedge means to lock it in or to fix the cost component. Specifically, book value capital structure weights will not fluctuate with changes to the market value of the securities. Fixed rate debt and preferred equity securities will also not move with changes to market costs. While in reality these costs can fluctuate based on changes in invested capital, and retained earnings, the major components are largely fixed and will not fluctuate with changes in market value and market capital costs.

9.2 If Mr. Gorman has in mind “hedging” by recovery of the embedded cost of debt, why is the utility not equally hedged if the utility is authorized recovery of the embedded cost of debt if regulated using the ATWACC approach? In other words, how is recovering the embedded cost of debt different if the ATWACC approach is used compared to the traditional approach?

Response 9.2

Under the ATWACC, the capital structure weights, cost of common equity, and cost of debt would change based on changes in a market value weighted capital structure and capital market cost. As such, the ATWACC will not allow for the hedging of major components of the utility’s rate of return, associated cost and revenue requirement.
9.3 If Mr. Gorman has in mind “hedging” by the fact that the rate base does not change with market conditions, please confirm that the ATWACC method does not change the ratebase. If not, please explain why not.

**Response 9.3**

Mr. Gorman would acknowledge that the ATWACC will not change the rate base; however, it will have a significant impact on the revenue requirement supporting the rate of return on rate base and associated income tax expense. As such, the costs of rate base would not be hedged but would fluctuate with changes in market value cost and market valuations.

9.4 Does Mr. Gorman agree that the market value of debt has an inverse relationship with the market cost of debt? If not, please explain fully why not.

**Response 9.4**

Mr. Gorman agrees.

9.5 Is it not possible that an increase in the market cost of debt for the sample group could be balanced by a decrease in the market value of debt so that the ATWACC remains relatively stable? If not, please explain fully why this possibility is excluded.

**Response 9.5**

This would not occur in the development of the revenue requirement supporting the rate of return applied to book value rate base. While the ATWACC total component of debt could change, the cost of common equity and weight of common equity could change, and could be rebalanced to the current market cost of capital. This current market cost of capital can change from one period to the next. However, the rate base would not. As such, over time, the rate of return will change based on changes in market capital costs and market valuations. As the rate of return moves with changes in market valuations and market capital cost over time, the revenue requirement necessary to support the rate of return on rate base will move with that ATWACC variability. On a static basis, the ATWACC would be held fairly constant, but over time it will move with changes in market valuation and market cost.
9.6 Is it not possible that an increase in estimated ROE for the sample group could be balanced by a decrease in the market value of equity so that the ATWACC remains relatively stable? If not, please explain fully why this possibility is excluded.

**Response 9.6**

It is possible for a static period of time. However, over time, the ATWACC will change with changes in market valuations and market capital costs. Hence, from one period to the next, the ATWACC can increase or decrease based on changes in market valuations/costs, which can introduce significant volatility in the development of the utility’s revenue requirement over time.

9.7 Given that the ATWACC approach envisions applying a market determined rate of return, i.e. the ATWACC, to the regulated company’s book value rate base, does Mr. Gorman accept the possibility that the revenue requirement could be more stable not less stable than under the traditional method of estimating the ROE alone from market data? If not, please explain fully why this possibility is excluded. Answers of “anything is possible” simply avoid the issue.

**Response 9.7**

Anything is possible, but highly unlikely. Based on the history of fluctuations in market capital costs, and the related valuations, Mr. Gorman would expect that the ATWACC methodology would introduce significantly more cost of service volatility in determining the utility's revenue requirement.

Préambule : Mr. Gorman asserts that the ATWACC inflates rates for utility investors. « The ATWACC unnecessarily increases rates to produce an excessive return on equity opportunity for utility investors. Inflating utility's rates to provide this excessive earnings opportunity is unjust and unreasonable and should be rejected. »

Demandes :

10.1 Is the basis of Mr. Gorman's assertion that the “ATWACC unnecessarily increases rates to produce an excessive return on equity” based simply on the observation that the rate of return is higher than Mr. Gorman would otherwise recommend? If not, please explain fully how the ATWACC produces “excessive return on equity opportunity for utility investors.”

