Newfoundland Power: Capital Structure Recommendations

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Is NP an "Above Average Risk" Regulated Canadian Utility?

- This is a new assertion
- NP executives agreed with this assertion, based primarily on the conclusions of Mr. Coyne (Hearings Transcript - March 29, 2016, pages 54-59).
- Mr. Coyne has stated on the stand (Hearings Transcript April 7 – page 46 (lines 15-25) and page 47 (lines1-2)) that this conclusion is based primarily on two factors:
  1. Muskrat Falls
  2. NL's weak economic forecast
- My evidence suggests these concerns are overblown and hence Mr. Coyne's conclusion that NP is an above average risk regulated Canadian utility is incorrect.
- My analysis suggests that NP is average risk - at best.

Economic Outlook

- Diverse growth prospects – both globally and within Canada:
- Globally
  - U.S. versus Euro and Japan
  - China slowing growth to just over 6%
  - Oil importers versus exporters
- Real GDP Growth Forecasts (2016-2017) – Table 2

Real GDP Growth (%)	2016		2017	
	Consensus	Bank of Canada	Consensus	Bank of Canada
World	2.7	3.3	3.0	3.6
U.S.	2.4	2.4	2.5	2.5
Euro Zone	1.7	1.6	1.7	1.6

Economic Outlook (cont'd)

- Within Canada (2013-15 – Bank of Canada Jan 2016 MPR)
  - Oil and gas industries (9% GDP) - -3.1% growth
  - Non-energy commodity related industries (7% GDP) - -1.6% growth
  - Non-resource sector (84% GDP) - +1.4% growth
- Canada's outlook – real GDP growth (%) - Table 3:

Consensus forecasts (Jan 2016)		
	2016	2017
Average	1.7	2.2
Median	1.7	2.2
IMF (Oct 15)	1.7	2.4
OECD (Nov 15)	2	2.3
Bank of Canada (Jan 2016)	1.9	2.5

Economic Outlook (cont'd)

- Conference Board real GDP growth forecasts for NL as per Fall 2015 (Table 7)

Growth (%)	2015	2016	2017	2018	2019	2020
Real GDP	-0.2	-0.8	0.2	1.4	7.0	-1.6

- Conference Board Updated 2015-2017 estimates (Winter 2016):

Growth (%)	2015	2016	2017	2018	2019	2020
Real GDP	-5.4	0.1	1.1			

- So, the CB update suggest 2015 was worse than expected, but the outlook for 2016 and 2017 (the test period) has improved, and is in positive territory, even if not strong.

- Utilities sector more resilient…

Growth (%)	2015	2016	2017	2018	2019	2020
Real GDP	9.9	0.4	0.6	0.8	1.3	5.9

The Economy and NP

- While the economic outlook could certainly be better, NP has demonstrated resiliency to previous downturns.
  - In fact, in 2015, despite slower than expected real GDP growth of -5.4% (CB estimate), NP's revenues grew by 3.7%, its operating earnings grew, and it earned an 8.98% ROE, 0.18% above its allowed ROE
- This is consistent with the evidence provided in Figures 5 and 6 of my evidence – as shown on the next two slides…
- This evidence also suggests the NL economic outlook does not make NP an above-average-risk utility.

