

**Alberta Energy And Utilities Board**

**ALTALINK Management Ltd.**

**2001 and 2002 Fair Return Application**

**Application No. 1279345**

**Written Evidence Of John McCormick**

**on Behalf of**

**the City of Calgary**

**December 13, 2002**

J. D. McCormick Financial Services, Inc.  
Suite 920  
910 7 Avenue South West  
Calgary, Alberta T2P 3N8

1 **Q.1 Please state your name, business address and occupation?**

2 A My name is John D. McCormick, and my business address is Suite 920, 910  
3 7<sup>th</sup> Avenue South West, Calgary, Alberta. I am a financial consultant and  
4 President of J. D. McCormick Financial Services, Inc. A description of my  
5 professional qualifications is found in Attachment 1.

6 **Q.2 What is the purpose of your evidence at this proceeding?**

7 A The City of Calgary has requested that I provide my views with respect to rate of  
8 return and capital structure that AltaLink seeks in this application.

9 **Q.3 Have you ever given evidence in a regulatory proceeding?**

10 A. Yes, I have appeared in two regulatory proceedings.

11 In 2001, I was retained by the Alberta Energy and Utilities Board (“AEUB”) as an  
12 independent financial expert to give evidence at the 2000 Pool Price Deferral  
13 Accounts Proceeding.<sup>1</sup> The 2000 Pool Price Deferral Accounts Proceeding was  
14 convened to permit the AEUB to determine the amount payable to the owners of  
15 six electrical distribution systems in respect of the prudent cost of financing of the  
16 deferral accounts, which in aggregate were approximately \$632 million. Pursuant  
17 to the relevant regulation, the prudent cost of financing of the deferral accounts  
18 could include the costs of “debt financing, equity financing or a combination of  
19 debt and equity financing.”<sup>2</sup> My duties included, among other things, analysis of  
20 the applications, and; filing a written submission on the prudent financing options,  
21 cost of financing, impact of debt financing on capital structure and the impact of  
22 the cost of financing for other corporate purposes.

23 In 2002, I filed evidence and appeared as a financial expert, having been retained  
24 by the Canadian Association of Petroleum Producers (“CAPP”) to give evidence

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<sup>1</sup> See the various decisions related to the proceedings including Alberta Energy and Utilities Board Decision 2001-92. In addition to written evidence, Mr. McCormick was examined on July 27, 28, and 30, 2001.

1 in respect of the TransCanada Pipelines Limited (“TransCanada”) 2001 and 2002  
2 Fair Return Application heard before the National Energy Board (“NEB”) in  
3 proceeding RH-4-2001<sup>3</sup>. The 2001 and 2002 Fair Return Application Proceeding  
4 was convened to consider, among other things, whether TransCanada’s  
5 “currently-approved return based on a deemed capital structure of 30% common  
6 equity and the rate of return on common equity (ROE) resulting from the RH-2-  
7 94 Formula”<sup>4</sup> was appropriate. My duties included, among other things, analysis  
8 of the application, reviewing financial market data with respect to TransCanada  
9 and certain companies and; filing a written submission in which I concluded that  
10 the ROE adjustment mechanism had performed well, allowing TransCanada to  
11 access the capital markets on a reasonable basis.

12 **Q.4 Was the evidence in this proceeding prepared by you or under your direct**  
13 **supervision and control?**

14 A Yes.

15 **Q.5 How is your evidence organized?**

16 A I have divided my evidence into two parts. In the first part, I offer observations  
17 on AltaLink’s applied for equity return and capital structure as compared to  
18 financial market requirements, and the financial performance of utilities which  
19 have equity returns set by an adjustment formula. In the second part, I reply to  
20 several statements in the materials filed in this AltaLink application with respect  
21 to the proposed capital structure, globalization and changes in the financial  
22 markets.

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<sup>2</sup> See section 4 of the Deferral Accounts Deficiency Correction Regulation, Alberta Regulation 240/2000.

<sup>3</sup> In addition to filing written evidence, Mr. McCormick was examined on March 19, 2002.

<sup>4</sup> RH-4-2001 Decision, page 1. In its decision, the NEB increased the Mainline’s deemed common equity ratio to 33% from 30% and determined that the rate of return on common equity resulting from the RH-2-94 Decision should continue to apply. See pages 59 and 56. TransCanada filed an application for Review and Variance in respect of this decision dated September 16, 2002.

1 **Q.6 Please summarize your conclusions.**

2 A The combination of the 10.75%<sup>5</sup> equity return applied for and the 37.5% common  
3 equity ratio<sup>6</sup> appear to be in excess of the current requirements of the financial  
4 markets, relative to the underlying business risk.

5 A more appropriate equity return would be one derived from a formula similar to  
6 those used by the NEB<sup>7</sup> or the British Columbia Utilities Commission (“BCUC”)<sup>8</sup>,  
7 adjusted to recognize that the shares of companies which are the owners of most  
8 regulated utilities subject to those formulas are trading at substantial premiums to  
9 the underlying book values.

10 The proposed capital structure places an unnecessary burden on the ratepayer as a  
11 result of the manner in which the premium is proposed to be financed and the debt  
12 financings are proposed to be allocated to the rate base. The choice to issue a  
13 Real Return Bond, may expose the ratepayer to an additional burden, relative to  
14 the costs of a fix coupon instrument, as future inflation rates may exceed the level  
15 of neutrality.

16 **Part I**

17 **Q.7 What facts do you rely on to support your conclusions?**

18 A The best evidence of the appropriateness of the current equity return resulting  
19 from these adjustment mechanisms and the allowed capital structures is found in  
20 the trading prices of the shares of the companies which are the owners of the  
21 utilities that earn the returns allowed by these formula. The common shares of

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<sup>5</sup> AltaLink Application Section 8.4, line 23.

<sup>6</sup> AltaLink Application Section 8.2, line 20.

<sup>7</sup> The RH-2-94 Decision covered Alberta Natural Gas Company Ltd, Foothills Pipe Lines Ltd., TransCanada Pipelines Ltd., Trans Mountain Pipe Line Company Ltd., Trans Quebec & Maritimes Pipeline Inc. and Westcoast Energy Inc. From time to time, certain of these pipelines have entered into negotiated settlements with their shippers and returns under those negotiated settlements may vary from that determined under the adjustment mechanism.

<sup>8</sup> The June 10, 1994 Decision of the British Columbia Utilities Commission on “Return on Common Equity” covered BC Gas Utility Ltd., Pacific Northern Gas Ltd. and West Kootenay Power Ltd. The return

1 TransCanada, the public entity that investors must buy to participate in owning  
2 the Mainline and the BC System, are trading at a material premium to book  
3 value.<sup>9</sup> The common shares of BC Gas Inc., the public entity that investors must  
4 buy to participate in equity ownership of BC Gas Utility<sup>10</sup>, Centra Gas British  
5 Columbia<sup>11</sup> and the Trans Mountain Pipe Line<sup>12</sup>, are trading at a material premium  
6 to book value.<sup>13</sup>

7 **Q.8 Is it correct to use the prices of TransCanada shares as a guide for**  
8 **determining whether the allowed return of its NEB regulated pipelines is**  
9 **adequate?**

10 A While the analysis would be easier with publicly traded stand-alone utilities,  
11 important information can be drawn from the trading prices of the securities of  
12 utility owners. Since TransCanada, the public entity which owns several NEB  
13 regulated pipelines, also owns other businesses the view that we may obtain of the  
14 required returns from the prices of its shares is a little blurred by the inclusion of  
15 those other businesses within the financing entity. Those other businesses have  
16 included both regulated and unregulated<sup>14</sup> businesses. To the extent that the other  
17 regulated businesses have returns that move in parallel with the returns allowed

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for Centra Gas Fort St. John was also determined to be the average of the ROEs allowed to BC Gas and West Kootenay.

<sup>9</sup> As at September 30, 2002, TransCanada shares were trading at 1.91 times book value. Since December 1995, calculated on a quarterly basis, the shares of TransCanada have traded at an average 1.64 times book value. During that period the low was 1.02 times book, which occurred at March 2000, following an announcement of a dividend cut and multimillion after tax write down of certain unregulated assets. The high was 2.10 times book value.

<sup>10</sup> The BCUC formula governs BC Gas Utility, but owing to the withdrawal of its 2002 application, the 2001 return on equity continued to apply in 2002.

