# **NEWFOUNDLAND POWER**

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# DIRECT TESTIMONY

Prepared by

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### FOSTER ASSOCIATES, INC.



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2043.Maintenance of creditworthiness/financial integrity: A reasonable capital205structure, in conjunction with the returns allowed on the various sources of206capital, should provide the basis for stand-alone investment grade debt207ratings, and the benefits of ratings in the A category. The importance of208debt ratings in the A category is discussed in detail in Section III.C.

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#### 210 B. BUSINESS RISKS

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212 Business risks have both short-term and longer-term aspects. The capital 213 structure and fair return on equity should reflect both short- and long-term risks. 214 Long-term risks are important because utility assets are long-lived. Because 215 utilities are generally regulated on the basis of annual revenue requirements, there 216 has been a tendency to downplay longer-term risks, essentially on the grounds 217 that the regulatory framework provides the regulator an opportunity to 218 compensate the shareholder for the longer-term risks when they are experienced. 219 This premise may not hold. First, customer resistance may forestall higher return 220awards when the risk materializes. Second, no regulator can bind his successors 221 and thus guarantee that investors will be compensated for longer-term risks in the 222 event they are incurred in the future.

Business risk encompasses those market demand, supply and regulatory factors that expose the shareholders to the risk of underrecovery of the required return on, and the return of, their capital investment. While different business risk categories can be identified, they are inter-related. The regulatory framework, for example, is generally designed around the inherent market and supply/physical risks.

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231 Market demand risk relates to those factors that can lead to annual volatility in 232 electricity sales or loss of customers or load. It includes market size, economic diversity and strength of the service area, growth potential, concentration of sales,
competition with alternative energy sources and weather.

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236 Supply and physical (operating) risks faced by an electric 237 distribution/transmission utility incorporate the risk of underearning due to the 238 inability to deliver electricity, or the inability to recover costs associated with the 239 delivery of electricity. The operating and physical risks of a distribution/ 240 transmission utility are a function of its geography, the age and reliability of its 241 assets, the design of the network (relative to different sources of generation and to 242 the customer load), and the ability to access alternative sources of supply.

The regulatory framework in which a utility operates is frequently viewed as the most significant aspect of risk to which investors in a utility are exposed. The financial community is very conscious of the regulatory environment, as highlighted in reports of both bond rating agencies and investment analysts.

249 Regulation has the power to expose utilities to enormous risks, by permitting 250 bypass of facilities, disallowing costs, approving rate designs that are tilted 251 against recovery of fixed costs, or returns that do not conform with informed 252 investors' perception of risk. Alternatively, regulation can provide an 253 environment characterized by consistency, and by even-handedness, conducive to 254 continued growth consistent with economic allocation of resources, affording the 255 utility a reasonable opportunity to achieve a fair return. Enlightened regulation 256 will mitigate risks that are substantially beyond management control, and award a ·257 return that provides both (1) fair compensation for the risks that are left with 258 management and (2) incentives to achieve (and exceed) the allowed return 259 through continued improvement in productivity.

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261To assess the business risk of NP, I have reviewed the trends since the PUB262issued P.U. 19 (2003) in June 2003. In its decision, the PUB concluded, "The263Board does not anticipate a change in the business risk of NP in the foreseeable

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future and concurs with the assessment of NP and the cost of capital experts that NP is of average business risk compared to other utilities." (p.34) As discussed below, that conclusion remains valid.

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268 As when its business risk was last evaluated by the Board, NP remains a relatively 269 small utility. Its year-end 2006 assets totaled \$889 million, with common equity of \$336 million. Despite 6% annual growth in assets since year-end 2001, NP is 270 271 still less than one-third the size of Nova Scotia Power, whose assets are over \$3 272 billion (common equity of \$1.1 billion). All other things equal, smaller utilities 273 require a more conservative capital structure than larger ones to achieve and 274 maintain similar debt ratings. Moody's, for example, has referred to NP's small 275 size as a credit challenge (Credit Opinion, Newfoundland Power Inc., July 2005).

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With respect to its service area, NP's business risk profile is in large part definedby its demographics and growth prospects over the longer term.

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 Real growth in the province from 2001-2005 averaged approximately 4.4%, with material year-to-year differences, ranging from 15.6% in 2002 to -0.9% in 2004.<sup>1</sup>
 Both pre-operational construction and ramp-ups in production from such megaprojects as Voisey's Bay mine and the offshore oilfield projects (Terra Nova and White Rose) have contributed to a high average level of growth over this period. The significant year-to-year swings in growth are also due to the effects of those projects.