Figure 5 – NP Sales Growth and NL Real GDP Growth

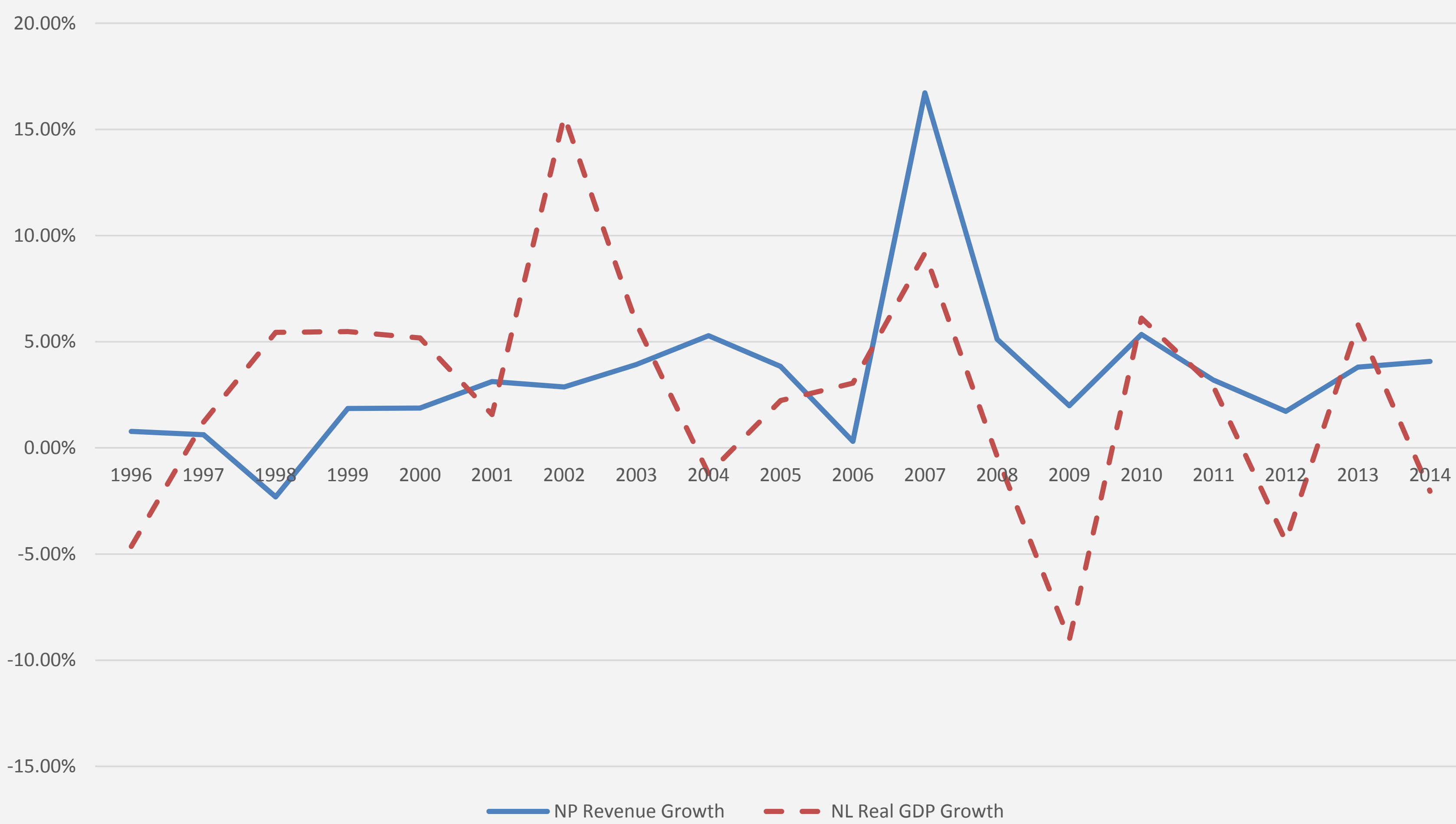
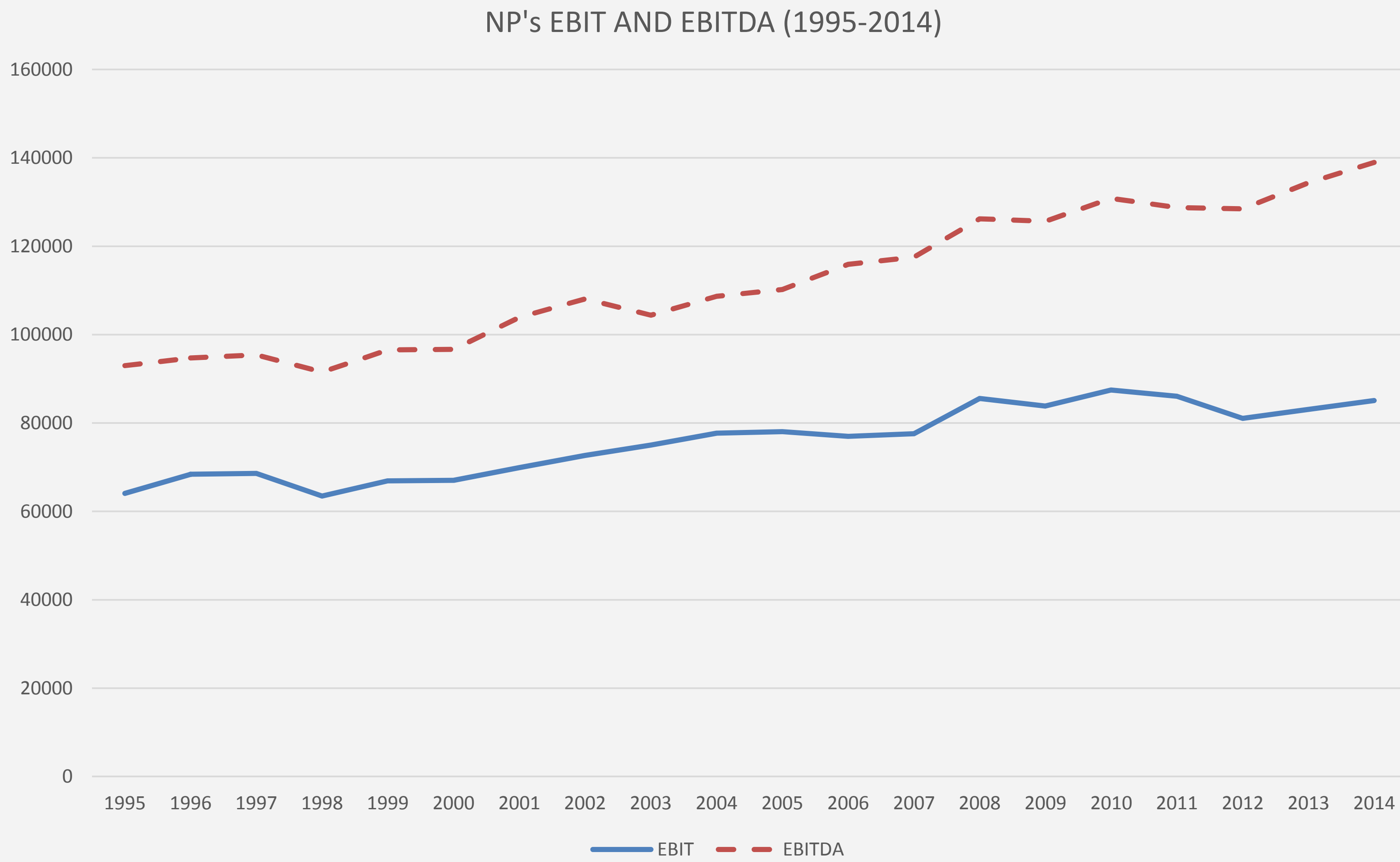