<sup>11</sup> Centra Gas British Columbia has negotiated an incentive regulatory arrangement which expires in 2002.

<sup>12</sup> Although Trans Mountain could be regulated under the NEB formula, since 1996 it has had a negotiated incentive toll settlement with its shippers.

<sup>13</sup> As at September 30, 2002, BC Gas shares were trading at 2.03 times book value. In the last year, calculated on a quarterly basis, the shares of BC Gas have traded at an average of 1.84 times book value.

<sup>14</sup> In response to written questions by participants in RH-4-2001, TransCanada replied in ADOE 1.59 that the “unregulated business of TransCanada represents less than 10% of the total assets of the Company” and in CAPP 210, that the non-regulated businesses “do not have a material impact on TransCanada’s consolidated financial fundamentals”.

1 under the NEB formula, there is little blurring.<sup>15</sup> To the extent that the proportion  
2 of unregulated business increases relative to the regulated businesses and the  
3 unregulated businesses have returns that vary from the returns allowed under the  
4 NEB formula, there is more blurring. Fortunately, the relative size of the  
5 unregulated businesses within the financing entity has been reduced in recent  
6 years. Share prices are the best evidence of the market reaction to TransCanada's  
7 expected relative returns. Even Mr. Lackenbauer, one of TransCanada's capital  
8 markets experts in the RH-4-2001 proceeding, testified that "the proxy for [the  
9 mainline], which is not a perfect proxy, is the TransCanada common equity".<sup>16</sup>  
10 While it would be ideal if the Mainline were in a separate financing vehicle so as  
11 to remove any blurring, it remains the largest asset and is therefore a major driver  
12 of TransCanada's results.

13 The same concepts apply to other companies, like BC Gas, where the major  
14 portion of its financial results are related to its regulated utility businesses. The  
15 relative importance of the regulated utility businesses will vary over time as each  
16 corporation acquires<sup>17</sup> and divests, but while the regulated utility businesses  
17 remain a major portion of the business their return on capital cannot help but be  
18 reflected in the trading price of the shares.

19 It is also noteworthy, that the NEB and BCUC formula generate slightly different  
20 returns. For 2002 the NEB formula provided a 9.53% return while the BCUC  
21 formula offered 9.13% return to the low risk benchmark utility. For 2003, the  
22 comparative rates are 9.79% and 9.42%. One of the factors giving rise to the  
23 difference is the cap on equity risk premium that exists in the BCUC formula  
24 when the forecast yield on the long-term Canada bond falls below 6%.

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<sup>15</sup> Certain of TransCanada's current pipeline investments were also part of the RH-2-94 decision, including Alberta Natural Gas Company Ltd, Foothills Pipe Lines Ltd., and Trans Quebec & Maritimes Pipeline Inc.

<sup>16</sup> RH-4-2001 Hearing Transcript February 28, 2002 at line 2073.

<sup>17</sup> On November 19, 2002, BC Gas announced the acquisition of an interest in the Express Pipeline.

1 **Q.9 Surely the use of the prices of the utility holding company shares as a proxy**  
2 **for the market required return on its regulated utility investment is a**  
3 **violation of the stand-alone principle and a misapplication of the capital**  
4 **attraction standard?**

5 A On the contrary, it is the use of the most obvious tool to arrive at a fair result.  
6 TransCanada is arguing this point in its review and variance application but there  
7 is no other route for an investor to supply capital to the Mainline, in  
8 TransCanada's case, but through the public company.<sup>18</sup>

9 In many proceedings, competing proponents of the mystical art of the  
10 "comparable earnings" method and the "equity risk premium" method offer  
11 complex analysis of corporate earnings, discount cash flows and select varying  
12 time periods and geographical data sets<sup>19</sup> to estimate long term equity risk  
13 premiums and reach divergent conclusions as to the required utility rate of return.  
14 Some of this evidence is apparently not perceived as helpful.<sup>20</sup> In these debates  
15 over the appropriate methods I am reminded of the principle of "misdirection" in  
16 magic<sup>21</sup> as the focus on method seems to overshadow the outcome of the process.  
17 Those who would seek to misdirect regulators' attention may be hoping that those  
18 regulators will not place emphasis on the real world current market data which  
19 shows many utility holding companies in Canada are trading well above book  
20 while earning a return on a large portion of those assets which is generally  
21 calculated with reference to the book value of the rate base.

22 We should little wonder at the fact that so many regulators have approved an  
23 adjustment formula when faced with differences between the company and  
24 intervenor experts. Having heard sometimes repetitive testimony supporting a

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<sup>18</sup> See page 19 of the Application for Review and Variance.

<sup>19</sup> The evidence filed in RH-4-2001 on behalf of TransCanada relied in large measure on U. S data. TransCanada also proposed the use of the "ATWACC" method.

<sup>20</sup> Decision 2001-96, page 57. See also the discussion by Dr, Evans on this point commencing at page 15 of his evidence.

<sup>21</sup> Misdirection in magic is the practice of directing the attention of the audience away from the movement of the hand which is executing the trick and directing that attention toward some other object.

1 range of recommended returns in each proceeding, and after making an award  
2 within the ranges recommended by regulatory experts, regulators can see the  
3 shares of the utilities trading at generous levels throughout the test period.

4 **Q.10 Are any utilities awarded returns greater than that awarded by the NEB**  
5 **adjustment formula%?**

6 A Yes, utilities from time to time enter into incentive arrangements<sup>22</sup> with their  
7 customers and may earn greater returns than allowed by these adjustment  
8 formulas. Other regulators have allowed different rates of returns as a result of  
9 hearing evidence<sup>23</sup> or applying different formulas.<sup>24</sup> Several pipelines, Alliance  
10 and Maritimes & Northeast, have been awarded higher rates of return on equity in  
11 the initial periods of their existence. In Canada, Alliance is allowed 11.3% on its  
12 30% equity layer and in the U.S. it is allowed 10.7% ROE.<sup>25</sup> Maritimes &  
13 Northeast is allowed a 13% return on its 25% equity layer for its first 5 years  
14 ending in 2004.<sup>26</sup> These rates of return were determined in the recognition that  
15 Alliance and Maritimes & Northeast were new pipelines facing different risks. In  
16 Alberta, TransCanada's Alberta System, the former Nova, and ATCO Gas North  
17 have had negotiated settlements with their customers.

18 **Q.11 Is there other market information which you considered relevant to the issue**  
19 **of required return on equity capital?**

20 A There are two areas of market information which I would like to like to add to the  
21 record. These two are the increasing investor interest in income funds and trusts  
22 and the reversal of the major gains earned by technology stocks in the last few  
23 years.

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<sup>22</sup> As disclosed on page 10 of the 2002 Westcoast Energy Inc. annual information form, their BC Pipeline System operated under a negotiated settlement between January 1997 and December 2001.

<sup>23</sup> See CAL.ALP-72.

<sup>24</sup> See CAL.ALP-32.

<sup>25</sup> Alliance Pipeline Limited Partnership, Bond Rating DBRS, June 28, 2002, page 3.

<sup>26</sup> Maritimes & Northeast Pipeline Limited Partnership, Bond Rating DBRS, August 26, 2002, page 3.

1 The first aspect, that I thought relevant to the issue of required returns on equity  
2 capital, was the growth in recent years in the market for trusts and income funds.  
3 These securities pay out a high proportion of the cash flow generated by the  
4 underlying assets, an amount which is often in excess of the income earned. As  
5 such, for tax purposes the distribution can be, in part, a return of capital. At the  
6 end of 1996, there were approximately 37 of these trusts and funds listed on the  
7 TSE. By September 2002, there were approximately 137 listed on the TSX. The  
8 market capitalization of the issued units of these trusts and funds had risen from  
9 just over \$7 billion at the end of 1996 to just over \$39 billion by September 2002,  
10 a compound annual growth rate of over 34%. The largest fund at the end of 1996  
11 had a market capitalization of just over \$700 million. By September 2002, there  
12 were three<sup>27</sup> that each had over \$2 billion in market capital and the 4 largest trusts  
13 or funds exceeded the total market capitalization of all the trusts which had  
14 existed at the end of 1996. In these 69 months, over 110 new trusts or funds were  
15 launched and while the process of bringing new trusts to market may slow, it does  
16 not seem to have stopped.<sup>28</sup> Clearly, these investment vehicles attracted a great  
17 deal of new capital in recent years.