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288 2. In 2006, real GDP growth in Newfoundland & Labrador, at 2.9%, is expected to
289 be among the highest of the provinces, behind Alberta, Manitoba, and British
290 Columbia.<sup>2</sup> However, the 2.9% growth rate represents a significant decline from

<sup>&</sup>lt;sup>1</sup> Government of Newfoundland and Labrador, Economic Research and Analysis Division, *Selected Economic Indicators*.

<sup>&</sup>lt;sup>2</sup> Conference Board of Canada, Provincial Outlook 2007, Long-Term Economic Forecast, February 2007.

291forecasts made earlier in 2006,<sup>3</sup> due primarily to lower than anticipated292production at Terra Nova and an extended strike at Voisey's Bay.

294 Housing starts, which experienced strong growth between 2001 and 2004 (annual rate of 18.4%), declined by 13% in 2005 and are anticipated to decline by almost 295 12% in 2006.<sup>4</sup> The decline in housing starts, when combined with the completion 296 297 of mega-projects, will result in lower construction activity in 2006 compared to 298 2005. The fishery industry continues to be relatively weak, with the impact of a 299 strong Canadian dollar, competition in processing from China, high fuel prices 300 and lower prices for shrimp and crab. In the pulp and paper industry, the closure 301 of the Abitibi Consolidated facilities in Stephenville in late 2005 has also had a 302 negative impact on the economy. Other facilities in the industry are also at risk, 303 largely due to a decline in competitiveness from the high Canadian dollar, whose 304 value relative to the U.S. dollar is (end of February 2007) approximately 37% 305 higher than it was at the end of 2001.

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307 3. Growth in the provincial economy is expected to remain strong in 2007, forecast by both the Provincial Government and the Conference Board of Canada at 308 5.7%<sup>5</sup>, compared to the consensus forecast of 2.3% for Canada.<sup>6</sup> Growth is 309 310 anticipated to remain stronger than the national average through 2007 due to a 311 rebound in production from Terra Nova following the extended downtime in 2006 312 and to increased production from both Voisey's Bay and White Rose. In the long 313 run, neither Voisey's Bay nor the offshore oil projects are expected to produce 314 relatively high growth in the province, nor are they expected to have a significant 315 impact on growth within NP's service area.

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<sup>&</sup>lt;sup>3</sup> In March 2006, the Government of Newfoundland and Labrador forecast that the economy would grow by 6.2% in 2006. Government of Newfoundland and Labrador, *The Economic Review*, October 2006. <sup>4</sup> Conference Board of Canada, *Provincial Outlook 2006, Long-Term Economic Forecast*, March 2006 and

Provincial Outlook 2007, Long-Term Economic Forecast, February 2007.

<sup>&</sup>lt;sup>5</sup> The Economic Review, p.2, Provincial Outlook 2007.

<sup>&</sup>lt;sup>6</sup> Consensus Economics, Consensus Forecasts, February 12, 2007.

From 2008-2030, the Conference Board of Canada expects real annual GDP
growth in the province to average only .4%, compared to 2.4% for Canada. Other
forecast key economic indicators, compared to those for Canada as a whole,
include the following:

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	Newfoundland and Labrador	Canada
Personal Disposable Income	2.7%	4.1%
Retail Sales	3.1%	4.5%
Housing Starts	-9.8%	-0.9%
Population	-0.3%	1.0%
Employment	-0.8%	0.8%
Service Producing Industries	0.9%	2.2%

Table	1
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Source: The Conference Board of Canada, *Provincial Outlook 2007, Long-Term Economic Forecast*, February 2007 (Tables 1, 2 and 12-21).

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As in 2002, population is still expected to decline as a result of out-migration,
particularly among younger people, and the aging of the population.

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The declining and aging population translates into lower growth in personal
disposable income and retail sales, and a decline in housing starts. Growth in
personal disposable income and retail sales are expected to lag the country as a
whole by a considerable margin.

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The weak economic prospects for the province will be mirrored in the long-term
outlook for electricity sales by NP. The impact of low economic growth in NP's
market is potentially compounded by two factors: the rising cost of power and the
population shift from rural to urban areas. The continued population shift is in

<sup>327 5.</sup> The expected long-term growth in service producing industries in the Province,
328 which are the backbone of NP's general service load, has not changed materially
329 since NP's last general rate application.

large part a result of the persistent decline in the fishery industry that hastraditionally been the economic backbone of the rural areas.