Response 10.1

Mr. Gorman believes the ATWACC methodology produces an excessive return on the amount of equity capital used in invest in utility plant based on market conditions that existed at the time of his analysis. As such, in this proceeding, Mr. Gorman finds that the ATWACC methodology is producing excessive return on equity.

10.2 In Mr. Gorman's opinion, should the rate of return allowed on investments of comparable risk be comparable?

Response 10.2

Yes.

10.3 If the book value capital structure of two other wise identical companies is different, should the allowed ROE be different? Please explain why or why not.

Response 10.3

The allowed ROE should reflect the investment risk of the enterprise which is based on an assessment of the business and financial risk. If the book value capital structure of two enterprises is different, implying greater financial risk, then the return on equity should be higher for the enterprise that has greater financial risk, assuming the business risk is comparable. However, financial risk can be more completely assessed based on capital structure financial weights, cash and earnings coverages of financial obligations, and off-balance sheet obligations of the enterprise. As such, development of an appropriate return on equity is more complicated than simply assessing differences in capital structure weights.
10.4 If the ROE were not different for two otherwise identical companies with different book value capital structures but the same cost of debt, would Mr. Gorman agree that otherwise identical assets would be allowed different overall costs of capital? If not, please explain why not.

Response 10.4

The rate of return should reflect fair compensation for the total investment risk of the enterprise. Financial risk may be composed of more than just differences in capital structure weights. Hence, Mr. Gorman cannot provide an answer to the question because there are too many factors undefined.

10.5 If an identical type of assets is financed with different proportions of debt and equity, does that difference in financing change the underlying business risk of the assets? (For purposes of this question, please assume that the financing options being considered would all result in an investment grade bond rating.) If so, please explain fully.

Response 10.5

No. Business risk is unrelated to financing decisions.
Préambule : « Dr. Kolbe asserts that the ATWACC methodology more accurately estimates the financial risk reflected in the current market cost of common equity. For the reasons set forth below, Dr. Kolbe’s arguments are erroneous. The investor-required returns are based on investors’ assessment of investment risk. Security analysts’ reports assess the financial risk of a utility primarily by its book value capital structure and audited financial statements. If investors primarily relied on market value financial risk assessments, security analysts’ reports would supply investors with these relevant data to form investment risk assessments. Equity and credit analysts’ reports do not assess a utility’s financial risk based on market value data. Therefore, it follows that investors assess investment risk primarily based on audited financial statements, or book value data. »

Demandes :

11.1 Please provide all references to academic articles or textbooks which agree with Mr. Gorman’s assertion that investors rely on book value capital structures as opposed to market value capital structures.

Response 11.1

See the following:


11.2 Does the textbook, Principles of Corporate Finance by Brealey, Myers and Allen cited by Mr. Gorman, say that investors rely on book value or market value capital structures to evaluate financial risk? Please specify the page numbers and version of the text supporting Mr. Gorman’s answer.

Response 11.2

Please see pages 481-483. The authors rely on book debt obligations to measure financial risk.
11.3 Does Mr. Gorman acknowledge that Value Line investor information sheets discuss market values and market returns extensively, arguably more so than book value information? In fact, isn't the Value Line displayed on the individual company report a comparison of the market price of the stock compared to its “value” as determined by Value Line?

Response 11.3

Value Line provides data to help assess the investment risk and investment profile of a company. Value Line explicitly provides capital structure book value information to investors to help investors make informed decisions. Value Line does also include market value information in terms of price, price-to-earnings ratios, and dividend yields. The information provided by Value Line clearly shows that investors use book value capital structure information as part of their information used to assess the investment risk and opportunities of equity securities. Value Line’s reports help gauge both the value of the security and the investment risk.

11.4 Are credit ratings a measure of default risk on the debt issued by the rated corporation? If not, please explain why not.