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<sup>27</sup> The 3 largest trusts were Enerplus, Canadian Oil Sands and RioCan.

<sup>28</sup> During the same period, a number of funds or trusts were consolidated. In the month of October 2002, 2 of the 8 new listings on the Toronto Stock Exchange were income funds or trusts of some type. Of the 6 other new TSX listings in October, 3 were transfers from the TSX Venture Exchange. In the month of November 2002, 7 of the 12 new listings on the Toronto Stock Exchange were income funds or trusts of some type. Of the 5 other new TSX listings in November, 3 were transfers from the TSX Venture Exchange. See pages 5-9 of the TSE Review for October and pages 5-13 of the TSE Review for November.

1 The table below presents the return on average equity earned by certain funds  
2 during 1998, for the last 12 months ending September 2002, and their recent  
3 distribution yields.<sup>29</sup>

Fund	1998 Return	Sept. 2002 Return	Yield
Algonquin Power Income Fund	3.5%	3.7%	10.0%
Clean Power Income Fund <sup>30</sup>		3.2%	9.8%
Great Lakes Hydro Income Fund <sup>31</sup>		8.2%	8.0%
Northland Power Income Fund	5.6%	8.2%	9.2%
Pembina Pipeline Income Fund	3.5%	7.7%	9.6%
Average	4.2%	6.2%	9.3%

4 While the earned return of each fund will vary based on a host of factors,  
5 including business cycles and commodity prices, none of the funds in the table  
6 above earned a return on equity equal to that sought by the applicant. None of  
7 these funds pay a pre-tax yield, which includes a partial return of capital, equal to  
8 the 10.75% after tax return sought by the applicant.<sup>32</sup> For the 12 months ended  
9 September 30, 2002, these funds earned between 3.2% and 8.2%, in all cases less  
10 than the 10.75% return sought by the applicant. Without earning the return which  
11 the applicant seeks, many of these funds have been able to attract capital.<sup>33</sup>

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<sup>29</sup> The funds were listed in a recent National Post article "Betting on a Shrinking Resource", and included all the power and pipeline funds listed therein having approximately 12 months operating history. The yield was calculated as the annualized value of the latest distribution divided by a mid day price on December 11, 2002.

<sup>30</sup> Clean Power Income Fund was established in October 2001.

<sup>31</sup> Great Lakes Hydro Income Fund was established in September 1999.

<sup>32</sup> By way of example, Northland Power indicated in its third quarter report that it expects that approximately 50% of distributions will be tax deferred for 2002. Pembina has indicated that approximately 85% of 2002 distributions will be taxable. Not all funds provide estimates of future tax deferral characteristics. Algonquin noted only that approximately 71% of 2001 distributions were return of capital.

<sup>33</sup> The Algonquin Power Income Fund filed a prospectus for \$85.1 million in trust units in October 2002, filed a prospectus for \$75.2 million in trust units in October 2001, filed a prospectus for \$65.3 million in trust units in June 2001, and filed a prospectus for \$65.0 million in trust units in January 2001. The Clean Power Income Fund filed a prospectus for \$75.5 million in subscription receipts for trust units in October 2002 and for \$187.9 million in trust units in November 2001. The Great Lakes Hydro Income Fund filed a prospectus for \$205.8 million in trust units in May 2002 and for \$141.4 million in trust units in December 2001. The Pembina Pipeline Income Fund filed a prospectus for \$87.5 million in trust units and \$87.5 million principal amount of convertible debentures in November 2001 and \$60 million principal amount of convertible debentures in March 2001. In addition to the power income funds listed in the table, the Boralex Power Income Fund filed a prospectus for \$250 million in trust units in February 2002, and the Calpine Power Income Fund filed a prospectus for \$230 million in trust units in August 2002. In some of the issues the demand was sufficient to allow the underwriters to exercise an over-allotment right. By way

1 If one were to assume that the market's required equity return was in the  
2 neighborhood of the 10.75% after tax return sought by the applicant, or even the  
3 9.4% to 9.8% returns currently allowed under the BCUC and NEB formulas, it  
4 might follow that income trusts averaging a rate of return of approximately 6%  
5 should be trading at a discount to book value. The table below sets out the market  
6 to book ratio of each of the income funds in the table above, calculated using the  
7 quarter end market prices. Clean Power, the most recently created income fund  
8 which began trading in mid November 2001, is trading the closest to book value.  
9 The market prices and the history of issues by these funds, in my opinion, make  
10 asignificant statement about the adequacy of single digit returns on equity in the  
11 current market.

Fund	30-Dec-01	30-Mar-02	30-Jun-02	30-Sep-02
Algonquin Power Income Fund	1.3 x	1.2 x	1.2 x	1.3 x
Clean Power Income Fund	1.0 x	1.1 x	1.1 x	1.2 x
Great Lakes Hydro Income Fund	1.3 x	1.4 x	1.3 x	1.3 x
Northland Power Income Fund	1.5 x	1.4 x	1.5 x	1.5 x
Pembina Pipeline Income Fund	1.3 x	1.3 x	1.4 x	1.4 x
Average	1.3 x	1.3 x	1.3 x	1.3 x

12 **Q.12 Will you comment on, the recent reversal of the major gains earned by**  
13 **technology stocks, the second aspect which you considered relevant to the**  
14 **issue of required return on equity capital?**

15 The second aspect that I thought relevant to the issue of required returns on equity  
16 capital in recent years was the reversal of the major gains earned by technology  
17 stocks in the last few years. In short, the returns on information technology stocks  
18 have been dismal. In October 2000, the TSX information technology index hit  
19 levels in excess of 110. In October 2002, the same index fell to levels below 10.  
20 Nortel may be the most famous Canadian example of the irrational exuberance  
21 that some saw gripping the capital markets. In July 2000, its shares were trading  
22 as high as \$123 and in October 2002 they had fallen to prices as low as \$0.69. In  
23 August 2000, Nortel represented 34.59% of the TSE 300 index but by September

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of example, as a result of the over-allotment being exercised, the Calpine issue achieved \$264 million proceeds, and the Algonquin Power issue of October 2002 closed with \$98.5 million gross proceeds.

1 2002, it had fallen dramatically and represented only 0.53% of the S&P/TSX  
2 composite index.

3 I believe that the poor returns on shares of companies in the technology sector is a  
4 factor which makes the returns available under a formula similar to the NEB  
5 adjustment mechanism quite attractive in the current market. The billions of  
6 dollars attracted to the units of the various income funds and trusts, some of  
7 which, as shown in the preceding tables, are not achieving the returns available  
8 under formula similar to the NEB adjustment mechanism, confirms this view.

9 **Q.13 Surely, the use of the comparable earnings and the equity risk premium**  
10 **methods are enshrined in the legal precedents which establish the**  
11 **responsibilities of the regulatory boards?**

12 A While this is primarily a legal question, the *Hope Natural Gas* decision relates, in  
13 the language of its day that, “the return to the equity owner should be  
14 commensurate with the returns on investments in other enterprises having  
15 corresponding risks. That return should be sufficient to assure confidence in the  
16 financial integrity of the enterprise, so as to maintain its credit and to attract  
17 capital.”<sup>34</sup> It seems a very reasonable test, but like much of life, the devil is in the  
18 details. The difficult task is figuring out which companies have corresponding or  
19 similar risk, but we should not lose sight of the goal which is the adequate return,  
20 not the process of considering what earnings are comparable or the process of  
21 determining the optimal data to support the calculation of an equity risk premium.

22 Certain of the proponents of the mystical art of the “comparable earnings” method  
23 and the “equity risk premium” analysis strive to ignore the obvious. What is  
24 obvious to me is that the common shares of utilities are generally trading at  
25 market to book multiples well above one. It is also obvious that major  
26 acquisitions of utilities are taking place by utilities and others at premiums to the

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<sup>34</sup> 320 U.S. page 591 at 603. This concept has been adopted in Canadian cases as well.

1 trading market prices which were already at a premium to book value.<sup>35</sup> There is  
2 nothing quite like a takeover bid to demonstrate that capital is being attracted to  
3 the rate base of a utility. In fact some of the issues in this hearing arise only  
4 because new capital was attracted to these rate base assets at a premium to book  
5 value.

