Reference: Section 3: Finance

Q. Volume 1, page 3-40. What weight does Newfoundland Power consider that the Board, in assessing Newfoundland Power's business risk, should give to the number and scope of approved regulatory mechanisms that provide for the recovery of costs that are largely beyond management's control?

A. **A. General**

Cost of capital is the rate of return that investors could expect to earn if they invested in securities of equal risk.[1] Therefore, cost of capital is a relative concept. The accepted relative measure for determining a business' cost of capital is risk.

Risk is an assessment of the capability of an enterprise to recover its investment and earn a return on that investment. For regulated utilities such as Newfoundland Power, risk is generally categorized into business risk and financial risk.

Business risk includes the regulatory framework under which the Company operates. This includes the Board's determinations of how costs are recovered and how risks are to be shared between investors and customers. Cost recovery is one element of business risk. Regulatory mechanisms are one form of cost recovery.

Newfoundland Power is not aware of examples of regulatory jurisdictions that assign specific weightings to different elements of risk. Each risk element must be considered as part of the overall risk assessment in determining the Company's cost of capital.

B. Assessment

The Board has approved regulatory mechanisms to provide for reasonable recovery of certain costs that are largely beyond management control. These regulatory mechanisms address variability in supply costs, employee future benefits costs and customer program delivery. The Board's regulation of Newfoundland Power, including its regulatory mechanisms, is generally viewed positively by credit rating agencies.[2]

In Newfoundland Power's view, the Board should assess the business risk associated with its regulatory mechanisms by considering the mechanisms approved for other utilities.

1 See, for example, Brealey, Myers et. al., *Fundamentals of Corporate Finance* (2nd Canadian Edition), page 271.

2 For example, in its rating report for Newfoundland Power, Moody's Investors Service states: *"The stable outlook reflects the PUB's regulation of NPI which we consider credit supportive. We expect the regulatory environment to remain supportive, with the company maintaining a suite of timely recovery mechanisms…"* See the *2022/2023 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Exhibit 4, Moody's,* page 2.

Newfoundland Power's research indicates that its regulatory mechanisms are broadly consistent with those of other Canadian utilities. This includes regulatory mechanisms that address variability in supply costs,[3] employee future benefits costs,[4] and customer program delivery.[5]

Additionally, in his *Cost of Capital* report, Mr. Coyne provides a comparison of Newfoundland Power's business risk to other investor-owned electric utilities. This assessment includes cost recovery through regulatory mechanisms. Mr. Coyne's assessment shows that Newfoundland Power's regulatory mechanisms are broadly consistent with other investor-owned electric utilities.

[3] See response to Request for Information PUB-NP-041, Attachment A, page 6.

[4] See the *2022/2023 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Section 3: Finance*, page 3-41, footnote 107.

[5] Ibid., page 3-54, footnotes 146 and 147.