Response 11.4

Yes. Default risk reflects whether or not the enterprise is producing earnings and cash flows adequate to support debt obligations without going into default. The equity investor then is entitled to cash flows and earnings that remain after all debt obligations are met. As such, the credit rating is a measure of default risk of debt securities, and is also a useful indication of the investment risk for the firm’s equity securities.

11.5 In Mr. Gorman's opinion, are investors in the debt of a corporation concerned about precisely the same risks as investors in the equity of the corporation? Do some risks matter to equity holders that do not matter to debt holders? Please explain fully.

Response 11.5

Investors in a corporation’s debt and equity securities have very similar concerns about the predictability and level of the enterprise’s earnings and cash flow to support expected investment return. However, debt holders are not concerned about the adequacy of earnings and cash flows to meet equity investors’ earnings expectations. Equity investors on the other hand are concerned about the earnings and cash flows strength to meet debt holders’ obligations, and the residual earnings and cash flows available to produce a return to equity investors. Equity holders can also be concerned about the long-term earnings strength of the company, while debt holders may be more concerned about near-term cash flow and earnings constraints which may prevent the enterprise from meeting the debt obligations. Hence, there are differences between the debt holders’ risk assessments and those of equity holder risk assessments, but they are generally aligned on assessing the stability and predictability of earnings and cash flows.
11.6 If investors are concerned about book value capital structures, why does the financial press report market prices and not book values of stocks?

Response 11.6

The financial press reports market prices because that represents the opportunity cost for an investor purchasing or selling an equity security. Book value weights of stocks are reported in financial press publications such as The Value Line Investment Survey, and other equity and credit analyst reports on companies. Further, Mr. Gorman disagrees with the premise of the question that book value capital structure weights are not reported in the financial press.

11.7 Is it possible that the reason security analyst reports referenced by Mr. Gorman report book value capital structures is that market value capital structures change with market prices while book value capital structures change very slowly or not at all?

Response 11.7

Anything is possible, but a professional security analyst that is in the business of providing investors with meaningful information to assess the investment risk and opportunities of investment, would publish relevant information to investors to help make informed investment decisions. As such, if book value capital structure data was not relevant in forming investment decisions, it is reasonable to believe that equity security analysts would not bother to include it in their security reports. Since this information is widely available in assessments of utility security investment reports, it is reasonable to conclude that investors use book value capital structure information to make assessments of investment risk and outlooks.

11.8 Is it Mr. Gorman’s view that an investor in the equity of a company with a book value and a market value capital structure with 50 percent equity and 50 percent debt have the same financial risk as a company that also has a book value capital structure with 50 percent equity and 50 percent debt, but which has a market value capital structure with 90 percent equity and 10 debt? Please fully explain your answer.

Response 11.8

No. Financial risk is composed of both a review of the company’s capital structure, and both earnings and cash flow strength needed to cover financial obligations. Hence, two companies could have relatively comparable book value capital structure weights, but may have different financial risk because of the earnings and cash flow strength coverage of debt obligations. Further, the business risk of two enterprises may not be comparable even if they have the same book capital structure weights.

Préambule : « 5. The ATWACC removes the transparency necessary to allow regulatory oversight of a utility’s rate of return to ensure that the utility attempts to manage its cost of capital with the objective of maintaining its financial integrity and maintaining competitive rates. Hence, it would restrict important regulatory oversight. »

Demandes :

12.1 If the regulator sets the allowed rate of return on book value rate base by determining the appropriate ATWACC, in what way would the “transparency” be removed for purposes of regulatory oversight?

Response 12.1

The capital structure should be managed to produce a rate of return that is sufficient to maintain the financial integrity, provide fair compensation, ensure the enterprise is able to continue to attract capital and maintain competitive rates. The ATWACC will not provide the transparency necessary to ensure that management is managing its capital structure in a way that will achieve this objective while preserving its competitive position. For example, a highly leveraged company with little to no access to capital may have the same ATWACC, as a company in relatively strong financial condition if the business risk of the two enterprises is comparable. This could be accomplished because management could be attempting to maximize its return on equity in one instance, rather than attempting to provide fair compensation and ensure its access to capital and maintain financial integrity in the other. The ATWACC methodology could erode the transparency necessary to ensure that management actions and decisions are reasonable.

