

C-1-15

EXHIBIT No. C-1-15
PIÈCE

N.E.B. / O.N.E.

DATE 24 Sept 08

National Energy Board

Reasons for Decision

**TransCanada PipeLines
Limited**

RH-2-92

February 1993

Tolls

Chapter 4

Cost of Capital

TransCanada, in its final revision, applied for a rate of return on rate base of 11.25% for the 1993 test year, as compared to the currently-approved rate of 11.56% for 1992. The applied-for rate of return on common equity for the 1993 test year was 13.25%, on a deemed common equity component of 30.0%, unchanged from that approved for 1992.

Details of the applied-for capital structure and requested rates of return, as revised, are shown in Table 4.1 and discussed in detail in sections 4.1 to 4.5.

Table 4-1
Applied-for Deemed Average Capital Structure and
Rates of Return for the 1993 Test Year

| | Amount (\$000) | Capital Structure (%) | Cost Rate (%) | Cost Component (%) |
|--|---------------------------|--------------------------------------|------------------------------|-----------------------------------|
| Debt - Funded | 3,475,577 | 55.19 | 10.92 | 6.03 |
| - Unfunded | <u>316,538</u> | <u>5.03</u> | 8.91 | <u>0.45</u> |
| Total Debt Capital | 3,792,115 | 60.22 | | 6.48 |
| Preferred Shares | 616,176 | 9.78 | 8.08 | 0.79 |
| Common Equity | <u>1,889,268</u> | <u>30.00</u> | 13.25 | <u>3.98</u> |
| Total Capitalization | 6,297,559 | 100.00 | | |
| Rate of Return on Rate Base | | | | 11.25 |

4.1 Funded Debt

In its initial application, TransCanada applied for a capitalization which included a funded debt component of \$3,476,125,000 (55.8% of total capitalization), costed at a rate of 10.84%. During the hearing this amount and the associated cost rate were revised to \$3,475,577,000 (55.19% of total capitalization) and 10.92% respectively. The funded debt amount and the associated cost rate were determined using the gross proceeds approach approved by the Board in its RH-2-85 TransCanada Reasons for Decision.

No intervenor took issue with either the applied-for amount of the funded debt or the cost rate of 10.92%.

Decision

The Board approves the Company's funded debt amount of \$3,475,577,000 for the 1993 test year at an embedded cost rate of 10.92%.

4.2 Unfunded Debt

Unfunded debt represents that portion of TransCanada's long-term debt which remains to be raised by the issuance of long-term debt. This figure is derived by subtracting the funded debt, preferred share capital and common equity capital from the total capitalization.

Initially, the Company applied for an unfunded debt rate for the test year of 8.74%, which was later revised upwards by 17 basis points to 8.91%. The Company argued that the currently-approved methodology, which uses a blend of short-term and long-term interest rates, for the calculation of an unfunded debt rate results in somewhat higher risk for TransCanada. The recent volatility in short-term borrowing rates and the risks associated with this volatility continuing into 1993 prompted TransCanada to revise its unfunded debt rate upwards.

CAPP in its filed evidence stated that, given current financial market conditions, the applied-for rate of 8.74% for TransCanada's unfunded debt for the 1993 test year is excessive. In final argument, CAPP argued that the 8.75% long Canada rate utilized by TransCanada for the calculation of its unfunded debt rate for the test year is too high. Furthermore, the requested increase of 17 basis points from the initially applied-for rate of 8.74% to 8.91% is caused, CAPP argued, by TransCanada rearranging its financing plans by projecting higher expenditures in the early part of 1993. CAPP suggested that this may have no relationship to reality.

CAPP's witness on capital structure stated in his filed evidence that, with the exception of 1987, TransCanada's actual cost for unfunded debt has been lower than the rate approved by the Board and TransCanada has been able to earn extra money by managing its unfunded debt position more effectively. TransCanada, however, disagreed with this witness' calculation and denied the suggestion that it overearned on the unfunded debt component of its capital structure. In final argument CAPP suggested that TransCanada's actual financing plan for its unfunded debt should be monitored on an ongoing basis to ensure that TransCanada does not overearn by rearranging the timing of its debt issues.

IGUA supported CAPP's position on unfunded debt.

