Reference: Section 3: Finance

Q. Volume 1, page 3-1, lines 14-16. Newfoundland Power states "*A 45% common equity component and a 9.8% rate of return on equity is consistent with maintaining Newfoundland Power's financial integrity and the fair return standard.*" In Newfoundland Power's opinion is there a range in which the equity component and the return on equity could be set that would maintain Newfoundland Power's financial integrity and the fair return standard? If yes, state the range for each of the return on equity and the equity component in the capital structure. If no, explain why maintaining Newfoundland Power's financial integrity and the fair return standard is dependent on the Board approving the specific return on equity of 9.8% and the capital structure consisting of 45% proposed in the Application.

A. **A. Introduction**

The Board is guided by the fair return standard in determining an appropriate rate of return on equity ("ROE") and capital structure for Newfoundland Power. Historically, the Board has interpreted a fair return as one that is: (i) commensurate with returns on investments of similar risk; (ii) sufficient to ensure the utility's financial integrity; and (iii) sufficient to attract necessary capital.[1] The Board has also provided that *"all three of these requirements must be met and no one requirement takes precedence over the other two."*[2]

B. Determining an Appropriate ROE

In Newfoundland Power's view, the determination of an appropriate ROE practically requires the consideration of a range of results that would reasonably meet the fair return standard.

For example, the Newfoundland and Labrador Court of Appeal has observed that:

> *"[25] There is no uniform methodology employed in the regulatory jurisdictions in North America for the determination of a just and reasonable rate of return. What recurs, however, is a theme that the process is not an exact science and depends on a variety of factors necessary to balance the competing interests involved. Rate setting is essentially a prospective exercise where determinations are made on the basis of estimates and information that will not necessarily remain static."*[3]

The Company's cost of capital expert, Mr. James Coyne of Concentric Energy Advisors Inc., recommends that a fair return for Newfoundland Power is 9.80%. Mr. Coyne's recommendation is based on an assessment of other utilities in North America

1 See Order No. P.U. 2 (2019), page 12, lines 9-12.
2 Ibid.
3 *The Stated Case*, June 15, 1998, Newfoundland and Labrador Court of Appeal, paragraph 25.

comparable to Newfoundland Power with respect to business and financial risks (e.g. a "proxy group").[4] The recommended ROE of 9.80% is within a range of 9.44% to 10.56% of ROE estimates for the North American proxy group.[5]

In addition to considering cost of capital expert evidence, the Board has historically considered approved ROEs in other Canadian jurisdictions when determining an appropriate ROE for Newfoundland Power.[6] Allowed ROEs for electric utilities across Canada currently range, in effect, from 8.50% to 9.35% consistent with the ROE range seen across Canada at the time of the Company's last general rate application.[7]

C. Determining an Appropriate Capital Structure

The Board has accepted a common equity ratio of 45% for Newfoundland Power for the past 25 years.

Newfoundland Power's 45% common equity ratio is a cornerstone of the Company's creditworthiness and, from a credit rating perspective, a primary indicator of the level of regulatory support.[8]

In Order No. P.U. 2 (2019), the Board continued to recognize the impact Newfoundland Power's longstanding capital structure has on its creditworthiness:

> *"In terms of capital structure, the Board has accepted a capital structure of 45% equity for rate setting for Newfoundland Power since 1996. Newfoundland Power's capital structure is recognized by credit rating agencies as a strength, which positively impacts its credit worthiness."*[9]

The importance of stability in capital structure management has been recognized by the Newfoundland and Labrador Court of Appeal:

> *"[135] In approaching these questions, it has to be remembered that there is no such thing as one ideal capital structure. It is a function of economic conditions, business risks and 'largely a matter of business judgement'. Furthermore, a*

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[4] For further information on Mr. Coyne's assessment of Newfoundland Power's business risks, see response to Request for Information PUB-NP-035.

[5] See the *2022/2023 General Rate Application, Volume 3, Expert Evidence, Tab 2, Cost of Capital*, page 3.

[6] See, for example, Order No. P.U. 18 (2016), pages 36 to 40.

[7] See the *2022/2023 General Rate Application, Volume 3, Expert Evidence, Tab 2, Cost of Capital*, page 50, for allowed ROEs for electric utilities across Canada. All allowed ROEs are consistent with those assessed by Mr. Coyne as part of the Company's last general rate application with the exception of the ROE for Ontario electric utilities set by the Ontario Energy Board ("OEB"). The formula-based ROE in Ontario is currently 8.34%, a decrease from the 9.0% in 2018. The formula result is based on September 2020 market conditions. Based on the April 2021 *Consensus* forecast and actual bond yields in July 2021, the OEB's formulaic approach for determining cost of capital would result in a ROE of 8.64% for regulated utilities in Ontario.

[8] For further information on the Company's credit ratings, see response to Request for Information PUB-NP-030.

[9] See Order No. P.U. 2 (2019), page 12, lines 20-22.

> *given capital structure cannot be changed easily or quickly. As well, the long-term effects of changes on capital structure on the enterprise and on the future cost of capital may not be easily predictable."*[10]

Mr. Coyne concluded that Newfoundland Power's current common equity ratio of 45% remains reasonable, if not conservative, given the business and financial risks of Newfoundland Power.[11]

It is Newfoundland Power's view that a reduction in its 45% common equity ratio in the current circumstances would represent a risk to the maintenance of the Company's creditworthiness and its cost-effective access to capital and, therefore, would not be consistent with the fair return standard.[12]

For further information on Newfoundland Power's business risks, see response to Request for Information PUB-NP-035.

[10] The *Stated Case*, June 15, 1998, Newfoundland and Labrador Court of Appeal, paragraph 135.
[11] See the *2022/2023 General Rate Application, Volume 3, Expert Evidence, Tab 2, Cost of Capital*, page 3.
[12] For further information on the Company's credit ratings, see response to Request for Information PUB-NP-030.