12.2 Does Mr. Gorman believe that the Régie has less ability to monitor its regulated entities than the National Energy Board has when it allowed TransQuebec & Maritimes (“TQM”) a rate of return based upon the ATWACC method? Please explain why or why not?

Response 12.2

No. While Mr. Gorman is not a legal expert, it is his understanding that both regulatory commissions have the authority to carry out their regulatory duties.
12.3 Does Mr. Gorman believe that the regulated entity would no longer be concerned about its “financial integrity and maintaining competitive rates” if the ATWACC approach were adopted? If so, please explain fully how the ATWACC approach changes the regulated company’s incentives with regard to its own financial integrity and competitive rates compared to the traditional approach.

Response 12.3

The ATWACC methodology could allow the utility to manage its capital structure in an effort to maximize its return on equity, rather than preserve financial integrity and earn a fair return on equity.

12.4 Please explain how the ATWACC approach restricts regulatory oversight.

Response 12.4

Please see Mr. Gorman’s evidence at 24-25.

Préambule : Mr. Gorman provides an example of how the ATWACC approach allegedly would increase the volatility of the rate of return used to set. This question seeks to understand the assumptions underlying the example.

Demandes :

13.1 The example seems to be based upon debt with a variable rate of interest cost. Is it Mr. Gorman’s understanding the Gaz Metro's debt in its capital structure is variable rate debt? If so, please provide support for this belief.

Response 13.1

No. The variable interest rate was used to simplify the example.

13.2 The example in Exhibit MPG-1 seems to be based upon the assumption that use of the ATWACC approach changes the value of the regulated entity's rate base to an estimate of its market value. Does Mr. Gorman assume that the regulated company’s rate base will change if the ATWACC method is used? If so, what is the basis of Mr. Gorman's belief that the regulated rate base will change if the ATWACC method is used? Please explain fully.

Response 13.2

The question imposes an incorrect assessment. The example does not make any assumption with respect to rate base. Rather, it simply shows the variation in rate of return, which would be applied to rate base in determining the revenue requirement or operating income and related income tax expense that would be included in the utility’s cost of service.

13.3 Why are the “earnings interest coverage ratios” in Exhibit MPG-1 based upon the assumption that the regulated rate base changes with adoption of the ATWACC approach?

Response 13.3

The example is not based on a change in the rate base value. Rather, the example measures changes to coverage of debt interest expense from changes to the weighted cost of debt and weighted cost of equity.

Préambule : Mr. Gorman implies that Dr. Vilbert found “that a fair return on equity for Canadian utilities would be around 9.9%”.

Demandes :

14.1 Please confirm that Dr. Vilbert did not recommend a “fair return on equity for Canadian utilities of 9.9 percent”?

Response 14.1

Confirm. This rate of return is based on the results of Dr. Vilbert’s studies.

14.2 Please confirm that the market value capital structures of both the Canadian utility and the gas LDC sample have a higher percentage of equity than the deemed capital structure of Gaz Métro. If not, why not?

Response 14.2

Confirm.

14.3 Please confirm that one reason that Dr. Kolbe recommended a higher ROE for Gaz Métro than Dr. Vilbert’s results reported for the samples in Table 2 of Mr. Gorman’s evidence is because the regulatory book value capital structure of Gaz Métro has less equity than the market value capital structures of the samples? If not, why not?