6 While we are discussing an adequate return on equity as the goal of the “capital  
7 attraction” test, the November 2002, filing by TransCanada of a shelf prospectus  
8 for \$2 billion in Canada, and \$1 billion in the United States, covering common  
9 and preferred shares and debt, gives evidence to their need to attract capital in the  
10 future. As equity tends to be more permanent capital, utilities are more frequent  
11 issuers of debt. While much of this capital may go to ventures other than their  
12 NEB regulated assets, there is a constant need to refinance maturing debt. It is the  
13 equity return that helps underpin the debt obligations. In the absence of an equity  
14 return, the interest coverage would be approach one. In that regard, one might  
15 have expected TransCanada and other companies regulated by the NEB formula  
16 to have been restricted in recent years in their capital market access by the  
17 allegedly low rates of equity return. For TransCanada, that appears not to have  
18 been the case.<sup>36</sup>

19 The senior debentures of TransCanada are and have been rated by DBRS as “A”  
20 since July 1998. The medium term note debentures of BC Gas are rated by DBRS  
21 as “A (low)”. The long term debt of BC Gas Utility is and has been rated by  
22 DBRS as “A” since at least 1992. Debentures of each of these firms will trade at  
23 spreads over the comparable government bonds of similar term within the range  
24 that ebbs and flows as demand for credit changes over time.<sup>37</sup>

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<sup>35</sup> Recent transactions include the Duke acquisition of Westcoast, the Enbridge acquisition of interests in Alliance and the BC Gas acquisition of Express Pipeline.

<sup>36</sup> See RH-4-2001 proceeding transcript at lines 820-1, where Mr. Girling of TransCanada replies to the question “When, since early 1999, have you been unable to raise debt on reasonable terms and conditions?” by saying “We haven’t been.”

<sup>37</sup> Spreads of certain bonds are set out in CAL.ALP-74. We would observe that no issuer is reflected in the information there presented with a DBRS “A (high)”, S&P “A-” rating combination.

1 **Q.14 Where do bond ratings fit within your analysis?**

2 A Bond ratings are one of many sources of information available to the market on an  
3 issuer's debt. Bond ratings provide the market with an independent assessment or  
4 measure of the relative probability that the debt of the various issuers will be  
5 repaid in accordance with the terms of the instruments. The rating could be  
6 viewed as a proxy for an assessment of business risk and financing risk. Each debt  
7 instrument has a position within the capital structure of the firm. First mortgage  
8 bonds would clearly be at the top on the heap in terms of security of repayment,  
9 while the various classes of unsecured debt would obviously rank below, each in  
10 accordance with its priority.

11 Bond rating does not appear to be an exact science.<sup>38</sup> The ratings for individual  
12 firms are developed through the individual judgment of those employed by the  
13 various rating agencies. Consequently the changing and sometime divergent<sup>39</sup>  
14 judgments of bond raters, at any particular time, should not be the sole driver of  
15 the allowed return for a regulated utility, and in my view, are no substitute for the  
16 views of the regulator. This is particularly true when the financing entity is also  
17 financing assets beyond those included in the rate base since the financing of  
18 those assets may affect the bond rating upon which the regulated entity will  
19 market its bonds.

20 A company's debt instruments do not always trade in line with the bond rating.  
21 As demand ebbs and flows spreads will vary from those in the same rating  
22 category. Spreads can widen out before downgrades occur because the debt  
23 markets can respond more quickly to changes in circumstances than do the rating  
24 agencies. Spreads can widen or narrow due to matters not directly related to the  
25 credit quality of the specific company including anticipated financings and

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<sup>38</sup> See page 2 of 108, in Ratings Criteria, CAL.ALP-5.

<sup>39</sup> AltaLink has enjoyed an "A (high) rating from DBRS since July 2002, but it appears that S&P was unwilling to grant an "A-" rating without AltaLink "securing its senior debt by granting a floating charge". See paragraph 8 to the AltaLink financing approval application dated December 12, 2002.

1 anticipated shortages of new government bonds due to increasing government  
2 surpluses.

3 **Q.15 Will an adjustment mechanism work well in any circumstance?**

4 A Any system created by human beings suffers from limitations, and as such, there  
5 may develop in the future a confluence of events in which the current adjustment  
6 mechanisms used by the NEB and BCUC would not provide an adequate return  
7 for a regulated company. However, it seems clear to me that these adjustment  
8 mechanisms have performed well for a number of years. TransCanada has been  
9 able to access the capital markets on a reasonable basis. The high market to book  
10 ratios currently enjoyed by TransCanada and BC Gas shareholders provide  
11 tangible support for the view that these formulas continue to work well.

12 **Q.16 Can you comment on the rates of return being earned by BC Gas on its \$198**  
13 **million purchase of one-third of the Express Pipeline System?**

14 A In its November 20, 2002 conference call, the officers of BC Gas declined to  
15 provide a rate of return on equity when asked to do so by one analyst. They noted  
16 that they anticipated earning \$12 million in 2003 from the investment, operating  
17 management fees and certain tax benefits which were described as “significant”.  
18 As such, the return on equity for 2003 appears to be approximately 6% or less.  
19 This return is based on the full through put volumes which were supported by a  
20 commitment of the vendor to continue to ship volumes above committed capacity  
21 for a minimum of two years.

22 In support of the acquisition, BC Gas offered 5.3 million shares to the market at a  
23 price of \$38.00.<sup>40</sup>

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<sup>40</sup> On December 3, 2002, BC Gas filed a prospectus for an issue of \$201.4 million of common shares. They had also undertaken a private placement of approximately \$100 million of common shares on the same terms to assist in the financing of the Express pipeline purchase. In November 2001, BC Gas filed a prospectus for \$188 million of Subscription Receipts for common shares.

1 **Q.17 Can you comment on the Duke purchase of Westcoast?**

2 A I was interested in comparing the statement which noted “the higher returns  
3 available in the U.S.”<sup>41</sup> with the statement that “the results of applying the NEB  
4 formula under current circumstances will understate the fair return on common  
5 equity”<sup>42</sup> and the action by Duke in committing U.S. \$8.5 billion in the purchase  
6 of Westcoast. Since Westcoast, in the absence of a negotiated settlement  
7 involving a higher or incentive rate of return, is saddled with the apparently  
8 burdensome adjustment mechanism, I could not believe that the synergies and  
9 returns on other aspects of their business outweigh the purportedly low rates of  
10 return on Westcoast’s NEB regulated pipeline investment, which Duke will  
11 acquire as part of the purchase.

12 **Part II**

13 **Q.18 Do you agree with the evidence filed in support of the AltaLink application,**  
14 **that there have been “three irreversible and therefore permanent changes**  
15 **that influence prospective share market rates of return”?**<sup>43</sup>

16 A No, I do not think that Dr. Evans has identified “the” three changes that will not  
17 be affected in the future. The capital markets are constantly changing and the  
18 myriad of factors that give rise to changes are unlikely to stop.

19 I suspect that the music instrument retailers thought that the arrival of radio in  
20 Calgary was a permanent and irreversible change as the market shifted from  
21 having to entertain yourself at home to this new media. I suspect that the  
22 instrument retailers and owners of radio stations thought that the arrival of

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<sup>41</sup> Written Evidence of Dr. Evans, Page I-6. We would observe that there may also be a higher risk component in U. S. investments. In April 2001, PG&E sought bankruptcy protection and Enron Corp and a number of its affiliates filed for Chapter 11 protection in the U. S. Bankruptcy Court for the Southern District of New York in December, 2001, in contrast, to the Canadian experience referred to in CAL.ALP-51, in which Dr. Evans notes that he is “unaware of any Canadian utility that has been the subject of a creditor restructuring”.

<sup>42</sup> Written Evidence of Dr. Evans, Page I-12. A similar concept appears in a statement on page 14 at line 6 and again on line 15.

<sup>43</sup> Written Evidence of Dr. Evans, Page E-2, last 2 lines.

1 television in Calgary in the 1950's was a permanent and irreversible change. I  
2 suspect that the instrument retailers and owners of radio and television stations  
3 thought that the arrival of cable television in Calgary in the 1970's was a  
4 permanent and irreversible change. At the time of each of these events more  
5 changes were still coming. The same is true today. It would be hubristic to  
6 suggest that we have now experienced "the" three changes that render historical  
7 market data prior to 1992 irrelevant. For example, the securitization concept  
8 which was one of the outcomes of the 2000 Pool Price Deferral Accounts  
9 Proceeding, had links to the take-or-pay and TOPGAS financings of the late  
10 1970's and early 1980's. It would be folly to suggest that the current market  
11 condition is permanent or that we have nothing to learn from history.

