

**GENERIC ROE AND COMMON EQUITY RATIO FOR  
ATCO PIPELINES**

**EVIDENCE OF**

**Laurence D. Booth**

**BEFORE THE**

**ALBERTA UTILITIES COMMISSION**

**March 23, 2016**

## EXECUTIVE SUMMARY

1. The Canadian Association of Petroleum Producers (CAPP) has asked me to prepare expert evidence on the generic ROE for test years 2016 and 2017 and capital structure of ATCO Pipelines in accordance with the schedule and directions of the Commission in its letters of December 22, 2015 and January 20, 2016. Similar to my 2011 and 2014 testimonies I was asked not to discuss issues that the AUC had already dealt with in prior hearings but, given the recency of the 2014 hearing, to emphasise what has changed since then. Consequently, I have followed the main themes of my 2014 testimony and focused on updating my testimony. In particular, I have not filed all my “normal” appendices, since much of this is fundamentally the same.<sup>1</sup>
2. In 2014, I characterised the situation as “waiting for Godot” since the Canadian economy had largely been in a holding pattern waiting on developments in both Europe and the United States. There had been positive developments with strong equity markets in the second half of 2013 and in May 2013 the Governor of the Federal Reserve had announced a road map to end the US Fed’s bond buying programme and then finally on December 16, 2013 the Fed announced a slight cutback from \$85 to \$75 billion a month. Since then the good news is that the US bond buying programme has ceased. The bad news is that there is at least a \$3.5 trillion overhang of US bonds owned by the Fed, while both the European Central Bank (ECB) and the Bank of Japan have ramped up their own bond buying programmes.
3. As one of very few AAA rated issuers, the impact of the massive liquidity in the capital markets has spilled over into Canada with the result that interest rates have yet to exhibit any signs of increasing to normal levels. Hence, “waiting for Godot” continues. In addition, the Chinese economy’s growth rate has finally started to slow as they shift from an export-led economy to a normal consumer-led one. In the process, the demand for industrial goods has weakened causing significant drops in commodity prices. The weakness in oil prices, in particular, has had a

---

<sup>1</sup> For example, the addition of two more years makes only minimal difference to the historic estimates of the market risk premium going back to 1926.

dramatic impact on Western Canada and been the major factor behind the drop in the C\$ to around 0.75 US\$ as long term Canada (LTC) bond yields hover around 2%.

4. In terms of the fair ROE my overall assessment is very similar to that in 2014:

- In 2014, I was hesitant about recommending a return to an automatic ROE adjustment mechanism, since I doubted that interest rates would increase to my “trigger” long Canada bond yield forecast of around 4.0%. This has turned out to be correct, as we are still waiting for a return to normality in government bond yields. If anything, I am more pessimistic now than in 2014, but as a result, I recommend the same ROE of 7.50% as in 2014 and suggest that this remain fixed until the next GCOC hearing.
- Since 2012, I have spent more time analysing discounted cash flow (DCF) estimates of the fair rate of return. Conceptually, both DCF and risk premium models are estimating the same thing. However, the relative value of each model depends quite heavily on the real interest and forecast inflation rates. When the real interest rate is very low, as it was in the 1970s and is now, the CAPM estimates tend to be significantly lower than the DCF estimates and the opposite happens when real yields are high.
- In terms of the traditional CAPM, I see no reason to change either my relative risk assessment for a benchmark utility or my normal market risk premium estimate. Currently, utility betas are very low, but that simply reflects their interest rate sensitivity and the fact that their high dividends cause them to behave like convertible bonds in weak markets. I continue to make a credit risk adjustment to convert the CAPM into a conditional CAPM, which is simply a CAPM conditional on the state of the economy. My risk-premium based ROE estimates are 6.0% for the 2016 test year and 7.0% for the 2017 test year.
- In 2014, I made adjustments to the forecast long term Canada bond yield to generate a “true” business cycle consistent yield. I am cognisant of the AUC’s decision that changes to the forecast LTC yield should be included in a revised market risk premium, but I prefer to keep them separate and consistent with surveys of professionals. However, I regard this as a semantic difference rather than a real one. Consistent with AUC practise I continue to use a 0.50% issue cost/flexibility adjustment.
- DCF estimates are only appropriate for low risk companies and the overall equity market, where even here adjustments are often made for the stage in the business cycle, which affects short run growth estimates. The AUC accepted such estimates in 2014 and, consistent with my evidence at that time, I would estimate the expected equity market return at 8.50-9.50%. This estimate directly supports my adjustment to the risk premium estimates and is slightly higher than that of independent capital market advisors.

- My direct DCF estimates for US S&P500 utilities and a sample of low risk gas utilities used by US company witnesses in the past supports my estimates for Canadian utilities. These estimates are based on forecast growth rates that can actually be achieved via retaining earnings within the firm, rather than the optimistic growth rates forecast by security analysts. Here I augment the evidence from 2014, where I referenced both academic research and the work of McKinsey, with recent research by the Royal Bank of Canada.
- Both DCF and CAPM estimates should be consistent, but as I pointed out in 2014, they usually differ due to changes in financial markets. However, any recommendation can *always* be expressed as a risk premium, even if the estimates come from other models such as the DCF model. For this reason, I take the evidence from both models and express my recommendation in terms of a risk premium where, as in 2014, I again add an adjustment for the impact of bond buying programs (“Operation Twist”) that have depressed long Canada bond yields.
- In terms of the capital structure of ATCO Pipelines, my recommendation is the same as in 2014. Although commodity prices have dropped since 2014, the Western Canadian Sedimentary Basin (WCSB) continues to be prolific with estimated reserves of over 100 years. Further NGTL sits on top of the enormous reserves in the WCSB with significant recent and planned infrastructure expansion, particularly in North East British Columbia. Since ATCO Pipelines’ revenue requirement is completely recovered as a prior charge in NOVA Gas Transmission’s (NGTL) revenue requirement, I see no change in its ability to recover its revenue requirement.
- In my judgement, there is minimal risk to the equity holders in ATCO Pipelines and I continue to recommend a 35% common equity ratio. As in 2014, I would point out the double leverage involved in several Alberta utilities. Fortis finances Fortis Alberta with 35% common equity and 10% preferred shares while it maintained an A- S&P bond rating, which it described as “strong.” With the disappearance of most stand-alone rate-of-return regulated utilities in Canada it is difficult to directly estimate how the market values either the debt or equity of a pure utility. However, there are clear instances of double leverage, where the value of an inefficient operating company capital structure is passed to the holding company.
- In my judgment ATCO Pipelines is clearly financeable with a “strong” investment-grade bond rating at 7.5% ROE on 35% common equity, which is similar to that by which Fortis Inc. finances its subsidiaries. Currently with A bond yields lower than in 2014, there is every indication that the cost of equity capital for a regulated utility has declined since then.