Ontario opposed TransCanada's request to increase its applied-for unfunded debt rate from 8.74% to 8.91%. Ontario suggested that some benefit of the overearned interest on TransCanada's 1992 unfunded debt should be passed on to the tollpayers.

Views of the Board

Having reviewed the evidence presented on this issue, the Board is of the view that the forecast rates used by TransCanada for three-month Treasury Bills, ten-year and long-term Canada bonds to arrive at a rate for unfunded debt are at the high end of the range of reasonableness. Also, given the current and prospective economic environment and capital

market conditions, the Board is not persuaded that an unfunded debt rate higher than 8.74% is warranted for the test year. The Board notes that the reason given by TransCanada for the requested increase for the unfunded debt rate was the increase in the short-term interest rates. That trend has since reversed itself. The Board finds 8.74% to be a reasonable rate for unfunded debt in the test year.

Decision

The Board approves an unfunded debt amount of \$330,045,916 for the 1993 test year and an associated cost rate of 8.74%. The applied-for unfunded debt amount has been increased by \$27,692,000 to reflect the Board's decision on the \$60,000,000 proposed preferred share issue for the 1993 test year (see section 4.3).

4.3 Preferred Shares

TransCanada's applied-for capital structure for the test year includes a preferred share component of \$616,176,000 (this represents 9.78% of the applied-for capital structure) with an associated weighted average cost rate of 8.08%. This applied-for amount includes the \$60,000,000 preferred share issue which the Company proposes to issue in July 1993. As a result of changes to the income tax treatment for dividend income in the last few years, companies are no longer able to issue preferred shares at rates as attractive as those existing in previous years.

In RH-1-91, TransCanada addressed the possibility of issuing subordinated debentures in limited amounts as an alternative to preferred-share financing. While noting that the issuance of subordinated debt would be a cost-efficient alternative to preferred shares, the Company stated that there would be a limit as to how much of this type of debt could be raised without an increase in TransCanada's deemed common equity ratio. In RH-1-91, the Company viewed as reasonable an eventual replacement of the preferred share component of TransCanada's deemed capital structure, 75% by debt and 25% by common equity. There was a preliminary discussion of this in RH-1-91 and the Board in its Reasons for Decision acknowledged that the preferred share replacement concept may have some merit and encouraged all parties to further explore this issue in a future TransCanada tolls proceeding.

In the current proceeding, TransCanada's witness on capital structure maintained his view that preferred-share financing is not a cost-efficient method and that, given the term of preferred shares and the retractable and convertible features, he did not feel that this capital is equity in real terms but is more related to debt. TransCanada's expert witnesses therefore proposed gradually eliminating this expensive form of financing starting in 1993, 50% by debt and 50% by common equity.

The witness for CAPP et al agreed with TransCanada and its witnesses that preferred-share financing is not cost-efficient and that these instruments presently included in TransCanada's deemed capital structure should gradually be eliminated as they mature. In final argument, CAPP agreed with TransCanada's witness on capital structure that preferred shares should be eliminated gradually over a period of time, but disagreed with TransCanada's proposal to replace them with a 50/50 mix of debt and equity. CAPP argued that in the current proceeding TransCanada changed its proposal to a 50/50 split rather than the

75/25 proposed in RH-1-91. CAPP took the position that the preferred shares should be replaced over time with 100% debt.

IGUA supported the position taken by the witness for CAPP et al and argued that the existing preferred share component of TransCanada's deemed capital structure should gradually be replaced with debt only, and not with a combination of debt and common equity as suggested by TransCanada's capital structure witness.

APMC agreed with the views of the witness for CAPP et al on preferred shares, namely, that for all practical purposes investors consider preferred shares as debt and that non-payment of dividends on preferred shares essentially has the same adverse effect on investor views regarding the financial health of the utility as would the non-payment of interest on debt when due. APMC concurred with the CAPP et al witness that existing preferred shares should gradually be replaced with debt only.

Views of the Board

The Board agrees with TransCanada and the intervenors that preferred shares no longer represent a cost-efficient form of financing for TransCanada's utility operations.

Various alternatives were suggested by parties as to how the preferred share component of TransCanada's deemed capital structure should be progressively replaced. The alternatives only relate to the appropriate ratio of debt and equity to replace the preferred shares.

