

- 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.