Figure 6 – NP’s EBIT and EBITDA Growth



Muskrat Falls

- No clear evidence that NP would not be able to pass on cost increases that might occur through to consumers:
  - COS arrangement, pass through mechanisms in place, supportive regulator
- Nor that rate increases would cause any significant loss in customer base (i.e., refer to response to PUB-CA-022):
  - Significant switching costs, evidence during the 1990s…
- No clear evidence that supply reliability will be reduced (i.e., refer to response to PUB-CA-023) – i.e., the matter is currently under study, as acknowledged by Mr. Coyne…

Qualitative Conclusions re NP's Business Risk

- NP has always been considered an average risk regulated Canadian utility
- This is consistent with the fact that it operates a virtual monopoly in electricity distribution, is well protected through various procedures and mechanisms, and operates under an extremely supportive regulatory regime.
- For example, DBRS (Aug 21, 2015) states that the procedures and mechanisms in place "allows Newfoundland Power to recover all prudently spent operating expenses and earn a reasonable return."

- The discussion above suggests that neither the NL economic outlook nor Muskrat Falls makes NP an above-average risk Canadian utility – the rating agencies appear to agree with this assertion.

Qualitative Conclusions re NP's Business Risk (cont'd)

- These views have been echoed by the debt rating agencies, as noted in my response to NP-CA-003:
  - Moody's (Jan 19, 2015) lists the first two points under "Ratings Drivers" as:
    - "**Low-risk** regulated electric utility"
    - "**Supportive regulatory and business environment**"
  - DBRS (Aug 21, 2015) noted that "The confirmations reflect the **stable nature of the Company's regulated electricity distribution business** and its **solid financial risk profile**."

