

## **Reid/Knecht Response to PG&E's Draft of Exhibit 35A**

### **DCF Results**

Presentation of DCF results presents the biggest challenge and is the area in which PG&E's summary is problematic. The problem is simple (and so is the solution, as explained *infra*): PG&E tries to stuff all results into the single-stage DCF model format (i.e., with only one G rate), but doing so by back-computation (as PG&E does) misrepresents the data that actually go into the multi-stage models such as ours.

For example, PG&E lists our final-stage G rate correctly as 4.04% and deducts that figure from our 8.79% VL Earnings DCF ROE to infer that we used a 4.75% yield with that DCF model. We did not use any such yield, and to make such a computation and call that our yield and claim that it represents our results and testimony, and is erroneous. The correct yield for our VL Earnings DCF results is 3.88%, not 4.75%. PG&E's inflation of our yield figure reflects the fact that it ignored our 6.15% initial G rate for that model (or, equivalently and still erroneously) folded the difference between that rate and our 4.04% final rate into the yield. The same critique, but with different numbers applies to our sustainable G DCF model.

The solution is to list an initial-stage G rate and a final-stage G rate for each DCF model, instead of insisting on listing only one G rate. For single-stage modeling, the two rates will be the same – that's the assumption on which the single-stage (Gordon, etc.) models are built. But for multi-stage models, the two different rates will be correctly listed, as will their yield and their ROE. To the extent that PG&E wants to use the results of one DCF model (e.g., in our case, the VL Earnings G model) as a high value and the results of another model (e.g., in our case, the sustainable G DCF model) as the low case, that will work just fine. And we do not object to listing an average of the two, although we see no real need for it.

So, the correct way to list our results is as follows:

<b><u>ValueLine Earnings DCF</u></b>	<b><u>Sustainable Growth DCF</u></b>
Initial-stage G: 6.15%	Initial-stage G: 3.09%
Final-stage G: 4.04%	Final-stage G: 4.04%
Yield: 3.88%	Yield: 3.88%
ROE: 8.79%	ROE: 7.95%

## CAPM and CAPM

In our CAPM (using VL betas), PG&E gets our Rf right at 2.48%. However, because it overlooks the adjustment we made to the Morningstar-Ibbotson MRP to get a NYSE-based MRP that is consistent with the VL betas, the MRPs that PG&E lists for our CAPM err, as do the betas that PG&E backs into. Thus, the MRP values we used for our CAPM estimates were ~20 bp below those we used for the ECAPM estimates that are based on the M-I data. The high value was 6.41% (vs. 6.62% for ECAPM, which uses M-I data and thus S&P, not NYSE), the low value was 5.45% (vs. 5.63%), and the average was 5.93% (vs. 6.12%, which PG&E lists as 6.13%). Due to that error, our VL beta average was 0.73, not 0.71 as listed by PG&E. So, the CAPM and ECAPM values should be listed as follows:

<u>CAPM (VL betas)</u>	<u>ECAPM (75% M-I beta CAPM; 25% beta =1.0)</u>
Rf: 2.48%	Rf: 2.48%
Beta: 0.71	Beta: 0.53
MRP High: 6.41%	MRP High: 6.62%
MRP Average: 6.12%	MRP Average: 5.93%
MRP Low: 5.45%	MRP Low: 5.63%
	Decile Size Premium: 1.01 bp
ROE: 6.81%	ROE: 7.47%

## Historic Risk Premium Model

For this model, PG&E again got our Rf right at 2.48% in all cases (the market data). However, while it got right our average risk premium, it overlooked that the average was determined from high and low values. Hence, the correct data are:

## Historic Risk Premium Model (CA+I)

Rf: 2.48%		
High RP: 6.19%	Low RP: 2.15%	Average RP: 4.17%
ROE: 6.65%		