Response 14.3

Dr. Kolbe’s evidence speaks for itself.
15. Référence : ACIG-7, Document 1, Written evidence of Michael Gorman for IGUA, pages 33-34

Préambule : « Actual interest expense is determined by setting the embedded interest rate by the amount of debt capital invested in utility plant. Dr. Kolbe simply increases the ATWACC by 10 basis points because the embedded interest rate is higher than the current market interest rate. He makes no attempt to ensure that the ATWACC when applied to rate base will recover Gaz Métro’s actual debt interest expense. Hence, the ATWACC and Dr. Kolbe’s modification to it to reflect actual debt interest expense, are severely flawed and inappropriate. » These questions seek to understand how Mr. Gorman interprets Dr. Kolbe’s recommendation for the recovery of the embedded cost of debts.

Demandes :

15.1 Given Mr. Gorman’s opinion that Dr. Kolbe’s modification to reflect actual (embedded) interest expense is severely flawed, please explain Mr. Gorman’s understanding of how Dr. Kolbe’s calculation of a 10 bps adjustment to the ATWACC to recover the embedded cost of debt is determined.

Response 15.1

The 10 basis point ATWACC adjustment is set out in Dr. Kolbe’s evidence at page 53. On that page, he proposes to increase the ATWACC by 0.1% based on the following procedure:

1. Determine the difference between the embedded interest rate and the market interest rate.
2. Adjust that interest rate differential by the income tax rate to determine the after-tax interest rate differential.
3. Multiply that after-tax interest rate differential by the amount of debt, to determine a dollar difference in interest expense.
4. Then divide that dollar amount of interest expense by amount of Gaz Métro’s book value capital.
5. The product of the dollar difference in interest expense, divided by the book value capital, produces a 10 basis point ATWACC adjustment.

This methodology would only be correct if the ATWACC would properly recover the amount of debt interest expense and produce fair compensation on the amount of common equity supporting Gaz Métro’s rate base. Since the ATWACC is not tied to book value capital structure weights, it does not properly determine the amount of Gaz Métro’s debt interest expense, and the dollar amount of equity return which represents fair compensation.
15.2 Please specify the errors in Dr. Kolbe's calculation of the 10 bps that would not result in the recovery of embedded interest expense.

Response 15.2

The error is that Dr. Kolbe’s rate of return does not provide a provision which reflects the amount of book value debt supporting rate base, and the embedded interest cost of that debt, to derive the amount of debt interest expense that supports the debt capital relied on to fund Gaz Métro’s investments in rate base assets. Rather, Dr. Kolbe’s ATWACC methodology establishes the market value capital structure weights, with an arbitrary ATWACC debt interest expense adjustment, with no demonstration that the product properly recovers Gaz Métro’s actual debt interest expense, and provides fair compensation on its equity capital.

15.3 If the Régie determined that it should award the ATWACC recommended by Dr. Kolbe and Dr. Vilbert and decided also that the embedded interest cost should be recovered, please explain why Dr. Kolbe’s recommendation would not result in the Company expecting to recover the embedded interest expense and the ATWACC allowed.

Response 15.3

Please see response to 15.2.

15.4 On p. 34, Mr. Gorman provides a calculation of the “errors” in the recovery of embedded cost of interest under the assumption that the about of debt in the rate base is equal to the market value capital structure of the sample. Please redo the example using the original book value capital structure.

Response 15.4

If rate base is equal to the capital amount of $1,787,980, the capital structure is composed of $965,512 of debt and the remainder of common equity. The capital structure would be composed of approximately 54% debt and 46% common equity. The rate of return would be composed of a weighted cost of debt of 3.71% (54% x 6.87%) plus the weighted cost of common equity. Applying the weighted cost of debt of 3.71% to the total rate base of $1,787,980 would provide debt interest cost recovery of $66,334 (3.71% x $1,787,980). This equals the amount of debt interest expense the Company would incur for the amount of debt used to fund investments in utility rate base. Therefore, this methodology provides the utility recovery of actual debt interest expense.

Préambule : Gaz Métro seeks to understand Mr. Gorman's criticism of Dr. Kolbe's recommended adjustment for equity flotation costs.