- My quantitative analysis of business risk below confirms the low-risk nature of NP's operations.

Business Risk

- "**Business risk** is the risk associated with operating earnings. Operating earnings are risky because total revenues are risky, as are the costs of producing revenues."
  - 2013 CFA curriculum (Reading 38, page 82).
- "Refers to the relative **variability of operating profits** induced by the external forces of demand for and supply of the firm's products, by the presence of fixed costs, by the extent of diversification or lack thereof of services, and by the character of regulation."
  - Dr. Morin in the 2003 hearings, as noted on page 31 of Order No. P.U. 19 (2003).
  - Was accepted by the Board at that time.
- Mr. Coyne agreed with the premise that operating risk shows up in earnings (Transcript – April 6, 2016, page 173, lines 6-10)

Business Risk and Operating Income Volatility

- A common measure of Operating Income Volatility is the Coefficient of Variation (CV) in EBIT."

- CV - Divide the Std. Dev. by the average (or expected value)
- Rationale – accounts for "volatility" after adjusting for scaling differences (e.g., larger EBIT, larger EBIT/Sales averages, etc.).

- Measures Used:

1. **CV(EBIT):** Std. Dev. of EBIT (1995-2014) / Expected EBIT
2. **CV(EBIT)-5 year:** The average of 5-year "rolling" estimates of CV(EBIT)
3. **CV (EBIT/Sales):** Std. Dev. (EBIT/Sales) / Average (EBIT/Sales) over (1995-2014)

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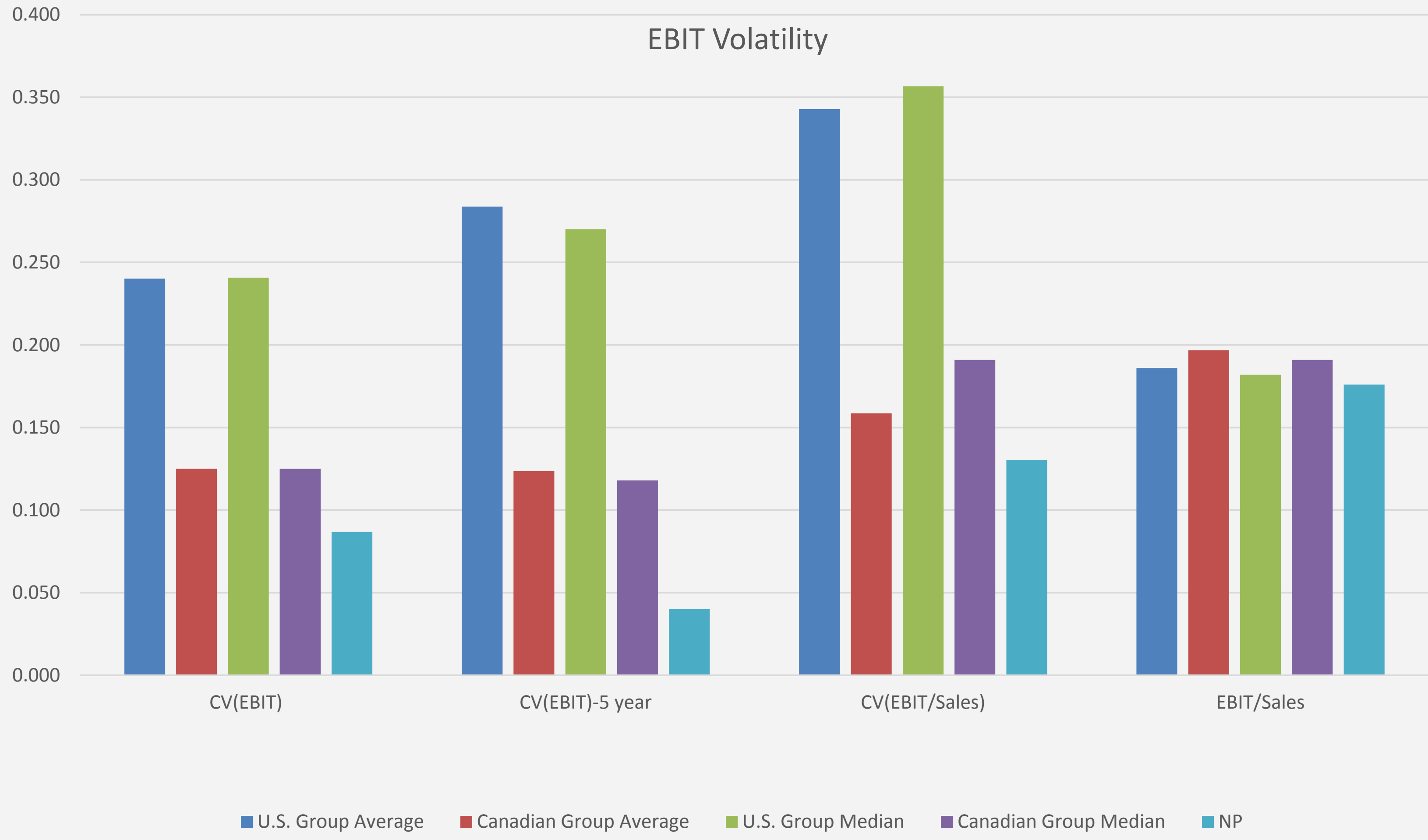
Business Risk – EBIT Volatility Analysis – Figure 7