12 But to argue about which, if any, changes are permanent is really a distraction  
13 from the real question of determining the appropriate rate of return to fund the  
14 utility. Simple observations of the market to book ratios of companies owning  
15 utilities under adjustment formulas show us that most of these companies are  
16 thriving with equity returns of approximately 9.5%.

17 Specifically, Dr. Evans attempts to support his proposition with the statement that  
18 "56% of the common shares held by Canadian investment funds are classified as  
19 foreign."<sup>44</sup> It would be impossible to argue that Canadians are not investing  
20 internationally. Regretfully, the data as used does not support the description of  
21 Dr. Evans' calculation. In CAL.ALP-57 we see that his calculation totals only  
22 three of the nine broad classifications used by the Investment Funds Institute to  
23 classify the over 1,900 funds that their members manage or sell. His calculation  
24 ignores that there are common shares in Balanced and Dividend funds and that  
25 foreign or global funds periodically invest in Canadian stocks.<sup>45</sup>

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<sup>44</sup> Written Evidence of Dr. Evans, Page E-3, third bulleted paragraph, line 5.

<sup>45</sup> The definition of Balance Fund found on the Investment Fund Institute of Canada web site provides that a balanced fund is "a mutual fund which has an investment policy of "balancing" its portfolio generally by including bonds and shares in varying proportions influenced by the fund's investment outlook". By ignoring Canadian and foreign shares in a host of funds, Dr. Evans' assertion extends beyond what the data will support.

1 In a related discussion on globalization commencing at page H-5, Dr. Evans  
2 correctly observes that the RRSP limits on foreign content have increased to 30%.  
3 While “the maximum allowable foreign content percentage has tripled” going  
4 from 10 to 30% for the year 2000, Canadians were only invested to about 20%  
5 foreign content in their RRSPs rather than the 30% limit.

6 **Q.19 Do you agree with the evidence filed in support of the AltaLink application,**  
7 **that “the multi-pipeline formula understates the fair rate of return”?**<sup>46</sup>

8 A No, if anything, the formula appears to be generating a return that is generous in  
9 the current market conditions.

10 The market is dynamic and as such, the market’s perception of the fairness of the  
11 “rate of return” will be adjusted on each trading day. The best that we can hope  
12 for is that the regulator will allow a return that is within a band that market will  
13 find acceptable. We currently have utility companies trading at high market to  
14 book ratios. As such, it seems inconsistent to suggest that a “9.25-9.5%” rate of  
15 return is required to be increased to achieve a “market-to-book ratio of 110-  
16 115%” when they have been earning in the upper end of those rates and utility  
17 shares have surpassed that market to book level.<sup>47</sup>

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By way of example, the Altamira Balanced Fund as at September 30, 2002, was made up of 61.6% equities of which 17.2% were classified as foreign. As at November 29, 2002, the Mackenzie Cundill Global Balanced Fund Series C had, among other things, 28% equities from Asian countries and 8% Canadian equities. By ignoring the Balanced Fund category, Dr. Evans is ignoring the amount of Canadian and foreign equities in those funds.

The Altamira Dividend fund, which describes itself as investing “mainly in Canadian companies”, was approximately 64% common shares as at September 30, 2002. By ignoring the Dividend Fund category, Dr. Evans is ignoring the amount of Canadian and foreign equities in those funds.

The proportion of foreign investment seems not to be permanent but to be in recent decline. From July 2000 to August 2002, the proportion classified as foreign, as Dr. Evans calculated it, has declined from 61% to 56%. The proportion of the three categories of funds considered by Dr. Evans to the whole reported by IFIC also declined from July 2000 to August 2002 from 68% to 61%. The data for August 2002 also shows that 12 of 69 IFIC members did not report.

The graph on page H-11 appears to suffer from the same methodological problem.

<sup>46</sup> Written Evidence of Dr. Evans, Page 14, line 15.

<sup>47</sup> Dr Evans refers to the 110-115% market of book ratio at page E-23 of his evidence.

1 **Q.20 Do you agree with the evidence filed in support of the AltaLink application**  
2 **that “the NEB has missed the point”<sup>48</sup> with respect to globalization?**

3 A No, the prices at which the shares of Canadian companies trade on Canadian stock  
4 exchanges reflect the host of Canadian and non-Canadian investment alternatives  
5 available to Canadian investors and a similar pallet of local and international  
6 investment alternatives available to non-Canadian investors. Canadian market  
7 data is not immune to the influences of matters arising outside of our country.

8 TransCanada and BC Gas, the public entities which own the various regulated  
9 utilities covered by the formulas, are followed by a host of equity analysts,<sup>49</sup>  
10 several bond rating firms and thousands of investors<sup>50</sup> and potential investors, all  
11 of whom to some degree make up the “market” and affect securities prices with  
12 their behavior. The “market” is made aware of the economic, competitive and  
13 political developments and regulatory changes through a host of communication  
14 options. The “market” is aware of the return to which the utilities are entitled  
15 under these adjustment mechanisms and may anticipate the result in advance of  
16 publication since the formulas are known.<sup>51</sup> The “market” is aware of a  
17 cornucopia of alternative investment opportunities in utilities and other industries  
18 in Canada and internationally and with all this knowledge still awards these firms  
19 a large premium over their respective book values.

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<sup>48</sup> Supplement to the Written Evidence of Dr. Evans, Page I-11, third paragraph, immediately following the quoted passage.

<sup>49</sup> On December 11, 2002, the TransCanada web site showed 11 analysts as providing research on TransCanada, and the BC Gas web site showed 9 analysts following that company.

<sup>50</sup> TransCanada’s annual report for 2001 shows 36,350 registered shareholders, up from 30,758 in the prior year. Registered shareholders represent a fraction of the total shareholders since many shareholders will own their shares through accounts registered with an investment dealer.

<sup>51</sup> On December 8, 2000, the NEB announced the approved rate of return on common equity of 9.61% for the year 2001, on December 6, 2001 announced 9.53% for the year 2002 and on December 5, 2002 announced 9.79% for the year 2003. The BCUC announcement of the appropriate return on common equity for a low risk benchmark utility for 2001 (9.25%) was made on December 21, 2000 in letter L-61-00, for 2002 (9.13%) on November 26, 2001 in letter L-43-01 and for 2003 (9.42%) on November 21 in letter L-26-02.

1 **Q.21 Do you agree that the premium paid by AltaLink in the purchase from**  
2 **TransAlta “does not form part of AltaLink’s applied for costs”<sup>52</sup> and is**  
3 **therefore irrelevant to this proceeding?**

4 A No, the manner in which the premium is being financed appears to have some  
5 considerable effect on the interest coverage ratios of AltaLink. The interest  
6 coverage ratios of the partnership, rather than the rate base portion of its business  
7 will be of interest to rating agencies. For that reason, the manner in which the  
8 partnership chooses to finance the premium will have an impact on the overall  
9 coverage ratios and, indirectly, on the debt rating and cost of funds on the rate  
10 base portion of the assets.

11 In Decision 2002-38, the Board noted that the applicants committed to a condition  
12 that “any premium paid over the rate base book value shall not be included in the  
13 future rate base of AltaLink. The Applicants submitted that customers are  
14 protected by AltaLink’s commitment to exclude any premium in the rate base.  
15 Further, AltaLink submitted that its ability to earn returns will ultimately justify  
16 the purchase price and remains a matter of commercial risk to the partners”.<sup>53</sup> In  
17 reading the decision, there appears to be neither a specific undertaking as to how  
18 the premium would be financed nor a specific undertaking that the financing of  
19 the premium would not increase the costs of financing the rate base assets. In  
20 Order U2002-293, the Board found “At the time of the upcoming AML 2002/03  
21 and 2003/04 GRA, the Board and parties will have an opportunity to fully review  
22 and test ALP’s existing debt, the Debt Securities to be issued, as well as the  
23 overall capital structure. With regard to the Debt Securities, all issues related to  
24 the Debt Securities will be examined, including the amount to be financed, the  
25 specific term associated with the proposed issues, the affiliate component of the  
26 issues, as well as the relationship of the Debt Securities to the total capital  
27 structure.”<sup>54</sup>

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<sup>52</sup> See IPCCAA.ALP-4 (a) second paragraph.

