Q. McShane Evidence - Capital Structure Changes, pages 27-31

a. In terms of the gas pipelines that have increased their common equity ratios please indicate whether or not these were the result of black box settlements or litigated hearings.

b. Please confirm that all the gas pipelines are export pipelines and face the same supply risks that promoted the NEB to award TQM an ATWACC equivalent to 9.7% ROE on 40% common equity, which is the common negotiated settlement for these pipelines.

c. Please comment on whether Ms. McShane judges NP to face the long run supply and competitive risks that caused the NEB to increase the ROE and common equity ratio of TQM.

d. Please confirm that the BCUC increased BC Gas (Fortis Energy BC) common equity ratio to 40% due to increased competitive pressure from BC Hydro, as the cost of electricity was in many cases less than the cost of natural gas in 2009; the reduced penetration of natural gas as the lower mainland moved more to condominium developments and provincial pressure for a carbon tax that would have been borne by natural gas but not electricity.

e. Please indicate whether any of the factors in d) above are relevant to NP given its assessment that its own risks have not changed.

f. Please confirm that Ms. McShane's view that capital structure is a management decision (page 29) reflects US practise that does not generally deem common equity ratios unless management decisions are felt to be egregious.

g. Ms. McShane judges NP to be an average risk utility, whereas the Board and the company have not restricted this assessment to the overall position of the company but its business risk. If the board accepts that NP's business risk is average and a 40% common equity ratio was appropriate would this change Ms. McShane's recommended ROE?

A. a. They were the results of negotiated settlements, but not black box settlements, as Ms. McShane understands the term. A black box settlement does not specify the various elements of revenue requirement, whereas the pipeline negotiated settlements referenced specified many of the individual elements, including ROE and capital structure.

b. They are all export pipelines and would face varying amounts of increased supply risk due to changes in the dynamics of North American natural gas supply markets. In its decision where the National Energy Board adopted the ATWACC model (equivalent to a common equity ratio of 40% and an ROE of 9.7%) for TQM, the Board noted that the expert for the Canadian Association of Petroleum Producers and the Industrial Gas Users Association "argued that a case could be made that TQM is the new low risk benchmark pipeline." (National Energy

Board, *Reasons for Decision, Trans Québec and Maritimes Pipelines Inc., RH-1-2008,* March 2009, page 11)

c. No. However, Ms. McShane does not agree with the premise of the question, which presumes that the entire change in the cost of capital that TQM was allowed was due to changes in business risk. The National Energy Board also determined that there was significant evidence that "cast doubt on some of the fundamentals underlying the RH-2-94 Formula" (page 16) as it related to TQM, and rescinded the formula in October 2009. To put the change in the cost of capital that TQM was allowed in perspective, the pipeline had previously been allowed a 33% common equity ratio and its ROE was based on the RH-2-94 formula. For 2007 and 2008, the years that the RH-1-2008 TQM decision applied, the automatic adjustment formula produced ROEs of 8.46% and 8.72%, respectively. An increase from those parameters to a cost of capital equivalent to a common equity ratio of 40% and an ROE of 9.7%, in Ms. McShane's view reflects the failure of the formula to produce a fair return as well as TQM's increased business risk.

d. The common equity ratio for FortisBC Energy Inc. was increased by the BCUC from 35% to 40% because the Commission determined that the utility's long-term business risks had increased since 2006 due to risks posed by First Nations and the introduction of climate change legislation by the provincial government, which had created a level of uncertainty that did not exist in 2005. The BCUC found that the change in government policy would quite probably cause potential customers not to opt for natural gas and persuade potential retrofitters to opt for electricity.

e. None of the business risk factors are directly applicable to Newfoundland Power. The point was simply to underscore the upward trend in common equity ratios among Canadian utilities with which Newfoundland Power competes for capital. She would note, however, that the factors that the Alberta Utilities Commission considered in raising the equity ratios of the utilities in that province are directly applicable to Newfoundland Power. In any event, Newfoundland Power is not requesting a change in its capital structure.

f. Ms. McShane's view that, within a reasonable range, the capital structure for a particular utility is appropriately a decision for management is because management is in the best position to assess its business risks, financing requirements and access to debt and equity capital, as stated at page 29 of her testimony. She agrees that, in the U.S., the actual capital structures of utilities are generally adopted for purposes of rate setting, unless they are outside a reasonable range. She does not hold this view because it is U.S. practice. She would also note that the use of deemed capital structures has not always been the predominant practice in Canada. In the case of Newfoundland Power, although the PUB has placed a cap on the allowed common equity ratio, the Company does not have a deemed capital structure.

g. Ms. McShane does not agree with the premise of the question. Newfoundland Power's application discusses its average risk in the context of business, regulatory and financial risks. The references to the PUB's decisions in this regard bear that out. In Order No. P.U. 19(2003), page 52, the PUB stated, "The investment risk of NP is average overall". Investment risk includes business, regulatory and financial risk. At page 13 of Order No. P.U. 43(2009), the Board stated that it "continues to believe that it is appropriate to consider Newfoundland Power's overall risk to be average in relation to Canadian utilities." If the Board were to consider that Newfoundland Power's equity ratio should be 40% rather than the 45% that the Company has maintained for over two decades, yes, Ms. McShane's recommended ROE would be higher.