Business Risk Conclusions

- Figure 7 and Table 8 show that NP possesses:
  – much lower business risk than Mr. Coyne's U.S. proxy group comprised of holding companies
  – slightly lower business risk than other similar Canadian operating utilities
- This confirms the inappropriateness of Mr. Coyne's U.S. sample – as expected given differences in structures, operating environments, etc.
- Also consistent with higher betas for U.S. sample even though they have less leverage (i.e., if had the same business risk, we would expect firms with less financial risk to have lower betas – yet the U.S. betas are higher, despite less leverage.
- It also confirms that NP displays low business risk according to objective quantitative measures – which supports qualitative assessments by debt rating agencies

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Financial Risk – Allowable ROEs and ERs (Tables 9 and 10)

- NP has slightly above average allowed ROEs and **much higher allowed ERs**

	Allowed ROEs				
Canadian G&E Distributors					
Average	8.83	8.72	8.57	8.73	8.67
Median	8.75	8.75	8.75	8.75	8.50
Newfoundland Power	8.38	8.80	8.80	8.80	8.80
	Allowed ERs				
Canadian G&E Distributors					
Average	39.36	39.16	38.82	38.80	38.73
Median	40.00	40.00	38.50	38.50	38.50
Newfoundland Power	**45.00**	**45.00**	**45.00**	**45.00**	**45.00**

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Financial Risk

- Mr. Coyne suggests in his evidence (Appendix A, page 10, lines 1-4) that NP's debt rating is "one notch lower than the Canadian proxy group average of A-."
- This statement is misleading:

1. Mr. Coyne compares NP's Moody's "issuer rating" to S&P ratings, ignoring the fact that the First Mortgage bonds issued by NP are rated A2, as noted by Fortis in its investor presentation (as per page 94 of Booth's evidence).
2. It also ignores the fact that NP is rated A by DBRS.
3. Assuming a Moody's rating is comparable to an S&P rating is inappropriate. For example, Fortis Alberta Inc. is currently rated A(low) by DBRS, A- (stable) by S&P, and Baa1(stable) by Moody's.

Financial Risk – DBRS Metrics Comparison (Table 11)

- My analysis using DBRS metrics suggest that NP actually has much **stronger credit metrics** than similar Canadian distributors and in the A(high) to AA(low) DBRS range