In considering the gradual replacement of TransCanada's preferred-share component of its deemed capital structure, the Board was cognizant of two issues: the first issue was the immediate and appropriate treatment of TransCanada's proposed \$60,000,000 issuance of new preferred shares in 1993; and the second was the manner in which the remaining preferred shares currently included in the deemed capital structure of TransCanada, as well as any future new issuances of preferred shares, should be handled.

With respect to the proposed \$60,000,000 issuance of preferred shares in 1993, given its finding that preferred shares no longer represent a cost-efficient form of financing, the Board has concluded that it would be inappropriate to allow TransCanada, for tollmaking purposes, to reflect the \$60,000,000 (\$27,692,000 on a paid-up equivalent basis) as preferred share capital in its 1993 deemed capital structure. Therefore, for tollmaking purposes, the \$60,000,000 of preferred shares should be considered as wholly replaced with debt in the 1993 test year. As a result, the applied-for preferred share balance of \$616,176,000 is reduced by \$27,692,000, leaving a balance of \$588,484,000.

With respect to the treatment of the remaining preferred shares which are currently included in TransCanada's deemed capital structure and which must be renewed or replaced, and the treatment of any proposed new issues of preferred shares, the Board is of the view that the costs and the tollmaking consequences of any such transactions should be dealt with in the context of the toll proceedings for the test years in which they are projected to occur.

Finally, the Board is of the view that, unless circumstances change so as to render preferred shares an efficient way of raising capital, the prudence of TransCanada's future use of preferred-share financing, for whatever purposes, will be examined in the relevant toll proceeding.

Decision

With respect to TransCanada's proposed issuance of \$60,000,000 of preferred shares in 1993, the Board believes that this form of financing is not cost efficient. It has therefore decided that it would not be prudent for TransCanada to issue additional preferred shares in 1993. In this light, and having regard to the Board's decision that a 30% common equity ratio is appropriate for TransCanada for 1993, the Board, for tollmaking purposes, has deemed the proposed \$60,000,000 to have been financed solely by debt and the unfunded debt balance has been increased to reflect this decision. For 1993, TransCanada's capitalization, for tollmaking purposes, will therefore show a preferred-share balance of \$588,484,000 and an associated cost rate of 8.11%.

With respect to the existing preferred-share financing which will need to be renewed or replaced and to any future new preferred-share financing, the Board has decided that the costs and tollmaking consequences of these transactions should be examined in the toll proceedings for the test years in which the transactions are proposed to occur.

Further, unless circumstances change so as to render preferred shares a cost-efficient means of financing, the Board will examine, for tollmaking purposes, the prudence of any further use of preferred-share financing by TransCanada.

4.4 Common Equity Ratio

TransCanada applied for a deemed common equity ratio of 30% for the 1993 test year, unchanged from the currently-approved level.

All TransCanada's expert witnesses stated that there is no basis to reduce the utility's deemed common equity ratio because its business risks have remained unchanged since RH-1-91. TransCanada's witness on capital structure was of the view that a 30% common equity ratio is the minimum required to successfully complete TransCanada's upcoming massive financing program. All of TransCanada's expert witnesses were of the view that the intervenor's proposal of a 28% common equity ratio and an 11.5% rate of return on common equity, if accepted by the Board, would definitely be perceived by investors and the debt rating agencies as a shift in regulatory ground rules. The risk would therefore arise of TransCanada's debt being downgraded from its current rating of A to, for example, BBB (high). If this happened, TransCanada's borrowing cost at the margin may increase by 25 to 50 basis points and the Company may have to rely more heavily on the U.S. market to issue debt, as the Canadian debt market may not have the capacity to absorb large BBB debt issues. During cross-examination, however, TransCanada's witness on capital structure did acknowledge that, in the past, the Company has been very successful in raising capital at reasonable rates with a 30% deemed common equity ratio.

The issue of the appropriate interest coverage ratio for TransCanada was discussed during the hearing. The Company and its expert witnesses stressed the need to have an interest coverage ratio of 2.0 times, or at worst marginally below that figure to maintain the confidence of the debt rating agencies. When questioned about the importance given to the interest coverage ratio by investors and the debt rating agencies in determining the creditworthiness of a company, TransCanada's witness on capital structure substantially agreed with the rate of return witness for CAPP et al that the interest coverage ratio is only one of many risk factors that affect the creditworthiness of a borrower. He also agreed that the difference between his views and the views of CAPP et al's rate of return witness is a matter of degree only.