Demandes :

16.1 Does Mr. Gorman acknowledge that the Régie's policy on the recovery of equity flotation costs is to allow an adder to the “bare bones” or baseline allowed ROE? If not, please explain Mr. Gorman's understanding of the Régie's policy with regard to the recovery of flotation costs.

Response 16.1

Mr. Gorman agrees.

16.2 Can Mr. Gorman provide a summary of Gaz Métro's account with “actual flotation cost expenses" incurred by Gaz Métro? Please provide the information for the last 20 years. If the information is not available, please so state.

Response 16.2

No.

16.3 If 4.5 percent of the value of equity issued is a reasonable estimate of the historical flotation costs incurred by Gaz Métro at initial stock issuance, would Dr. Kolbe's recommendation for flotation cost recovery be appropriate? If not why not?

Response 16.3

No. Dr. Kolbe is proposing an ATWACC methodology which establishes an overall rate of return based on the market value capital structure weights, not the book amount of common equity actually received through the sale of equity securities to the market. The flotation cost is based on the fact that some of the proceeds from the sale of equity securities to the market go to cover flotation cost, and not available to fund rate base investments. As such, Dr. Kolbe’s proposed flotation cost adjustment completely contradicts the premise of his proposed market value ATWACC methodology.

Préambule : Mr. Gorman’s critique of Dr. Vilbert's implementation of the DCF model.

Demandes :

17.1 Does Mr. Gorman agree that the DCF model is based, in part, on the assumption that the current market price reflects investors’ expectations with regard to all future dividends and earnings for a particular company? If not, please explain why not?

**Response 17.1**

Yes.

17.2 If investors’ expected rate of return (also called require rate of return or the cost of capital) were to increase for any particular company, does Mr. Gorman agree that the stock price would decline even if expected dividends and growth rates were unchanged? If not, please explain why not.

**Response 17.2**

Yes.

17.3 Does Mr. Gorman flatly reject the possibility that the fall in market prices reflect increased investor risk aversion given the uncertainty in the market? If so, please explain why investors required rates of return could not possibly increase in response to increased market uncertainty.

**Response 17.3**

No.
17.4 Does Mr. Gorman agree that Dr. Vilbert used the most recently available earnings growth rate forecasts at the time of the preparation of his written evidence and used the current 15-day average of the stock prices at the time? If not, please explain why not.

Response 17.4

Yes. However, Mr. Gorman is concerned that the equity analysts’ growth rate projections have not been modified as quickly as market investors outlooks are reflected in stock prices, and, therefore, do not reflect current investor outlooks.

17.5 Does Mr. Gorman acknowledge that Dr. Vilbert also used a 2-stage version of the DCF model in which the estimated growth rate for dividends and earnings in the long-term was the forecast growth in GDP in the U.S. for the U.S. sample and in Canada for the Canadian sample at the time of his analysis? If not, please explain why not.

Response 17.5

Mr. Gorman agrees.

17.6 Does Mr. Gorman acknowledge that Dr. Vilbert also subtracted the difference in forecast risk-free interest rates from the DCF estimates from the U.S. samples? If not, please explain why not.

Response 17.6

Mr. Gorman confirms.

Préambule : Mr. Gorman paraphrases a presentation by Mr. Thomas R. Kuhn, President of the Edison Electric Institute (“EEI”) in testimony before the U.S. House of Representatives Subcommittee on Energy and Air Quality, Committee on Energy and Commerce, on February 10, 2005.

Demandes :

18.1 Did Mr. Kuhn actually say or include in the slides of his presentation a comment that “transmission investment was not limited by investors’ perceptions of inadequate authorized rates of return”? If the answer is anything but “no”, please provide all support for the answer.

Response 18.1

Mr. Kuhn outlined the “critical factors” that discourage transmission investment. ROE was not a critical factor.

18.2 In the same presentation paraphrased by Mr. Gorman, please confirm that Mr. Kuhn had the following comments, under the heading “Reform FERC Transmission Rate Policies -We believe that FERC and the states should utilize innovative transmission pricing incentives, including performance-based rates and higher rates of return, to attract the capital necessary to fund needed investment in transmission.”? If the answer is anything but an unqualified “yes”, please explain fully.