<sup>53</sup> See page 30 and 31 of Decision 2002-38.

<sup>54</sup> Order U2002-293 page 5.

1 The table below is intended to show the impact on interest coverage on the  
2 assumptions of a 40% income tax rate, a 6% debt cost and a 9.5%<sup>55</sup> after tax  
3 return on equity applied to arbitrary balances of rate base and total enterprise  
4 capital, which included the financing of some excluded assets, to show the effect  
5 of financing the premium with a mix of debt and equity. The example is based on  
6 an allowed rate base of \$600 and a “premium” of \$200.

**Calculation of Interest Coverage on Rate Base and Total Enterprise**

	Capital Structure	Return	After tax Return	Tax	Pre tax Return	Interest Coverage
Rate Base	\$ 600					
Debt	\$ 390	65.0%	6.0%	\$ 23.40	\$ -	\$23.40
Equity	\$ 210	35.0%	9.5%	\$ 19.95	\$ 13.30	\$33.25
						\$56.65
						2.42 x
Total Enterprise	\$ 800					
Debt <sup>56</sup>	\$ 480	60.0%	6.0%	\$ 28.80	\$ -	\$28.80
Equity	\$ 320	40.0%	5.2%	\$ 16.71	\$ 11.14	\$27.85
						\$56.65
						1.97 x <sup>57</sup>
Financing of Premium						
Debt	\$ 90	45.0%		\$ 5.40	\$ -	
Equity	\$ 110	55.0%		-\$ 3.24	-\$ 2.16	
Total <sup>58</sup>	\$ 200	55.0%		\$ 2.16	-\$ 2.16	

7 Using a 65% debt 35% equity capital structure, similar to that allowed in past  
8 decisions relating to the appropriate capital structure for the transmission assets  
9 now owned by the applicant, the interest coverage based on the rate base alone  
10 would be approximately 2.42 times. Applying a 60% debt 40% equity capital  
11 structure to the enterprise including the premium, similar to the capital structure  
12 proposed by the applicant, results in a reduction of the interest coverage on these  
13 assumptions to approximately 1.97 times.<sup>59</sup> Subtraction suggests a higher equity  
14 component is used for financing the premium than the rate base. Based on the

<sup>55</sup> The cost of equity in this example is arbitrary and chosen to reflect an average ROE. In CAL.AL-45 (b) a comment by S&P is quoted referring to “Approved ROEs in Canada (on average around 9.5%)”

<sup>56</sup> In CAL.AL-5 (d) the partnership capital structure is said to be approximately 60% debt 40% equity.

<sup>57</sup> On page 3 of the DBRS rating report on AltaLink attached to CAL.AL-181 (a) a table appears in which DBRS estimates the 2003 AltaLink fixed charge coverage at 2.01 times, treating subordinated debt as debt.

<sup>58</sup> The table attached to CAL.AL-189 shows goodwill of approximately \$201.8 million.

<sup>59</sup> The interest coverage determined on the rate base will be constant based on these tax rate, interest rate and return assumptions. The difference in the interest coverage ratios calculated for the total enterprise will change depending on the amount of the premium in the total enterprise capitalization relative to the amount of rate base in the total enterprise capitalization.

1 assumed rate base of \$600 and premium of \$200, about \$90 in debt is required to  
2 fund the premium. The \$90 represents about a 45% debt ratio for assets which are  
3 excluded from the rate base for return purposes.

4 The table below, using the assumptions set forth above, presents the capital  
5 structure for the enterprise which would be required to provide the same interest  
6 coverage multiple, as was calculated above, for the rate base portion of the assets.

**Calculation of Capital Structure Required to maintain Interest Coverage**

Total Enterprise	Capital Structure	Return	After tax Return	Tax	Pre tax Return	Interest Coverage
Debt	\$ 390	48.8%	6.0%	\$ 23.40	\$ -	\$23.40
Equity	\$ 410	51.3%	4.9%	\$ 19.95	\$ 13.30	\$33.25
Total <sup>60</sup>	\$ 800				\$56.65	2.42 x

Financing of Premium

Debt	\$ -
Equity	\$ 200
Total	\$ 200

7 In the first example above, the financing of the premium with a debt component  
8 places an additional interest burden on the enterprise, in that it depresses the  
9 interest coverage ratios that would have otherwise existed had the premium not  
10 been paid in a purchase transaction. Financing the premium with 100% equity as  
11 shown in the second example, however unpalatable that might be to the current  
12 equity owners of AltaLink, would restore the interest coverage ratio to the level at  
13 which it would have existed in the absence of the purchase.

14 Several pages<sup>61</sup> of Dr. Evans evidence are devoted to a discussion of the  
15 importance of interest coverage to the result of the debt rating process. He has  
16 provided us with examples that rating agencies are concerned that utilities  
17 “coverage ratios remain relatively weak”<sup>62</sup> without the added burden of additional

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<sup>60</sup> When compared to the S&P ratio benchmarks found in table B.1 on page B-8 of Dr. Evans’ evidence this capital structure would suggest an “AA” debt ratio and an “A” Pre-tax interest coverage. Were the 8% subordinated debt not issued the average interest rate would be lower and the interest coverage ratio would be expected to increase.

<sup>61</sup> See pages B-7 through B-11 in which Dr. Evans considers a number of S&P rating benchmarks including pre-tax interest coverage.

<sup>62</sup> See the DBRS comment quoted in CAL-13 (b).

1 debt financing of assets excluded from the rate base. While his recommended  
2 solution to the issue of low interest coverage ratios is to increase both the rate of  
3 return on equity and the common equity layer on the regulated portion of the  
4 enterprise from those allowed in prior hearings, fully funding the premium with  
5 equity will also improve the coverage ratios.

6 On the regulatory balance sheet we will only have the value of assets carried  
7 forward from TransAlta and new capital spending. On its enterprise balance  
8 sheet, though, the value of the assets must include the additional premium paid.  
9 Looking at the question of financing the premium in another way, Dr. Evans in  
10 his definition of business risk noted a number of factors “to which the income-  
11 earning potential of the business assets is exposed.”<sup>63</sup> For rate base purposes it  
12 appears that the premium is to be excluded and has no current income earning  
13 potential. With no current income earning potential, I would suggest that the  
14 financial risk that it can support, and the debt allocated to it, should be very low or  
15 non-existent. Any material amount of additional debt incurred to fund the  
16 premium will impact the interest coverage ratios.

17 Schedule 8.2 of the Application sets out the proposed debt instruments to be  
18 issued by April 30, 2004 and therefore gives us some important information on  
19 how a portion of the premium is debt financed. The financings listed there  
20 include two \$150 million tranches of senior debentures, \$125 million in real  
21 return bonds, and \$85 million of 8% subordinated debt.<sup>64</sup> Each of these issues are  
22 allocated between the financing of the rate base assets and other corporate  
23 purposes.<sup>65</sup> Had there been no premium paid, there would be no need for the 8%  
24 subordinate debt and some portion of the real return bonds and those costs would  
25 not be in the rate base debt calculation. Were the 8% subordinate debt not issued,  
26 or not allocated to the rate base assets, the interest costs to customers would be  
27 lower.

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<sup>63</sup> Supplement A, page 1, paragraph 2, line 2. On the following page, Dr. Evans also observes that  
“Business and financial risks tend to be inversely related to each other.”

<sup>64</sup> See also the Scotia Capital Letter in Section 12.7.

1 To look at the cost of financing the premium, Schedule 8.2 suggests that the  
2 premium enjoys the low rate of all series of senior debt as well as a portion of the  
3 higher rate subordinated debt. Based on its income potential having been  
4 excluded from the rate base, I am hard pressed to see how the premium would be  
5 able to attract capital at the rates which an “A” rated utility could enter the  
6 market. As such, it is not clear to me why any of the most senior debt instruments  
7 are allocated to the premium or any significant debt component is included in the  
8 enterprise capital structure to finance the premium.

9 The financing program, no doubt, was carefully and tightly crafted. The 8%  
10 subordinated debt exists to provide the capital to support the purchase of the  
11 assets and the payment of the premium in a manner that supports the more senior  
12 indebtedness. In the absence of the premium there would be no requirement for  
13 the funds being raised with the 8% subordinated debt, and, since the premium is  
14 not to be included in the rate base the rationale for including the 8% subordinated  
15 debt in the regulated capital structure is not obvious to me.