TransCanada's witness on capital structure acknowledged, in his filed evidence, that the common equity ratio for TransCanada's non-jurisdictional operations is at the lower end of the desired level. Under cross-examination, he also agreed that some of TransCanada's non-jurisdictional operations may be of a marginally higher risk than its utility operations. However, he denied the suggestion that cross-subsidization exists.

The rate of return witness for CAPP et al agreed with TransCanada's capital structure witness that the Company's business risks have not changed materially since RH-1-91. However, keeping in mind TransCanada's business risks, he was of the view that a 30% common equity ratio is too high. Furthermore, in his evidence he stated that a 30% common equity ratio allocation for the utility operations would leave less than 30% common equity for TransCanada's non-regulated investments. As well, some of these involve "double leveraging" and are therefore of higher risk than TransCanada's utility operations. CAPP's expert witness on capital structure shared the view of the rate of return witness for CAPP et al that TransCanada's non-regulated investments are of higher risk than its regulated operations, and do not have sufficient common equity underpinning them.

In discussing the issue of the appropriate common equity ratio for TransCanada's utility operations, CAPP argued that under certain circumstances the common equity ratio could be lowered, even though the Company's business risks have remained unchanged. TransCanada's rate of return witness shared this view, provided those circumstances resulted from changes in the capital market conditions and no such change, in his view, has taken place in this case. CAPP argued that the change has taken place in terms of lower economic expectations in the marketplace.

During cross-examination, while discussing TransCanada's debt rating, CAPP's financial panel took the view that the likelihood of TransCanada being downgraded from its current debt rating of A to the BBB category is remote, and that it is not in the best interest of CAPP's members to see TransCanada's debt rating lowered. CAPP's capital structure witness acknowledged that if TransCanada's debt rating were to be lowered to the BBB category, its borrowing cost at the margin could go up by 40-50 basis points.

In final argument, IGUA took the view that, given the number of deferral accounts that TransCanada has, its business risks are minimal and that a 28% deemed common equity ratio is appropriate.

APMC argued that, along with the evidence provided by the expert witnesses on capital structure and rate of return issues, the Board should give weight to the evidence provided by CAPP's financial panel. APMC and the Province of Quebec also supported CAPP et al's rate of return witness' recommendation of a 28% deemed common equity ratio for TransCanada's utility operations.

Views of the Board

There was much discussion about the conditions needed for TransCanada to maintain its present A credit rating, including interest coverage. The Board notes that there is general support for the desirability of TransCanada maintaining its present rating and that the interest coverage ratio is but one factor considered by rating agencies in their assessment of a company's creditworthiness. The Board also notes that TransCanada's own evidence is that its A rating by Standard & Poor's is essentially based on continuation of a consistent regulatory approach to capital structure and equity return. The Board does not believe that it should adopt a specific criterion regarding interest coverage ratios for TransCanada. Rather, the Board expects that fair regulatory treatment, particularly as to TransCanada's capital structure and equity return, will continue to send positive signals to rating agencies.

The Board finds some merit in the views expressed by the witnesses for CAPP and CAPP et al that the common equity ratio underpinning TransCanada's non-jurisdictional investments may be at the lower end of the desired level. However, the Board is also aware of the fact that TransCanada's non-jurisdictional assets now comprise a much smaller portion of the Company's asset base than in previous years.

The Board agrees with the Company's witnesses that there has not been any significant change in the TransCanada's business risk since RH-1-91.

Decision

The Board approves a deemed common equity ratio of 30% for the 1993 test year.

4.5 Rate of Return on Common Equity

TransCanada applied for a 13.25% rate of return on its 30% deemed common equity ratio, unchanged from the currently-approved level. In requesting this rate, the Company relied on the advice of its expert witnesses on rate of return, who based their 13.25% rate of return recommendation on consideration of the results of the comparable earnings, DCF and equity risk premium techniques for estimating the cost of common equity capital. The rate of return witness for CAPP et al applied the DCF and the equity risk premium tests to arrive at his 11.5% recommended rate of return on common equity for TransCanada. The results of the various tests applied by the witnesses are summarized in the following tables.