Response 18.2

Mr. Gorman agrees.

18.3 On p. 31, Mr. Gorman notes an EEI document that reports that authorized ROEs have declined from around 10.8 percent in 2004 to about 10.3 percent in the first quarter of 2009. Are these allowed ROEs from state commissions or from the Federal Energy Regulatory Commission (“FERC”)?

Response 18.3

These authorized ROEs are from state commissions.
18.4 Please provide a copy of the EEI report referenced in part c) of this information request.

Response 18.4

Please refer to Vilbert Attachment 18.4.

18.5 What is the average equity thickness corresponding to the allowed returns in part c) of this information request?

Response 18.5

The EEI report did not disclose the equity thickness.

18.6 Does Mr. Gorman acknowledge that the FERC has authorized ROE and other incentives for new transmission projects since Order 679?

Response 18.6

Mr. Gorman acknowledges that the FERC has normally set rates using a base ROE, and ROE incentives for qualifying transmission plant, and other incentives for qualifying transmission projects.

18.7 Would Mr. Gorman agree that the average allowed ROE for electric transmission as well as natural gas transmission exceeds the allowed returns reported by EEI for 2009? If not, please provide the FERC allowed ROEs and capital structures for new transmission projects.

Response 18.7

Mr. Gorman has not compiled this information.
18.8 Does Mr. Gorman acknowledge that FERC also adopted, on a case by case basis, a series of additional measures designed to encourage investment in electric transmission including allowing CWIP in rate base, full recovery of investment in the event of forced, abandonment, and recovery of prudently incurred development costs? If not, please explain why not.

Response 18.8

Mr. Gorman is aware that FERC allows for CWIP under certain circumstances to be included in rate base and other incentives to encourage additional investment.

18.9 In Mr. Gorman's opinion, if FERC did not believe that allowed ROEs may have been too low to encourage transmission investment, why would FERC authorize incentive ROEs?

Response 18.9

Mr. Gorman has not attempted to explain the reasoning the FERC relied on to begin to authorize incentive return on equity. However, generally, it is his understanding that the FERC believed that the incentive ROEs would encourage additional investments in transmission plant in areas that would provide benefits to transmission users.

18.10 Does Mr. Gorman acknowledge that the dollar amount of transmission investment has increased substantially following the adoption of incentive ROEs for new transmission investment? If not, please explain fully.

Response 18.10

Mr. Gorman understands that transmission plant investment has increased substantially for transmission plant that receives an incentive ROE, and plant that does not receive an incentive ROE.

Préambule : In support of Mr. Gorman's assertion that the revenue requirement would be much more variable if the ATWACC method were adopted, Mr. Gorman reports the difference in the average current market value capital structure versus the 5-year average capital structure to be about 4 percent. Specifically, the DCF (i.e., current) capital structure for the U.S. gas LDC sample is 59% versus 63% for the CAPM (i.e., 5-year average) capital structure, or a difference of 4%. The difference is also 4% for the Canadian utility sample.

Demandes :

19.1 Assume that the ATWACC estimated for the Gas LDC sample is 7.22%, calculated as the weighted-average of 59% equity with a 10% estimated ROE and 41% debt at a cost of 6.5% with an income tax rate of 30.15%. Does Mr. Gorman confirm that the ATWACC at a capital structure with 63% equity is 7.43% if only the market value capital structure changes, or a change of about 21 bps? If not, why not?

Response 19.1

No. The example does not produce the numbers asserted in the question.

19.2 Using the same assumptions as in part a) of this data request, does Mr. Gorman confirm that the ATWACC at a capital structure with 63% equity is 7.43% if the market value capital structure changes and the estimated ROE declines to 9.5% is 7.17%, or a change of only about 5 bps for a change in capital structure of 4%? If not, why not?

Response 19.2

Please see response to 19.1.