Volume 2: Cost of Capital: Expert Opinion of Mr. James Coyne – Return on Equity

Q. Volume 2, Cost of Capital Report page 37, line 27 to page 39, line 23. In Order No. P.U. 13(2013), page 31, lines 13-16 and Order No. P.U. 18(2016), page 39, lines 17-20, the Board expressed concern on the assumption of constant growth in perpetuity and no offsetting adjustment for analysts' bias in the Constant Growth DCF method used by Mr. Coyne to estimate a fair return for Newfoundland Power. Mr. Coyne addresses this concern and referred to various factors which, in his opinion, demonstrate that projected analysts' growth rates are reasonable but all pre-date 2016. Have there been any changes since the Board's decision in 2016 that would lead the Board to now reach a different conclusion on the issue of analysts' bias in the Constant Growth DCF method? In the response explain in detail why the Board should now accept the assumption of constant growth in perpetuity in the Constant Growth DCF method.

A. The Board has asked several related questions pertaining to the Constant Growth DCF model (PUB-NP-111, PUB-NP-112 and PUB-NP-113) which Concentric addresses here.

On the issue of whether there have been any changes since the Board's decision in 2016, it is useful to look at the 2016 decision as Concentric has for this proceeding. In 2016, the Board observed:

> *The Board also notes the concerns identified by Dr. Booth in relation to the constant growth DCF model used by Mr. Coyne, which assumes constant growth in perpetuity and no offsetting adjustment to account for analysts' bias. The Board continues to prefer the multi-stage model.*

In response, there have been several notable developments.

First, new research has been developed and presented by Concentric in this proceeding. If analysts were biased, one would expect a track record of growth rate projections that exceeded the actual earnings growth of the subject companies. To address this concern, Concentric has specifically researched the actual earnings and dividend growth of the companies in all three proxy groups over the past 15 years (see Figure 22, Concentric's *Cost of Capital* report). That research shows that these companies, on average, grew earnings at 5.87% per year and dividends at 6.5% per year, both of which exceeded GDP growth by a reasonable margin. The analyst forecasts used in Concentric's DCF models, for the same three proxy groups, project earnings growth averaging 5.37%, a full 0.5% lower than their actual growth over the last 15 years. There is no apparent basis evidenced in this data to suggest analyst bias of any degree. Lacking any evidence to the contrary, Concentric would hope this research would assist the Board in reconsidering its acceptance of the constant growth DCF model applied using these inputs.

Second, the constant growth DCF model has been both considered and accepted by other Canadian regulators. It was one of the models presented to the Ontario Energy Board ("OEB") by both Concentric and Dr. Vander Weide in 2009 which formed the basis of the current formula rate of return in Ontario. There was no adjustment for, or recognition

of potential analyst bias, by the OEB.[1] In its most recent decision, the BCUC also considered the results of both the constant growth and multi-stage DCF models presented by Concentric. There the BCUC concluded:

> *For the DCF model, Mr. Coyne presented two versions of the model: a constant DCF model and a Multi-Stage DCF model, consisting of three stages. Mr. Coyne only uses the latter's results in his ROE recommendations. Both experts agree on the merits of using the Multi-Stage DCF model. Consistent with the BCUC's preferred approach in the last two GCOC proceedings, the Panel finds that a Multi-Stage DCF model is preferable to a Constant Growth DCF model because the former allows for recognition that the proxy utility companies' dividend growth rates may not perform the same in different time horizons. Also, since no interveners commented on the pros and cons of using a two-stage versus a three-stage DCF model and most of them supported the three-stage DCF model presented by Mr. Coyne, the Panel finds it reasonable to use a three-stage DCF model to estimate the ROE for FEI and FBC, with each of the first two stages lasting five years.*[2]

In the most recent Alberta cost of capital proceeding, all utility experts presented constant growth DCF models for consideration by the AUC, with a focus on the reasonableness of analyst growth rates. Directly related to this Board's prior concerns, based on the extensive evidence presented in Alberta, the AUC concluded:

> *In this regard, the Commission finds it reasonable to use in the constant growth DCF model the minimum and mean analyst growth rates submitted in this proceeding; however, maximum EPS growth rates appear to be unreasonably high. Despite its general criticism of using high dividend growth rates, the Commission notes that analyst EPS growth estimates are widely used by the investment community, and concerns relating to analyst EPS optimism bias for large capitalization stocks like those in the comparator group may be overstated, at least relative to estimates for small to mid-cap stocks of which there are not many in the comparator group, in any event. The use of analyst EPS estimates supplied by established data service providers, such as Value Line, Zack's, Yahoo! Finance, SNL Financial, and Thomson First Call minimizes the opportunity for arbitrary adjustments and custom calculations for which there is no broad support among parties to the proceeding.*[3]

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1 Ontario Energy Board, EB-2009-0084, *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities, December 11, 2009*, at page 38.

2 British Columbia Utilities Commission Generic Cost of Capital Proceeding (Stage 1) Decision and Order G-236-23, September 5, 2023, at page iv.

3 Alberta Utilities Commission, Decision 27084-D02-2023, October 9, 2023, at para 156.

Lastly, Concentric's ROE recommendation of 9.85% is based on the average results of three models for the North American Electric proxy group: the multi-stage DCF model; the CAPM; and the Risk Premium as shown in Figure 43. Although the Constant Growth DCF model is widely used in the U.S. to establish the authorized ROE for regulated utilities, and has also been accepted in Canada, Concentric recognizes that the Board has previously expressed concern with whether short-term growth rates can be expected to continue in perpetuity. Therefore, Concentric has reported the results of the Constant Growth DCF model for the three proxy groups but has not included those results when developing its ROE recommendation for Newfoundland Power.

Bearing in mind that the constant growth DCF model was developed by Dr. Myron Gordon of the University of Toronto to estimate the cost of equity for stable, dividend paying companies in mature industries such as public utilities, Concentric believes the constant growth model is an important tool that should be considered by the Board.