

1 Q. Reference: *Fair Return and Capital Structure for Newfoundland Power (NP)*,
2 Evidence of Laurence D. Booth, April 2024, Appendix E, page 18, lines 14-16.

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4 *“the market equity cost and utility equity cost both fall as interest rates fall, which is*
5 *that all non-derivative securities are substitutes, that is, they move together but not*
6 *necessarily equally.”*

7
8 **Would the same be true if the beta coefficients for utilities, which are calculated**
9 **relative to the broad market, increased? In other words, would a ROE formula**
10 **produce a return that satisfies the fair return standard if the return derived from**
11 **the formula decreased as interest rates decreased, even though utility risk, as**
12 **measured by beta, had increased? Please explain.**

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14 A. If there has been a change in risk that affects a security’s price, then that will distort the
15 estimation of the beta coefficient over the estimation period. For example, if the risk
16 unexpectedly decreases during a strong equity market and the stock experiences
17 unexpected price gains, then its beta coefficient is increased and may not reflect its future
18 risk. Conversely, if a firm experienced an unexpected increase in risk, which resulted in
19 lower prices during a strong equity market, then its estimated beta is lower than that
20 expected in the future. The estimated beta can only estimate the relationship over the
21 estimation period.

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23 The passage referenced refers to future returns and the current equity cost, not a past
24 estimated beta, that is, that securities are what are generally referred to as gross
25 substitutes. Obviously, if there has been a change in risk going forward, no mechanical
26 ROE adjustment formula can capture that, since it has yet to occur, and estimates can only
27 capture the past.