	Issuer Rating	Total Debt to Capital	CF/Debt	EBIT Interest Coverage
Canadian Regulated Utilities				
1. CU Inc.	A (high)	60.20%	12.60%	2.67
2. Enbridge Gas Distribution Inc.	A	55.70%	16.40%	2.60
3. FortisAlberta Inc.	A (low)	56.70%	17.00%	2.18
4. FortisBC Inc.	A (low)	58.40%	14.10%	2.44
5. Gaz Metro Limited Partnership	A	67.20%	15.70%	1.82
6. Nova Scotia Power Inc.	A (low)	61.20%	15.80%	2.19
Average		**60.88%**	**15.65%**	**2.16**
Median		**59.80%**	**15.75%**	**2.19**
DBRS "A" range for Canadian Utilities		55-65%	12.5-17.5%	1.8-2.8
Newfoundland Power (Aug 21, 2015 DBRS)				
2014	A	**55.30%**	**17.70%**	**3.06**

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Total Risk Conclusions

- NP has low business risk
- NP has lower financial risk than similar Canadian operating utilities:
  - Slightly above average allowed ROEs
  - Much higher than average allowed ERs
  - Better credit metrics
- Combining the statements above implies **low total risk**
- Earning an ROE above the allowed ROE for 19 of the last 20 years confirms this low risk (20 of 21 including 2015)
- No evidence to suggest NP possesses “above average” risk – they are average, at best.

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Credit Metric Scenarios – under existing rates (Table 13)

- NP's metrics would remain in the upper half of Moody's Baa range and DBRS's A(high) to AA(low) range at existing rates. Very strong.

Moody's Metrics	2013	2014	2015E	2016E	2017E	NP
(CFO pre-WC + Interest)/Interest	3.61	3.65	3.77	3.90	3.78	Baa(mid-high)
CFO pre-WC/Debt	18.75 %	18.40 %	18.01 %	18.20 %	17.43%	Baa(high)
(CFO pre-WC - Dividends) /Debt	14.14 %	13.95 %	16.20 %	14.88 %	15.41%	Baa(high) to A(low)
Debt/Capitalization	54.07 %	54.51 %	54.45 %	54.12 %	54.15%	Baa(mid)
DBRS Metrics - calculated						
Cash flow to debt	18.75 %	18.40 %	18.01 %	18.20 %	17.43%	A(high) to AA(low)
Debt to Capital	54.34 %	54.85 %	54.72 %	54.38 %	54.39%	AA(low)
EBIT to Interest	2.48	2.52	2.57	2.49	2.36	A(high)

Credit Metric Scenarios (Table 15)

- NP’s metrics would remain in Moody’s Baa range and DBRS’s A range if allowed ER was reduced and if allowed ROE was reduced

2016 Metrics	ROE	ROE	ROE	ROE	
	7.50%	8.00%	8.30%	8.50%	
Moody's Metrics					
(CFO pre-WC + Interest)/Interest	3.50	3.56	3.59	3.62	Baa(mid)
CFO pre-WC/Debt	14.91%	15.25%	15.45%	15.59%	Baa(high)
(CFO pre-WC - Dividends) /Debt	12.19%	12.53%	12.73%	12.87%	Baa(high)
Debt/Capitalization	59.00%	59.00%	59.00%	59.00%	Baa(low)
DBRS Metrics					
Cash flow to debt	14.91%	15.25%	15.45%	15.59%	A(high)
Debt to Capital	59.24%	59.24%	59.24%	59.24%	A(mid)
EBIT to Interest	2.21	2.29	2.34	2.37	A(mid) to A(high)

Credit Metric Scenarios (Table 15) - continued

2017 Metrics	ROE	ROE	ROE	ROE	
	7.50%	8.00%	8.30%	8.50%	
Moody's Metrics					NP
(CFO pre-WC + Interest)/Interest	3.49	3.55	3.58	3.61	Baa(mid)
CFO pre-WC/Debt	14.78%	15.12%	15.32%	15.46%	Baa(high)
(CFO pre-WC - Dividends) /Debt	13.13%	13.46%	13.67%	13.80%	Baa(high)
Debt/Capitalization	59.04%	59.04%	59.04%	59.04%	Baa(low)
DBRS Metrics					
Cash flow to debt	14.78%	15.12%	15.32%	15.46%	A(high)
Debt to Capital	59.28%	59.28%	59.28%	59.28%	A(mid)
EBIT to Interest	2.22	2.30	2.35	2.38	A(mid) to A(high)

Credit Metric Calculations

- As per page 16 of my rebuttal evidence:
- NP's reported interest coverage ratios (Exhibit 3) are lower than those I report, and those of DBRS (for 2013 and 2014):

