Q. When did NP issue its preferred shares and when was the last time it considered either issuing preferred shares to the public market or to its parent company?

A. **1. Introduction**

At Newfoundland Power's *2013/2014 General Rate Application,* it was recommended by Dr. Lawrence Booth, on behalf of the Consumer Advocate, that the Company's common equity ratio be reduced to 40% with the issuance of preferred shares.[1]

In response to this recommendation, the evidence of Newfoundland Power's Chief Financial Officer, Ms. Jocelyn Perry, was summarized by the Board as follows:

> "*Ms. Perry explains that Newfoundland Power is a small issuer in financial markets and she questions whether Dr. Booth's suggestion in relation to retractable preferred shares is possible. Further, she states that it would be costly and, from a credit rating perspective, retractable preferred shares would effectively be the same as issuing additional debt".*[2]

The financial viability of Newfoundland Power's issuing preferred shares has not changed since the time of this evidence. Accordingly, Newfoundland Power does not consider it advisable to issue preferred shares to the public market or to its parent company.

This response outlines in detail the basis of Newfoundland Power's perspective on this matter.

2. Prior Regulatory History

The recommendation that Newfoundland Power should issue preferred shares and reduce a portion of the 45% common equity reflected in its capital structure has been made a number of times.

In Newfoundland Power's *1996 General Rate Application,* Dr. Basil Kalymon, on behalf of the Consumer Advocate, recommended that Newfoundland Power's capital should be 40% common equity, 15% preferred shares and 45% debt. At that time, the Board concluded that *"The Board has heard no convincing arguments that suggests that the range for common equity approved in 1991 has become inappropriate. The Board is of the opinion that the proportion of common equity should be in the range of 40% to 45%".*[3]

[1] See Order No. P.U. 13 (2013), page 13, lines 41 to 42.
[2] See Order No. P.U. 13 (2013), page 14, lines 26 to 29.
[3] See Order No. P.U. 7 (1996-97), pages 23 to 24.

In the Board's 1998 investigation into Newfoundland Power's cost of capital (the "1998 investigation"), the question of Newfoundland Power's possible issue of preferred equity arose again. The Board described the evidence relating to this issue as follows:

> "*Preferred equity in Canada has been under increased scrutiny during the 1990s. Both in 1996 and again in this hearing, Dr. Kalymon emphasized the under utilization of preferred shares in the Company's capital structure…*
>
> *However, Dr. Winter [the Board's expert] agreed that when the current accounting treatment of non-perpetual preferred shares was considered, the effect for accounting purposes of choosing debt or preferred shares is the same. Dr. Winter agreed the cost of preferred shares would then be treated as interest when preparing the income statement and interest coverage calculation…*
>
> *The key, in Dr. Kalymon's opinion, will be to issue long term preferred shares."*[4]

At the time of the 1998 investigation, the Board resolved matters relating to common and preferred equity as follows:

> "*The Board is comforted by the fact that the common equity range accepted by the Board in 1996 includes both schools of common equity recommendations, 40% and 45%, albeit at the extreme ends of the range. The Board had considered the criteria of the bond rating agencies presented in the responses to information requests in assessing credit worthiness.*
>
> *The Board believes that, in order to maintain an "A" rating and appropriate access to the capital markets, as a small utility, NLP will require a stable and strong capital structure.*
>
> *For the purposes of setting interim rates utilizing 1997 test year data, pursuant to Section 75 of the Act, the Board will deem a common equity ratio of 45%. Common equity above this level will be treated as preferred equity."*[5]

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4 See Order No. P.U. 16 (1998-99), pages 52 to 53.
5 See Order No. P.U. 16 (1998-99), page 58.

At the next Newfoundland Power general rate application following the Board's 1998 investigation (and subsequent general rate application), the matter of the Company issuing preferred shares arose again. In Newfoundland Power's *2003/2004 General Rate Application*, it was suggested by Dr. Kalymon, on behalf of the Consumer Advocate, that Newfoundland Power's common equity ratio be reduced to 40% and the differential between the then current 45% common equity and the 40% equity could be substituted with preferred shares.[6]

Following consideration of the issue, the Board observed:

> *"Dr. Kalymon's proposal to substitute preferred shares for equity is not seen as an acceptable solution in the judgement of the Board. The Board notes this same proposal by Dr. Kalymon was rejected in Order P.U. 16 (1998-99). In reaching this decision of a maximum 45% common equity component, the Board recognizes NP will continue to retain one of the most favourable capital structures among Canadian utilities of comparable risk…*
>
> *Having reviewed the evidence the Board is of the opinion that it is reasonable and prudent to maintain the capital structure deemed appropriate in Order No. P. U. 16 (1998-99). The proportion of regulated common equity in the capital structure should not exceed 45%."* [7]

At Newfoundland Power's *2003/2004 General Rate Application*, the Board considered Standard and Poor's credit linkage of the Company to its parent Fortis Inc. At issue was the potential for adverse conditions experienced by the parent affecting the costs borne by Newfoundland Power's customers. The Board described the issue as follows:

> "*The Board takes particular note that, for the first time in NP's [Newfoundland Power's] history, a link has been made by a credit rating agency (S & P) assigning it the same corporate credit rating as Fortis, which has now been placed on a negative credit watch, citing the parent's unacceptable financial ratios. The Board agrees the outcome of this review by S & P remains uncertain but could conceivably result in a downgrade to NP's corporate rating and in turn affect its "A" bond rating. A downgrade in its bond rating will translate into higher debt costs to NP and potentially higher rates to its customers, a situation the utility has stridently argued against throughout the course of the hearing. This prospect is unacceptable and the Board will require NP to take all steps possible to mitigate against this outcome."*[8]

6 See Order No. P.U. 19 (2003), page 45.
7 See Order No. P.U. 19 (2003), pages 45-46.
8 See Order No. P.U. 19 (2003), page 39.

