

- 1 **Q. Evidence, page 70, lines 21-23; page 74, lines 3-9 and page 85.**
2 **(a) Explain how, in Dr. Booth's opinion, the DCF method and DCF estimates**
3 **should be considered by the Board in its determination of a fair return for**
4 **Newfoundland Power in this proceeding.**
5 **(b) Is CAPM, with adjustments to reflect current market conditions, still Dr.**
6 **Booth's preferred method?**

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9 A. a) and b). Dr. Booth judges that both the CAPM and DCF models are theoretically
10 valid. However, he judges the DCF model to be less useful for individual
11 firms and more useful for the overall market return. This is because there
12 are very few pure utilities left and analyst and other growth estimates for
13 individual firms are known to be biased. In contrast, the DCF model is
14 the standard for overall equity market expectations as produced on pages
15 75 to 79 of his testimony. Note that on pages 78-79 J. P Morgan uses a
16 modified DCF model for their equity market forecast. Once the overall
17 market equity cost is estimated using the DCF estimates, survey and
18 historic data it is then a question of the reduction in the discount rate for
19 the lower risk of a typical utility. This is where the CAPM comes in. So
20 apart from building *up* from a forecast long Canada yield it is also
21 possible to come *down* from the 9.0% equity market cost. We can do this
22 by using the 5.50% market risk premium and the 0.50 utility beta which
23 means the typical utility would have a 6.25% equity cost (9.0%-2.75%).
24 The recommended ROE with the 0.50% floatation cost would then be
25 6.75%.

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27 The key is that the utility equity cost has to fit into the hierarchy of equity
28 costs bounded at the top by the market cost of about 9.0% and the cost of
29 preferred shares of about 5.0%. It is unreasonable to judge that a utility's
30 equity cost is less than that on preferred shares or more than that for the
31 overall stock market. The CAPM beta adjustment provides the tool for
32 assessing where in the risk hierarchy the utility equity cost should be.