346 Rising power costs put downward pressure on average customer usage from 347 conservation, which, since NP's distribution costs are largely fixed, then tends to 348 increase unit costs of delivered power. Population migration from rural to urban 349 areas also tends to increase the investment that must be recovered from effectively 350 the same customer base. New facilities must be built to serve the urban load, but 351 the rural facilities must be maintained as long as there are customers using those 352 facilities. Increasing unit costs, in turn, act as an incentive for customers to 353 reduce electricity consumption.

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355 On the positive side, NP continues to capture a high percentage of new load in the 356 urban area around St. John's. The high cost of home heating oil, along with 357 regulations governing its use, are supporting NP's capture rate.

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With respect to supply and physical risks, NP continues to rely on Newfoundland
and Labrador Hydro (NLH) for close to 90% of its power supply. While DBRS
views NP's reliance on NLH for supply as a challenge (*Credit Rating Report*, *Newfoundland Power Inc.*, March 9, 2007), the supply risk has not changed since
NP's last general rate application.

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With respect to regulation, NP's regulatory framework remains constructive, 365 10. 366 including mechanisms for risk factors over which the Company has no control. NP has a Rate Stabilization Account that permits the pass-through to customers of 367 368 changes in the cost and quantity of fuel burned by NLH to produce the electricity (energy) sold to NP. The utility also has a weather normalization mechanism 369 370 which decreases the volatility in earnings arising from weather related deviations from average energy consumption. The weather normalization mechanism 371 primarily entails non-cash adjustments to earnings, so that the cash flows of the 372 373 utility are not impacted by its operation.

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The major change that has occurred since NP's last general rate application is the implementation of a demand and energy wholesale rate applicable to NP's purchases of electricity supply from NLH. The new rate structure, approved in Order No. P.U. 44 (2004), introduced on January 1, 2005, is designed to encourage conservation.

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381 Subsequent to the introduction of the demand energy rate, the Board approved a 382 reserve for both demand and energy variances between actual and forecast costs, 383 with the amounts to be transferred to and from the reserve subject to a deadband. 384 The treatment of amounts included in the reserve was subject to the discretion of 385 the Board, based on NP's efforts to reduce the system peak. In this GRA, NP is proposing a modification to the reserve mechanism so that it applies specifically 386 387 to demand variances. Transfers to the Company's proposed Demand Management Incentive Account would occur when the variance in demand supply 388 389 costs exceeds 1% of forecast test year demand costs.

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391The wholesale energy rate is based on a two-block inverted rate structure, with the392second block tied to NLH's marginal cost of production, that is, the forecast cost393of fuel oil.

395NP's retail rates to its customers are based on a forecast combined average unit396cost of purchased power, which includes the projected average per Kwh cost of397energy. However, for every Kwh NP purchases each month over 250 million398Kwh, it pays the second block rate. For the test year, the second block rate is399estimated to be approximately 3.3 cents higher than the forecast average unit cost400of energy.

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NP has historically operated on a multi-year general rate application (GRA) 402 cvcle.<sup>7</sup> If the multiple year cvcle continues, NP's rates in 2009 and 2010 will be 403 404 based on its 2008 forecasts, including the 2008 load forecast. As NP adds 405 incremental customers and load beyond the test year, it will be required to 406 purchase additional energy at the higher second block rate. The more new 407 customers and load that are added, the further apart will be NP's actual unit cost 408 of energy supply and the unit cost of energy supply that is included in customer 409 rates. Thus, in the absence of a recovery mechanism, there will be an erosion of 410 NP's margin as new customers and new load are added.

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NP is proposing a change to its Rate Stabilization Clause that is designed to
provide a reasonable opportunity to recover its actual prudently incurred energy
supply costs. NP is proposing to recover or refund through the RSA the difference
between the average and the marginal energy supply cost applied to energy
purchases above or below the test year forecast.

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In the absence of the proposed change to the Rate Stabilization Clause (or,
alternatively, more frequent GRAs), NP's business risks would be materially
higher than at the time of its last GRA.

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In summary, based on the premise that the proposed change to the Rate
Stabilization Clause is adopted, and thus no significant change in NP's ability to
recover its total costs, the business risk profile of NP has not changed materially
since the PUB last reviewed the business risks at the time of the 2002 general rate
application.

<sup>&</sup>lt;sup>7</sup> NP's last GRA utilized a 2003-2004 test period. The previous GRA was based on a 1998-1999 test period.