In Newfoundland Power's *2008 General Rate Application* and *2010 General Rate Application*, the matter of the Company's capital structure was settled. In both cases, the agreement of the parties was that Newfoundland Power would maintain a capital structure not to exceed 45%. In approving the parties' agreement, the Board noted in each case the consistency of the proposed settlement with its prior Orders.[9]

3. Current Electric Utility Financing Practice

General

The issue of preferred shares by Canadian electric utilities is not common financing practice. Newfoundland Power is not aware of any Canadian electric utility that has issued preferred shares directly in Canadian capital markets over the past decade.

ATCO Electric is the only Canadian electric utility to issue preferred equity over the past decade. These issuances were to CU Inc., an intermediate utility holding company used by the ATCO Ltd. to hold, and finance, ATCO's regulated Alberta interests. All of the subsidiaries of CU Inc. are regulated by the Alberta Utilities Commission. [10]

ATCO Electric's use of preferred equity to finance utility operations appears to be diminishing. ATCO Electric had 10% preferred equity in its capital structure in 2010 but had less than 4% preferred equity in 2014.[11]

On October 15, 2015, Nova Scotia Power redeemed *all* of its $135 million outstanding first preferred shares.[12]

Current Canadian Preferred Share Market

Newfoundland Power has consulted with its investment bankers concerning the current Canadian preferred share market.[13]

The Company has been advised that preferred shares with a fixed coupon rate and perpetual term are not currently marketable in Canadian capital markets. Preferred shares which have a coupon rate which is reset at a predetermined time (typically 5 years) are currently marketable in Canadian capital markets.

Preferred shares which have a coupon reset provision are exposed to changes in market interest rates. This makes them similar to debt financing and distinguishes them from preferred shares with perpetual terms and fixed coupon rates. Preferred shares which

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[9] See Order No. P.U. 32 (2007), page 24 and Order No. P.U. 43 (2009), page 10, lines 8 to 22.

[10] These regulated interests include ATCO Electric, ATCO Gas and ATCO Pipelines. The utility assets of these companies total approximately $12.5 billion (See 2014 Annual Financial Statements, CU Inc.). By comparison, the utility assets of Newfoundland Power, Fortis Inc.'s sole regulated interests in the Province of Newfoundland and Labrador, total approximately $1 billion.

[11] Rule 005 filings with Alberta Utilities Commission for ATCO Electric (Distribution) for 2010 and 2014.

[12] Nova Scotia Power Inc., 3rd Quarter 2015 Management Discussion and Analysis, page 12.

[13] Newfoundland Power consulted with Scotiabank.

have a coupon reset provision are not treated simply as equity for accounting and credit rating purposes.[14]

Newfoundland Power has also been advised that a minimum issue of $100 million would be required for a utility preferred share issue with a coupon reset to be marketable in current Canadian capital markets.

4. Why Newfoundland Power Doesn't Issue Preferred Shares

Newfoundland Power does not consider it advisable to issue preferred shares for a number of reasons.[15]

The issue of preferred shares is not consistent with current Canadian electric utility financing practice. This is largely because of the debt like attributes of preferred shares which have coupon reset provisions. Because preferred share issues typically carry a higher cost than debt issues, preferred shares have largely been displaced by lower cost debt in utility capital structures.

The Board has recognized that Newfoundland Power's relatively small size reduces its financial flexibility.[16] The minimum issue size of a utility preferred share issue of $100 million highlights this point. $100 million represents approximately 10% of the Company's forecast rate base. Newfoundland Power capital structure with 10% preferred equity would be significantly out of step with current Canadian electric utility practice.

At Newfoundland Power's *2013/2014 General Rate Application* the suggestion was made by Dr. Booth that Fortis Inc. could issue preferred shares and "…mirror down the cost to its subsidiaries…" similar to CU Inc. However, it was also acknowledged by Dr. Booth that if this were done the preferred shares issued by the Company would have a Fortis credit rating.[17] This might expose Newfoundland Power to a downgrade on account of the financial affairs of Fortis and be contrary to the Board's requirement in Order No. P.U. 19 (2003) that Newfoundland Power "…take all steps possible to mitigate against…" such an outcome.[18]

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[14] See, for example, DBRS Criteria *Preferred Share and Hybrid Criteria for Corporate Issuers*, January 2015.
[15] Newfoundland Power last issued preferred shares in 1979.
[16] See, for example, Order No. P.U. 16 (1998-99), page 37. By comparison, the ATCO utilities financed through CU Inc. have assets more than 11 times the assets of Newfoundland Power.
[17] See *2013/2014 General Rate Application*, Transcript January 18, 2013, page 88, line 1, *et seq*. The preferred shares of ATCO Electric have a CU Inc. credit rating.
[18] See page 3 of 5, lines 40-41, *supra*.