**Table 4-2
TransCanada's Rate of Return Witnesses' Evidence**

| Investors' Required Rate of Return | Adjustment for Lower Risk of Utilities | Adjustment for Market to Book Ratio | Required Rate of Return for Low Risk Utilities |
|---|---|--|---|
|---|---|--|---|

| Test: | (%) | (%) | (%) | (%) |
|--|-------------|-------|-----------|--------------|
| Comparable Earnings | 13.5 | (.30) | N/A | 13.2 |
| Discounted Cash Flow | 12.1 | (.30) | 1.10 | 12.9 |
| Equity Risk Premium | 12.25-12.50 | - | 1.00-1.25 | 13.5 |
| Recommended ROE for TransCanada | | | | 13.25 |

**Table 4-3
CAPP et al's Rate of Return Witness' Evidence**

| Test: | Investors' Required Rate of Return (%) | Adjustment to Reflect Lower Risk of Pure Utilities (%) | Adjusted Test Results (%) | Required Rate of Return for Low-Risk Utilities (%) |
|--|---|---|----------------------------------|---|
| Comparable Earnings | N/A | N/A | N/A | N/A |
| Discounted Cash Flow | 11.0 | (.60-.80) | 10.20-10.40 | 10.25-10.50 ¹ |
| Equity Risk Premium | 10.25-11.00 | N/A | 10.25-11.0 | 10.25-11.0 |
| Adjustment for "cushion" | | | | 0.50 |
| Recommended ROE for TransCanada | | | | 11.50² |

Notes:

1. Rounded
2. Final recommendation placed reliance on the high end of the range of the Equity Risk Premium Test results to which the witness added 50 basis points as a cushion to reflect prevailing financial conditions.

TransCanada's rate of return witnesses applied the comparable earnings technique to a sample of 28 low-risk industrial companies chosen from the consumer sector of the Canadian economy, and based their findings on the achieved returns of these companies for the time period 1983-1991. The sample companies' earned returns averaged 13.5% over this time period. This rate was adjusted downwards by 30 basis points in order to reflect the witnesses' finding that a high grade utility such as TransCanada is of lower risk than the companies included in their sample. The witnesses found no evidence to suggest that rates of return of some companies in the sample have been excessive as a result of monopolistic elements inherent in their operations. They therefore made no downward adjustment for this factor.

The witnesses' final rate of return recommendation based on the comparable earnings technique was 13.2%. The rate of return witnesses for TransCanada gave 50% weight to the results of this test which, in their view, is a reflection of the "fairness" standard.

During this proceeding, TransCanada's rate of return witnesses took the view that the time period 1983-1991 represented a full business cycle. However, they did acknowledge that the 1992 partial year average achieved returns for the sample companies appear to be lower than 13.5%. Therefore, if one were to include the achieved returns of the low-risk industrials for 1992, then the average achieved returns over the time period 1983-1992 would be less than 13.5%.

TransCanada's rate of return witnesses also applied the DCF technique to their sample of 28 low-risk industrial companies. The witnesses acknowledged that the application of the DCF test is highly subjective, because it is difficult to measure investor growth expectations with a high degree of precision and reliability. Their analysis suggested that investors' growth expectations for these companies was 9.5%. This growth rate, combined with a dividend yield of 2.6%, produced a "bare bones" cost of common equity of 12.1%. This rate was also reduced by 30 basis points for the lower risk of TransCanada relative to the sample companies. The resultant rate of 11.8% was adjusted upwards to 12.9% in order to allow for a market-to-book ratio of 1.15. Keeping in mind the difficulties associated with the application of the DCF technique, the witnesses only gave a weight of 10% to the results of this test.

TransCanada's rate of return witnesses, using the DCF-based risk premium study over the last two business cycles (1976-1991), arrived at an equity risk premium for a high grade utility in the range of 3.3-4.0%. The studies, based on achieved returns over a long period of time, suggested an average equity risk premium of 4.5% for the market as a whole. This 4.5% market risk premium was discounted by 30% to allow for the lower risk of utilities relative to the market as a whole. The estimated equity risk premium of 3.50-3.75%, when added to a projected long Canada rate of 8.75%, produced a "bare bones" common equity cost in the range of 12.25-12.50%. Adjusting this rate for market-to-book ratio considerations led the witnesses to conclude that the required return for low-risk utilities, as measured by the equity risk premium approach, is 13.5%. This result was given a 40% weight by the witnesses in reaching their final rate of return recommendations. During cross-examination, TransCanada's rate of return witnesses agreed that amongst all the tests discussed in this proceeding, in terms of attracting capital, the equity risk premium is the most relevant.

