Utilities
2011 Generic Cost of Capital Proceeding
Application No. 1606549
Proceeding ID. 833

Information Response to:
Canadian Association of Petroleum Producers (CAPP) Information Request to Ms. Kathleen C. McShane (McShane)
Received: April 11, 2011

CAPP-McShane (ROE)-9

Reference: Weak debt ratings, page 24, lines 608-609 and page 25, lines 629-636

Issue/Sub-Issue: Opinion Capital Structure and Return on Equity for the Alberta Utilities

Request:

(a) Ms. McShane states that Canadian utilities have weak debt ratios, would she agree that this is offset by their lower business risk and that the median debt rating of a utility in Canada is *higher* than that in the United States even though debt ratios are lower in the US?

(b) In the generic hearing in 2009, Professor Booth provided data that the median utility debt rating in Canada was A, while that in the US was BBB; does Ms. McShane disagree with this assessment? If she disagrees please provide similar comparative data for US and Canadian utilities to that which she has provided in previous hearings.

(c) Would Ms. McShane agree that the "proof of the pudding" is not in whether debt ratios are higher or lower, but the terms on which utilities can raise financing? Can Ms. McShane update her estimate of current utility A rated debt costs and their spread over equivalent maturity long Canada bonds.

(d) Ms. McShane indicates that a decline in income taxes all else constant decreases the EBIT interest coverage ratio. Would she also agree that this is partly why rating agencies also look at after tax interest coverage ratios and have downgraded the EBIT interest coverage ratio?

(e) Would Ms. McShane agree that a decline in income taxes lowers the pre tax cost of capital and makes the utility service cheaper and more "competitive"? Would she agree that a utility is healthier if it can charge less for its services? Alternatively, is Ms. McShane of the view that higher corporate income taxes are good for the financial health of a utility?

(f) Would Ms. McShane agree that rather than increasing the common equity ratio, the AUC could also impute a preferred share component into a deemed capital structure similar to the practice of the Regie de l'Energie for Gaz Metro.

(g) Would Ms. McShane agree that such deeming (as in (f) above) would also increase the EBIT interest coverage ratio and that traditionally the ATCO group of companies did have a large preferred share tranche for tax reasons and relatively thin common equity ratios? If she disagrees please provide the common equity ratios for NorthWestern Utilities and Canadian Western Natural Gas for each year since 1980 prior to being reorganized.

(h) Please indicate which if any Alberta utilities have a restriction in their debt agreements that require an interest coverage ratio of 2.0 prior to issuing funded debt. If there are any please indicate whether this also applies to issuing first mortgage bonds.

(i) Please provide the full calculations underlying the data in Table 5

Response:

(a) Ms. McShane's evidence states that "Further, it is important to recognize that, prior to Decision 2009-216, the allowed common equity ratios of the Alberta utilities were regarded by the debt rating agencies as weak." She would agree that the universe of U.S. utilities has higher business risk than the typical Canadian utility, which is a wires or pipes utility, whereas the preponderance of U.S. utilities are integrated electric utilities, which are of inherently higher business risk than distribution utilities. The same may not be true of the proxy sample of similar risk utilities presented in Ms. McShane's evidence.

(b) Ms. McShane agrees that the median US utility S&P debt rating is BBB. The median utility S&P debt rating in Canada is approximately A-. The median S&P rating of Ms. McShane's U.S. utility proxy sample is A. Please see lines 1019 to 1031 of Ex. 0086.01.ATCO UTL-833 McShane Evidence Capital Structure ROE.

(c) Ms. McShane agrees that the terms and conditions on which the utilities can raise capital are critical. Capital structures and ROEs are both important factors in determining credit metrics and ratings, as is the perceived credit supportiveness of the regulator. In her application of the DCF-based risk premium test, Ms. McShane relied on a forecast of long-term Canada bond yields for 2011 of 4.25% and a spread of 140 basis points, reflecting the January 2011 spread between a series of Canadian A-rated utility bonds maintained by Foster Associates. As of April 14, 2011 the bonds in that series were yielding 5.27%, which represents a spread of 150 basis points over the yield on long-term Canada bonds. Ms. McShane has not changed her estimate of the yield or spread for 2011.

(d) Yes, all other things equal a lower income tax rate lowers the EBIT coverage. Ms. McShane would not agree that debt rating agencies have downgraded the EBIT coverage due to lower tax rates. Debt rating agencies do focus on cash flow coverage ratios (FFO/debt and FFO/interest coverage), which are after-tax, because they are cash flow oriented, while EBIT coverage is not. However, a review of recent DBRS reports indicates that two of the principal ratios that the agency looks at are EBIT coverage and EBITDA coverage, both of which are pre-tax. A review of recent S&P reports indicates that the key ratios listed include EBIT coverage and Debt/EBITDA, both of which are pre-tax. Pre-tax earnings are relevant, because all of the pre-tax earnings are available to pay cover interest expense.

(e) Yes, lower income tax rates lower the pre-tax cost of capital. All other things equal, a lower cost structure is beneficial to a corporation because it increases its competitive position. In the specific context being discussed in the testimony, lower income tax rates negatively impact pre-tax interest coverage ratios and increase the variability in after-tax ROEs. The AUC and its predecessor recognized these effects in Decisions 2009-216 and 2004-052 in deeming higher common equity ratios for tax-exempt and *de facto* non- taxable utilities.

(f) Theoretically, the Commission could impute a preferred share component, but it would have to determine what the appropriate component of preferred shares should be, the terms those preferred shares would take (e.g., floating rate or fixed rate), what the forecast cost rate for the specific form of preferred shares would be for each utility at the time of each GRA or GTA, some of which would not actually have access to the preferred share market (and assuming the preferred share market was open to utility issuance at the time), and whether preferred shares were economic at the time of each GRA/GTA. For non-taxable utilities, a deemed preferred share component would actually lower EBIT coverage ratios at typical spreads between debt and preferred rates. Please also note that the proposed increase in common equity ratios is not based solely on credit metrics, but also reflects consideration of the equity ratios that have been adopted for the Alberta Utilities' peers as part of the fairness of the resulting return.

(g) Deemed preferred shares (as a replacement for debt) could increase the EBIT coverage ratio, although the increase, assuming, for example, a 5% preferred component at current debt and preferred cost rates and income tax rates, would be marginal. The ATCO Utilities and TransAlta had preferred share ratios at 20% and above while the Public Utilities Income Tax Transfer Act (PUITTA) was in place, because 95% of the related provincial and federal tax that was paid by the utilities was refunded to customers. The 1995 Federal Budget eliminated PUITTA. As a result the utilities reduced their preferred share components.

(h) ENMAX requires an interest coverage ratio of 2.75X before incurring funded debt.

(i) The requested workpaper is attached as "CAPP McShane 9(i) Attachment 1.xls". Please note the EBIT coverage on Table 5 with CWIP and 12.5% tax rate (right hand column) should be 41%/47% not 40%/46%.