	NP	Cleary	DBRS
• 2013	2.3	2.48	2.95
• 2014	2.3	2.52	3.06

- On page 4 of NP's rebuttal evidence (for ROE=7.5% and ER =40% scenario) and in U-4 (March 31) – (for ROE =8.3% and ER =40%), they also calculate **lower Interest Coverage ratios** than me, but **similar ratios for "cash flow" related measures** – CF/Debt and CF/Interest – as shown on the next slide.
- There is an old finance saying that earnings can vary with assumptions, but **"cash flows wash out these differences"**…

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Table R-1 (NP Rebuttal) and U-4 (March 31) vs. Cleary (Table 15)

	NP 2016 (7.5/40)	Cleary 2016 (7.5/40)	NP 2017 (7.5/40)	Cleary 2017 (7.5/40)	NP 2017 (8.3/40)	Cleary 2017 (8.3/40)
CF/Debt Coverage	15.9%	14.91%	14.5%	14.78%	15.0%	15.32%
CF Interest Coverage	3.7	3.50	3.5	3.49	3.6	3.58
Interest Coverage	2.0	2.21	2.0	2.22	2.1	2.35

Interest coverage (EBIT/I)

- Two ways to construct EBIT (for interest coverage (EBIT/I)):
  - Top-Down – Start with sales and subtract oper. costs, etc.
  - (e.g., 100 – 60 - 18 = 22)
  - Bottom-Up – start with income before taxes (or net income) and add back interest (and taxes) (e.g., 12 + 4 + 6 = 22)

Revenue	100
- Oper costs	-60
EBITDA	40
- Deprec and Amortiz	-18
EBIT	22
- Interest	-6
EBT	16
- Taxes (25%)	-4
NI	12

U-7 March 31, 2016

- Table 1 in U-7 calculates "Net Earnings" (to use as EBIT) using a "top-down" approach of $80,199 – NI or EBT data **not** provided.
- However, if we subtract the Interest figure (after new issue) of $41,454 provided by NP, we get EBT of $38,745
- If we then apply a 29.14% tax rate to EBT (from NP's Exhibit 3 assumptions), we get an implied net income available to common shareholders figure of **$27,455**.
- Using CE figure of $440,199 (which is the $495,199 for 2017E from Exhibit 3 page 6 minus the $55 million), this **implies an ROE of 6.24% ???**
  - (Note: using the implied debt figure of $674,539 (which = the 2017E figure + $75 million), we get an equity ratio of 39.5%, so close to 40%)
- Or if assume $27,455 is an 8.3% ROE, this implies Equity = 330,780 and **implies an equity ratio of 32.9%???**

U-7 March 31, 2016 (cont'd)

- In contrast, I use a "bottom-up" approach, based on a net income available to common shareholders that corresponds to an 8.3% ROE and a 40% equity ratio
- I leave common equity unchanged, so a $102 million debt issue is required to obtain a 40% equity ratio.
- For metric calculations, I then add back taxes (at 29.14%) and interest (based on 2017E interest forecast + new interest on $102 million bond issue at 4.45%) to determine EBIT
- Obviously, there are numerous combinations of debt issues, or common dividend payments to achieve a 40% equity ratio, and NP could decide what makes the most sense for it…
- But it would seem that the credit metrics and EBIT used to calculate such, should be consistent with an 8.3% ROE and a 40% equity ratio…

Conclusions

- NP is **low business risk**
  - Virtual monopoly in low risk distribution
  - Very strong regulatory support
  - Resiliency in revenue and EBIT/EBITDA through time
  - Low volatility in operating income (EBIT)
- NP also possesses **low financial risk**
  - Allowable ROEs about average; equity ratios (ERs) well above average
  - Credit metrics above average
- Have earned an ROE above allowed for 20 of last 21 years – confirms **low total risk**…
- NP is NOT above average risk – it is average risk at best.

Conclusions (cont'd)

- I recommend a **decrease in equity ratio (ER) to 40%** - in line with Canadian peers
  - 45% is overly conservative and is not necessary
- Credit metric scenario analysis confirms that such a reduction will allow NP to retain financial integrity