In their evidence, TransCanada's rate of return witnesses stated that their forecast long-Canada rate of 8.75% for 1993 is slightly higher than the "consensus" forecast since they believe that, amongst other things, the need to finance the rising government deficits in the U.S. and Canada will keep upwards pressure on interest rates in North America. The witnesses acknowledged that, should the GDP grow by 2.0% rather than the projected 3.5% for 1993, the long-Canada rate of 8.0% may be more appropriate.

During cross-examination, when discussing the fair rate of return for TransCanada, and the market perception of the "regulatory ground rules", TransCanada's capital structure witness took the view that a rate of return below 12.5% may be perceived as a shift in those rules. The rate of return witnesses for the Company viewed 12.75% as the minimum rate of return for TransCanada.

With respect to the DCF approach, the rate of return witness for CAPP et al determined the investors' required rate of return for a sample of 20 low-risk non-utilities to be currently no more than 11.0%. To

arrive at this conclusion, he added the indicated dividend yield of 2.9% to be the historical growth rate estimates of 6.8-8.2%. The resultant range of 9.7-11.1% would be the investors' required rate of return. The witness put more weight on the high end of this range as the indicated dividend yield of 2.9% when combined with the mean growth rate of 8.2% for individual companies in his primary sample also indicated the investors' required rate of return to be in the 11.0% range. This rate was adjusted downwards by 60-80 basis points to reflect the lower risk of pure utilities relative to his sample of 20 low-risk non-utility companies, resulting in an investors' required rate of return of 10.25-10.50%.

The second market-based test employed by this witness was the equity risk premium approach. His analysis led him to the conclusion that the market risk premium over long-Canada's was in the range of 4.0-4.5%. In the light of his view that the risk exposure of low-risk utilities is no more than one-half of the equity market as a whole, this range was adjusted downwards to 2.0-2.25%. To this range the witness added a forecast long-Canada rate of 8.25-8.75%; the resultant investors' required rate of return range for low-risk utilities based on the equity risk premium test was 10.25-11.0%. Keeping in mind the recent fluctuations in long-term interest rates, the witness put more weight on the upper end of this range.

Although, the rate of return witness for CAPP et al used the DCF test, he essentially relied on the equity risk premium test results, citing concerns with the results he observed from his DCF analysis. He placed greater weight on the risk premium test because of the unsettled conditions currently prevailing in financial markets and his contention that this test reflects current market conditions to a greater degree than does the DCF approach. He concluded that the investors' required rate of return for TransCanada was in the range of 10.25-11.0% with emphasis on the upper end of this range. To this range he added a cushion of 50 basis points in order to allow for the high degree of uncertainty currently prevailing in the financial markets and for the unlikely possibility of a dilution effect.

In his evidence, the rate of return witness for CAPP et al pointed out that, relative to the long-term bond holders, TransCanada's common equity shareholders are protected from purchasing power risk because the Company's allowed rate of return is reviewed on a regular basis and adjusted to reflect the current and prospective financial conditions. TransCanada's witnesses did not share this view.

In final argument, TransCanada took the view that the witness for CAPP et al when making a downward adjustment for the lower risk of utilities relative to the market as a whole did so twice: first by applying a geometric mean to historical data, which produced a lower market risk premium compared to the results obtained by using an arithmetic mean; and second, by adjusting the market risk premium by 50% for the low-risk of utilities relative to the market as a whole. The rate of return witness for CAPP et al acknowledged TransCanada's argument but took the view that both adjustments were appropriate.

Views of the Board

Both the comparable earnings and equity risk premium techniques provided the Board with useful information in its determination of the appropriate rate of return to be allowed on TransCanada's deemed common equity component. However, the Board remains of the view that the results of the risk premium method should be given more weight than those of the comparable earnings method. The Board shares the concerns expressed by all rate of return witnesses as to the usefulness of the DCF test results in this case and has therefore given these little weight.

With respect to the comparable earnings evidence presented during the hearing, the Board notes that TransCanada's rate of return witnesses made an adjustment of 30 basis points to the results of the comparable earnings test in order to allow for the lower risk of the Company relative to the companies included in their sample of 28 low-risk Canadian industrials. The Board continues to believe that an adjustment of this nature is warranted. However, in the Board's view, bearing in mind TransCanada's risk relative to the sample companies, the magnitude of this downward adjustment should be more than 30 basis points. The Board also notes the evidence presented during the hearing that the addition of 1992 financial data for the low-risk industrials to the 1983-1991 series would lower the results of the comparable earnings test.

