

1 **Q. PUB-CA-018 Pages 99-101: Dr. Booth provides analysis of the impact on**  
2 **Newfoundland Power's interest coverage if its common equity is reduced to 40% as**  
3 **recommended and at page 101 states that all the values indicated are "consistent**  
4 **with maintaining the financial integrity of NP". In Dr. Booth's opinion what**  
5 **reduction in interest coverage would there have to be for a concern on**  
6 **Newfoundland Power's financial integrity to arise?**

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8 A. Dr. Booth does not recommend minimum interest coverage ratios and would note  
9 that NP's sister company FortisBC Energy Inc (FEI) has had an interest coverage ratio  
10 below 2.0 for much of the last 20 years, while maintaining an A rating by DBRS. Further,  
11 this A rating has been unchanged during periods when FEI has had a regulated common  
12 equity ratio as low as 33% and as high as 40%. The most important factor in a bond  
13 rating is the quality of the regulatory protection afforded the utility and the support  
14 provided the utility to earn its allowed ROE.

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16 For NP Dr. Booth is not proposing a capital structure that would result in an interest  
17 coverage ratio below 2.0, which may limit the company's financing options. However,  
18 even an interest coverage ratio consistently below 2.0 might be justified if the utility has a  
19 very high embedded debt cost or very low corporate tax rate.

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21 To illustrate, the basic formula for the interest coverage (times interest earned or TIE)  
22 ratio using the current market costs is as follows:

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$$TIE = (r \cdot d + (ROE / (1 - T)) \cdot (1 - d)) / (r \cdot d)$$

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26 This simply says that it is the earnings before interest and tax divided by the interest,  
27 where interest is the current cost of, r, times the debt ratio, d, and the pre-tax net income

1 is the before tax ROE times one minus the debt ratio. The actual dollar amounts don't  
2 matter since everything is ratioed up from a basis of \$1.

3 At a current approximate 4.5% debt cost, 29% tax rate and 40% debt financing this  
4 equation collapses to

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6

$$\text{ROE}=(2.7*(\text{TIE}-1))/.56$$

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8 If the interest coverage is 2, then the ROE can be as low as 4.8% if all values are at  
9 current market rates. To the extent that the embedded cost of debt exceeds the current  
10 cost of debt, the ROE has to be higher as discussed in Dr. Booth's testimony.