16 In fact, it appears that the financing program is so tightly crafted that an issue of  
17 additional senior securities in substitution for the 8% subordinated debt could  
18 result in a downgrade, since the senior securities would lack the “equity-type  
19 support”<sup>66</sup> of the 8% subordinated debt. The importance of the “equity like  
20 support” is also discussed in SPPA.ALP-26 (a) where, in response to a question  
21 related to the payment of a premium for reduced liquidity, we learn that the 8%  
22 subordinated debt provides “equity like support to the senior indebtedness without  
23 requiring the full common equity return, while allowing AILP to participate  
24 incrementally as an equity provider to the benefit of customers.” If, in the  
25 absence of paying a premium for the acquired assets, there would be no need for

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<sup>65</sup> Approximately 80% of each of the issues is included in the rate base financing.

<sup>66</sup> See CAL.ALP-78 (a) “It is not certain that additional senior securities in the form of Capital Markets [Bonds] could be issued on similar terms and conditions. Additional senior bonds would not provide the equity-type support to the currently contemplated issue that the Subordinated Bonds provides. Further to which, to the extent that the Subordinate Bonds were replaced with Senior Bonds, this could result in a credit rating downgrade on the Senior Bonds resulting in a commensurate increase in the yield required by investors.”

1           these funds, including part of the 8% subordinated debt in the regulated capital  
2           structure could be construed as providing the holder of that instrument with a  
3           return on excluded assets.

4           The existence of the 8% subordinated debt could not be ignored in the analysis by  
5           the rating agencies in determining the rating. While substituting an issue of  
6           additional senior securities in place of the 8% subordinated debt apparently could  
7           result a downgrade, substituting equity for the 8% subordinated debt would only  
8           serve to strengthen the financial position of the enterprise. Whether this would  
9           merely avoid a future downgrade, or allow an upgrade, is a matter upon which we  
10          all may speculate. Similarly, in determining the appropriate interest rates for  
11          marketing the senior tranches, costs of the 8% subordinated debt would be  
12          included.

13   **Q.22   Would the same principles apply to the costs of the bridge financing?**

14   A       Yes, I believe the logic is applicable and that the interest costs related to the  
15          premium should not be a charge to the customers in the rate base. Approximately  
16          80% of each the three series of Bridge financing are also allocated to the rate  
17          base. Were we to apply the same logic, that in the absence of the premium less  
18          financing would have been required to be raised, then none of the 8% Series 3 and  
19          only a part of the Series 2 financings would have been incurred and included in  
20          the rate base revenue requirement.

21          There was one other aspect of the bridge financing that I found interesting.  
22          AltaLink is proposing to amortize the costs of the bridge financing over a 5-year  
23          period, rather than the life of the instruments.<sup>67</sup> I was struck by the contrast in this  
24          method to the approach they took with intergenerational equity in the tax method.  
25          In defense of their use of the liability tax method they pointed out that it was  
26          appropriate to charge users fairly, rather than benefit those in one time period and

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<sup>67</sup> Section 8.3.1 of the Application.

1 penalize those in another as a result of timing differences.<sup>68</sup> Extending the  
2 amortization of the costs of the bridge financing for 5 years, when the bridge  
3 financing is expected to be retired by the end of the 2004 financial year, seems to  
4 overlook the goal of intergenerational equity.

5 **Q.23 Will you comment on the costs, rational and pricing of the Real Return**  
6 **Bonds?**

7 A Today, no one can be sure whether the ultimate cost of funds of the proposed Real  
8 Return Bond will be lower or higher than that of a conventional bond of similar  
9 term, since the ultimate cost of funds will depend on inflation during the life of  
10 the instrument. There are a number of inflation forecasts for 2003, made at  
11 various times, contained in documents filed in this matter which include values  
12 such as 2.0%<sup>69</sup> to 2.7%.<sup>70</sup> It appears that the constant annual inflation rate that  
13 would make an investor indifferent as to the purchase of the Real Return Bonds  
14 would be between 1.5% and 1.7%.<sup>71</sup> As such, the customer in the near term is  
15 being exposed to what may be slightly higher costs of borrowing than would have  
16 existed had a conventional bond been issued.

17 The rational for some other corporations issuing this type of security included a  
18 recognition that their tolls were to be “regulated and limited to increase no more  
19 than a specified percentage of the Consumer Price Index”.<sup>72</sup> In AltaLink’s case,  
20 as its rates are not regulated in that manner, the rational appears to be based in  
21 part on the anticipation of Performance Based Regulation, which does not seem to  
22 be immediate or assured.

23 In my experience, when a new bond issue is priced, the calculation is partly a  
24 matter of judgment and partly based on the then current market conditions.

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<sup>68</sup> Section 4.2.1 of the Application, “Rational For Use of Liability Method”, pages 4-3, 4-4.

<sup>69</sup> Consensus Estimate for 2003, April 2002, page 26, in CAL.ALP-52.

<sup>70</sup> Scotia Capital Estimate September forecast, page 2, in CAL.ALP-77.

<sup>71</sup> See CAL.ALP-77 (c). The calculations in the attached spreadsheet are not based on midyear cash flows commonly used in calculating bond yields. See also CAL.ALP-73 (k).

<sup>72</sup> See the Scotia Capital Letter in Section 12.7, page 3.

1           September 16, 2002 data appears to have been used in the Scotia Capital letter,<sup>73</sup>  
2           and in pricing the Capital Market Bonds the yield is determined based on the then  
3           current Benchmark Government of Canada yield of bonds with comparable  
4           maturity. That does not appear to be the case in the pricing of the Real Return  
5           Bonds. Pricing is compared to a 30-year issue, and an adjustment factor of 18  
6           basis points is applied based on the long term spreads between 10 and 30-year US  
7           real return bonds rather than the then current spread between those terms. The  
8           then current 10-year to 30-year spread, described in the letter, was 42 basis  
9           points.<sup>74</sup> In addition to applying a spread other than the current market spread, the  
10          pricing also incorporates a “liquidity premium.” The result of these methods is  
11          that the spread intended for AltaLink’s A (high) rated 10-year real return bond  
12          was approximately equal to the longer term A rated 407 International issue.<sup>75</sup>

13          In the absence of consumer support for this rarely used type of financing, I would  
14          recommend that the Board, for any portion of the proceeds required to fund the  
15          regulated capital structure, neither subject the customer to the risk of higher  
16          interest costs due to inflation, nor award the customer with the benefit of lower  
17          interest costs due to lower than expected inflation, but rather deem for regulatory  
18          purposes an interest rate derived from the rates available at the time the senior  
19          tranches are financed as the appropriate rate for those funds.

20      **Q.24   What is more important an “A” rating or a 2.3<sup>76</sup> times interest coverage**  
21      **ratio?**

22      A       Of the two, I would view the “A” rating as more important. However, neither of  
23      those items, the rating or the interest coverage ratio, are as important as the  
24      “market” reaction to the financial position of the company.

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<sup>73</sup> See the Scotia Capital Letter in Section 12.7, page 2.

<sup>74</sup> Scotia Capital Letter in Section 12.7, page 4, final paragraph referring to yields of 2.27% and 2.69%.

<sup>75</sup> CAL.ALP-75 (b).

<sup>76</sup> In Table B.1 on page B-8 of Dr. Evans’ evidence, the lowest pre-tax interest coverage ratio for an “A” rated issuer with a business position ranking of 2, is 2.3 times.

1 It is also clear that the various rating benchmarks, including interest coverage  
2 ratios, “are not written in stone”. A comparison of the benchmarks applied to  
3 Hydro One, with its 2001 financial ratios is set out in CAL.ALP-44<sup>77</sup>. For each of  
4 the four benchmarks, Hydro One falls below the minimum recommended level.  
5 TransCanada has been able to maintain an “A/A-” rating for a number of years  
6 with a fixed charge coverage ratio below 2 times.