The evidence presented by the TransCanada witnesses on inflation indicated an average achieved inflation level as measured by the consumer price index and the GDP deflator was 4.67% and 4.05% respectively for 1983-1991. Furthermore, all parties agreed that the rate of inflation for 1993 is likely to be much lower than that experienced during 1983-1991. TransCanada's witnesses, however, stated that the inflation rate over the next complete business cycle is likely to be no different from the previous business cycle. Having reviewed the vital signs of the Canadian economy such as unemployment, the current and forecast rate of economic growth, long-term interest rates and inflation, the Board is of the view that inflation in Canada is likely to stay at low levels in the foreseeable future. The factors identified above indicate the need for a further downward adjustment to the results of the comparable earnings test.

With respect to the application of the equity risk premium test, the Board notes the arguments advanced by TransCanada's rate of return witnesses in support of their reliance on a long-Canada rate 25 basis points higher than the rate relied upon by the rate of return witness for CAPP et al. The Board considers that an 8.75% long-Canada rate for the test year is at the high end of the range of reasonableness. Having made an adjustment for the lower risk of utilities relative to the market as a whole, TransCanada's rate of return witnesses concluded an appropriate equity risk premium for low-risk utilities to be in the range of 3.50 - 3.75%. On the other hand, the rate of return witness for CAPP et al, having made a similar adjustment but of a different magnitude to his market risk premium, arrived at an approximate equity risk premium range of 2.0 - 2.25% for low-risk utilities. The Board finds some merit in the argument put forward by the Company that the adjustments made by the rate of return witness for CAPP et al to arrive at an appropriate risk premium for low-risk utilities were excessive. The Board also finds the equity risk premium for low-risk utilities is not as high as suggested by the Company witnesses. The Board is of the view that the reasonable range lies somewhere between the ranges suggested by the Company and intervenors' witnesses.

The Board was persuaded by the argument put forward by the rate of return witness for CAPP et al that, relative to long-term bond holders, TransCanada's common equity shareholders are protected from the purchasing power risk. This is because the return on TransCanada's equity can be, and has been, adjusted periodically to reflect the changing financial environment, whereas the return on bonds with a fixed maturity date remains unchanged.

The Board agrees that an adjustment is necessary to raise the "bare bones" return so that the Company is able to attract new capital without dilution to existing equity. However, the Board is not persuaded that the magnitude of this adjustment should be to the degree suggested by the Company witnesses.

Having weighed all the evidence presented and giving particular consideration to the current and prospective interest rates and inflation levels, the Board finds 12.25% to be a fair rate of return on TransCanada's deemed common equity of 30% for the 1993 test year.

Decision

The Board approves a rate of return on common equity of 12.25% for the 1993 test year.

4.6 Rate of Return on Rate Base

Decision

The Board approves a rate of return on rate base of 10.95% for the 1993 test year. The approved capital structure and overall rate of return are shown in Table 4-4.

**Table 4-4
Approved Deemed Average Capital Structure
and Rates of Return for the 1993 Test Year**

| | Amount (\$000) | Capital Structure (%) | Cost Rate (%) | Cost Component (%) |
|--|---------------------------|--------------------------------------|------------------------------|-----------------------------------|
| Debt - Funded | 3,475,577 | 55.37 | 10.92 | 6.05 |
| - Unfunded | 330,046 | 5.26 | 8.74 | 0.46 |
| Total Debt Capital | 3,805,623 | 60.63 | | 6.51 |
| Preferred Shares | 588,484 | 9.37 | 8.11 | 0.76 |
| Common Equity | 1,883,189 | 30.00 | 12.25 | 3.68 |
| Total Capitalization | 6,277,296 | 100.00 | | |
| Rate of Return on Rate Base | | | | 10.95 |

4.7 Income Taxes

4.7.1 Flow-Through Tax Calculation

Decision

The Board has adjusted the 1993 flow-through income tax provision from \$67,364,000 to \$55,409,649, a decrease of \$11,954,351 as a consequence of the Board's decisions in