

1 **Q. CA 20.0 NP**

2
3 **Reference: Exhibit NP-3, p. 9**
4 **Evidence of JT Browne, p. 16**
5

6 **Preamble: NP states: “Cash flow and related metrics are crucial measures used**
7 **by investors and credit analysts to assess the financial health of**
8 **Newfoundland Power. Therefore, Newfoundland Power’s recognition**
9 **of Unbilled Revenue is limited by the resulting cash impacts and their**
10 **effect on the Company’s financial integrity.”**
11

12 **Please provide an analysis showing (i) the impact of full recognition in one year on**
13 **all relevant “cash flow and related metrics [that] are used by investors and credit**
14 **analysts to assess the financial health of Newfoundland Power”, (ii) evidence that**
15 **the resulting metrics would compromise the financial integrity of the company, and**
16 **(iii) evidence that the resulting metrics would result in a reduction in NP’s credit**
17 **rating or would otherwise increase the company’s cost of capital or access to capital.**
18

19 **A. Cash Flow and Creditworthiness - General**
20

21 Recognition of the 2005 Unbilled Revenue for regulatory purposes in 2006 does not
22 result in any additional cash for Newfoundland Power. Effectively, the proposed
23 recognition of \$9,579,000 of 2005 Unbilled Revenue in 2006 does displace cash revenue
24 that would otherwise be required from customers. This will tend to increase the debt
25 component within Newfoundland Power’s capital structure, thereby resulting in an
26 increase in interest costs.
27

28 Credit metrics are quantitative measures used by credit rating agencies and investors to
29 assess the existing and prospective financial health of a company. Credit rating agencies
30 use quantitative measures in conjunction with qualitative analysis to assign both
31 corporate and debt ratings for Newfoundland Power. The resulting ratings have a direct
32 impact on Newfoundland Power’s cost of issuing debt.
33

34 Interest costs and the amount of debt within a company’s capital structure are key
35 measures used by credit rating agencies to assess the financial health and
36 creditworthiness of that organization. Cash revenue reduces debt, whereas accrual
37 revenue does not. Therefore, the use of accrual revenue versus actual cash revenue is
38 limited by the resulting impacts on debt and associated interest costs.
39

40 In Order No. P.U. 16 (1998-99) the Board indicated that a pre-tax interest coverage in the
41 range of 2.4 to 2.7 is suitable for Newfoundland Power and the economic environment in
42 which it operates. In Order No. P.U. 19 (2003) the Board noted that a 2.4 times pre-tax
43 interest coverage, while at the lower end of the range previously accepted by the Board,
44 serves as a realistic and compatible balance between Newfoundland Power and its
45 customers.

Cash Flow Impacts - Full Recognition of the 2005 Unbilled Revenue in 2006

In its response to PUB 8.0 NP, Newfoundland Power provided an analysis of the impact of recognizing the full amount of the 2005 Unbilled Revenue in 2006. Attachment A to that Response shows that if the full amount of the 2005 Unbilled Revenue were recognized in 2006, it would result in excess revenue of \$11.8 million. Additionally, it would effectively mean that Newfoundland Power would earn at the upper limit of its allowed range of return on rate base in 2006.¹

The \$11.8 million in excess revenue would be credited to the Excess Earnings Account for final disposition by order of the Board. In similar situations in both 2000 and 2001, the Board ordered that the excess revenue be refunded to customers the following year (i.e., in 2001 and 2002 respectively). If the Board was to order either that the total excess revenue of \$11.8 million be (i) fully refunded to customers in 2007, or (ii) used to offset a 2007 rate increase with the balance refunded to customers in 2007, Newfoundland Power's 2007 cash flows would be negatively impacted.

Resulting Impacts on Credit Metrics

Due to the cumulative nature of debt and associated interest costs, the impacts resulting from full recognition of the 2005 Unbilled Revenue in 2006 on Newfoundland Power's credit metrics cannot be determined by an analysis of the 2006 forecast in isolation.

Tables 1 and 2 provide a *pro forma* comparative analysis for the years 2006 through 2008 of the impact on relevant credit metrics of Newfoundland Power's proposals as filed in the 2006 Accounting Policy Application (Table 1), and full recognition of 2005 Unbilled Revenue in 2006 (Table 2).

¹ Allowed range of return on rate base is 8.50% to 8.86% as per Order No. P.U. 50 (2004).

Table 1
Newfoundland Power's Proposals
2006 Accounting Policy Application

	2006 Forecast	2007 <i>Pro Forma</i>²	2008 <i>Pro Forma</i>⁶
Pre-Tax Interest Coverage	2.34x	2.22x	2.26x
FFO/Debt ³	15.2%	14.1%	14.3%
FFO Interest Coverage ⁴	2.9x	2.8x	2.9x
% Debt In Capitalization ⁵	55.7%	55.9%	55.9%

Table 2
Full Recognition of the
2005 Unbilled Revenue in 2006

	2006 Forecast	2007 <i>Pro Forma</i>	2008 <i>Pro Forma</i>⁶
Pre-Tax Interest Coverage	2.43x	1.99x	2.03x
FFO/Debt ³	15.8%	12.2%	12.6%
FFO Interest Coverage ⁴	3.0x	2.6x	2.7x
% Debt In Capitalization ⁵	55.5%	56.3%	56.3%

As the *pro forma* comparison in Tables 1 and 2 show, the reduction in cash flow resulting from full recognition of the 2005 Unbilled Revenue in 2006 results in an increase in the percentage of debt in the Company's capital structure in 2007 and 2008 and a reduction in interest coverage ratios in these years.

Newfoundland Power's Credit Ratings

Newfoundland Power's credit ratings are established by Canadian credit rating agencies. Newfoundland Power cannot say definitely that the *pro forma* credit metrics resulting from full recognition of the 2005 unbilled revenue in 2006 would result in a credit rating downgrade. However, references have been made in past credit rating reports that reaffirm the importance of credit metrics in the ratings process and the distinct possibility that a downgrade would result.

² Assumes the remaining 2005 Unbilled Revenue of \$14.3 million is recognized evenly over 2007 and 2008.

³ FFO is defined as cash flow from operations less preferred dividends and before any non-cash working capital items. Preferred shares are treated as 100% debt.

⁴ Interest is before interest capitalized and includes preferred dividends.

⁵ Based on year-end capitalization.

⁶ The slight improvement in the *pro forma* interest coverage ratios in 2008 over 2007 is due to the redemption of Series AC bonds, which carry a relatively high interest rate of 11.875%.

1 For example, in a June 8, 2005 ratings report on Newfoundland Power's First Mortgage
2 Bonds, Moody's Investor Services made the following comment related to
3 Newfoundland Power's rating outlook:⁷
4

5 "The rating could be negatively impacted by expectations for a sustained
6 weakening of NPI's financial measures, such as FFO to Interest Coverage below
7 2.5x and FFO/Debt below 15%."

⁷ This report was filed with the Board on June 15th, 2005.