7 Dr. Evans provides an analysis of the S&P Utility Rating Benchmarks in his  
8 Supplement B. From the information in that Supplement and in CAL.ALP-46, it  
9 appears clear that AltaLink expects to be awarded an “A-” rating by S&P without  
10 meeting all the benchmarks for an “A” company in addition to the A (high) rating  
11 it enjoys from DBRS.<sup>78</sup> It is also clear that, on a 35% equity layer with a 9.53%<sup>79</sup>  
12 rate of return, while there would be some erosion in coverage ratios, AltaLink  
13 would not be further reduced in respect of the indicated rating category suggested  
14 by three of the four benchmarks. The benchmark in which there is further erosion  
15 is the debt ratio, one that most Canadian utilities would have trouble meeting. As  
16 such, AltaLink does not appear to have a compelling need for the higher return  
17 based on the criteria alone. To put it another way, at a 9.5% return on 35%  
18 equity, AltaLink would actually fall within two of the benchmarks for an A rating,  
19 unlike Hydro One which did not fall within any of the benchmark ranges.

20 To propose a minimum target interest coverage ratio effectively makes the equity  
21 return a function of the weighted average cost of the existing debt issues and the  
22 current tax rate. The table below provides interest coverage numbers for a  
23 simplified example of a 65% debt and 35% common equity capital structure using

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<sup>77</sup> The benchmarks set out in CAL.ALP-44 vary slightly from those used in Table B.1 on page B-8 of Dr. Evans’ evidence.

<sup>78</sup> A comparison of Table B.2 with Table B.1 shows that AltaLink fails to meet the requirements for an A rating in its debt ratio. This would not be the case were the premium financed with equity. A comparison of benchmarks in CAL.ALP-46 shows that AltaLink, in the absence of the higher equity layer and return on equity requested, would still meet the minimum requirement of 2.3 times pre-tax interest coverage for an A rating, but would continue to fail in the debt ratio.

The DBRS rating report is found in CAL.ALP-181.

<sup>79</sup> 9.53% was the NEB 2002 rate. At the time of the preparation of the interrogatories, the NEB had not announced the rate for 2003.

1 a 40% tax rate for a range of interest and equity return rates.<sup>80</sup> To maintain a 2.3  
2 times interest coverage ratio as the imbedded average debt costs increase from 6%  
3 to 9.5%, the after-tax equity return must increase from approximately 270 basis  
4 points greater than the average imbedded debt rate to 425 basis points greater than  
5 the average imbedded debt rate.

Rate Base	\$	600		Pre Tax	Pre Tax
Tax Rate		40%	Rate	Rate	Return
Debt		65%	6.00%		\$ 23.40
Equity		35%	9.50%	15.83%	\$ 33.25
					\$ 56.65

Debt Rate	Interest Coverage						
	8.00%	9.00%	10.00%	11.00%	12.00%	13.00%	14.00%
6.00%	2.20	2.35	2.50	2.65	2.79	2.94	3.09
6.50%	2.10	2.24	2.38	2.52	2.66	2.79	2.93
7.00%	2.03	2.15	2.28	2.41	2.54	2.67	2.79
7.50%	1.96	2.08	2.20	2.32	2.44	2.56	2.68
8.00%	1.90	2.01	2.12	2.23	2.35	2.46	2.57
8.50%	1.84	1.95	2.06	2.16	2.27	2.37	2.48
9.00%	1.80	1.90	2.00	2.10	2.20	2.30	2.40
9.50%	1.76	1.85	1.94	2.04	2.13	2.23	2.32

6 **Q.25 Do you agree that AltaLink need be awarded a return of 10.75% based on an**  
7 **equity layer of 37.5%?**

8 A No, I do not. For the reasons stated above, as the ROE resulting from the NEB  
9 adjustment mechanism appears to be well within the range of what the market  
10 requires, it is impossible for me to recommend a 10.75% return.

11 **Conclusion**

12 **Q.26 Please review your conclusions.**

13 A The combination of the 10.75% equity return applied for and the 37.5% common  
14 equity ratio appear to be in excess of the current requirements of the financial  
15 markets, relative to the underlying business risk.

<sup>80</sup> For simplicity in the example, I have used an arbitrary rate of interest of 6% for all debt. Were the premium financed with equity, using the interest assumptions in Schedule 8.2, the average interest rate for 2004 would be approximately 5.67%.

1 A more appropriate equity return would be one derived from a formula similar to  
2 those used by the NEB or the BCUC, adjusted to recognize the shares of  
3 companies which are the owners of most regulated utilities subject to those  
4 formula are trading at substantial premiums to the underlying book values.

5 The proposed capital structure places an unnecessary burden on the ratepayer as a  
6 result of the manner in which the premium is proposed to be financed and the debt  
7 financings are proposed to be allocated to the rate base. The choice to issue a  
8 Real Return Bond, may expose the ratepayer to an additional burden, relative to  
9 the costs of a fix coupon instrument, as future inflation rates may exceed the level  
10 of neutrality.

11 **Q.27 Does this conclude your evidence?**

12 A Yes.

**ATTACHMENT 1**

## PROFESSIONAL QUALIFICATIONS OF JOHN D. McCORMICK

### *Academic Training*

LL.B. from the University of Alberta (1978)  
M.B.A. in Accounting from the University of Alberta (1975)  
B.A. in Political Science, from the University of Calgary (1972)

### *Professional Organizations*

Law Society of Alberta

### *Professional Experience*

September 1975 - May 1978 - Sessional Lecturer for the Department of Accounting, the Faculty of Business Administration and Commerce, the University of Alberta

June 1978 - March 1983 – Barrister & Solicitor and Articling Student, Parlee, Irving, Henning, Mustard & Rodney, Edmonton

September 1980 - May 1982 - Sessional Lecturer (M.B.A. Tax) for the Department of Legal and Industrial Relations, the Faculty of Business Administration and Commerce, the University of Alberta

March 1983 - October 1991 – Associate rising to Vice-President and Director, ScotiaMcLeod, Toronto and Calgary

In this capacity, Mr. McCormick represented the firm in transactions ranging from small private placements to major financings including the initial public offerings of Telus and Petro-Canada. The transactions included the issuance of preferred and common shares, special warrants, rights, warrants, partnership units, and trust and royalty units . . . domestic deals and crossborder financings. He executed approximately \$5 billion of financing, wrote five trust deeds for major borrowers in the energy industry covering secured and unsecured obligations in the domestic and European markets, and assisted a major airline to renegotiate the terms of its convertible debentures with key financial institutions. In the utility area, he provided coverage of a number of western Canadian utility issuers including Nova, Alberta Natural Gas and Foothills Pipe Lines. He developed expertise in a number of industries including Canadian energy and petroleum services, pipelines, basic and specialty chemicals, airlines, pulp and forest products, telephone and telecommunications, and magnesium.

November 1991 – January 1994 – President, J. D. McCormick Financial Services, Inc., Calgary

January 1994 – January 1997 – Vice-President & Director, Levesque Beaubien Geoffrion, Calgary

In this capacity, Mr. McCormick was responsible for account coverage of over 125 account relationships in Alberta, British Columbia and Saskatchewan. He gained additional expertise in the banking, gold and satellite communications industries.

January 1997 – October 1997 – President, J. D. McCormick Financial Services, Inc., Calgary

October 1997 - May 1998 – Sprott Securities, Calgary

May 1998 – present – President, J. D. McCormick Financial Services, Inc., Calgary

In this capacity, Mr. McCormick secured and executed valuation and financial advice assignments with junior and senior public companies and government. He assisted a senior issuer in a securitization transaction. He provided financial advice with respect to the recapitalization of Sunoma and Barrington, which had over \$400 million in debt, fairness opinions to directors of TSX, CDNX and ASE listed companies. He provided financial advice in respect of several oil and gas industry merger and acquisition assignments, including advice to Tappit in respect of its attempted \$13 million hostile takeover of Backer, and expert testimony or reports in three securities cases in Alberta and Saskatchewan. Among other things, he was retained to provide, strategic advice with respect to several corporate reorganizations, a valuation of a U.S. corporation with equity valued at over \$200 million and strategic advice to its owner, advice in respect of a \$15 million equity financing, the negotiation of a long term joint venture, disposition of an oil services firm, and, advice in respect of software company concerning a private placement by a major industry partner.

#### *Previous Expert Reports*

Mr. McCormick was retained by the Alberta Energy and Utilities Board to give evidence at the 2000 Pool Price Deferral Accounts Proceeding, which resulted in Decision 2001-92. Mr. McCormick was retained by the Canadian Association of Petroleum Producers to give evidence at the 2002 TransCanada PipeLines Proceeding, which resulted in Decision RH-4-2001. He has provided expert reports in respect of a number of lawsuits related to securities matters.