Q. Opinion on Capital Structure and Return on Equity
Kathleen McShane – Volume 3

Please provide a table identifying utilities that you would consider to be comparable to Newfoundland Power, detailing the characteristics that would cause them to be considered comparable.

A. The term "comparable" in the context of cost of equity must consider the composite of business, regulatory and financial risks, as there are trade-offs among the three components of total risk. All other things equal, utilities with the lowest levels of business/regulatory risk are able to carry higher levels of debt than those with higher levels of business/regulatory risk and vice versa. Utilities with different levels of business/regulatory risk are able to achieve similar levels of total risk by adopting different capital structures compatible with their differing levels of business/regulatory risk.

Nevertheless, there are certain characteristics of the utilities that would be relevant to establishing comparability. The companies should be either electric utilities or gas distribution utilities. The utilities should have limited unregulated operations and those that they have should be largely integral to their regulated operations. The utilities should be investor-owned, to ensure that any market-related information, e.g., debt ratings, are a function of the utilities' stand-alone risks, not of the implicit or explicit support that might be provided by government ownership. The utilities should be established utilities, with relatively mature markets. For example, Ms. McShane would not consider relatively immature utilities like Enbridge Gas New Brunswick or Heritage Gas to be comparable to Newfoundland Power. The utilities should be of reasonable size, i.e., large enough that they are able to achieve strong investment grade debt ratings on the basis of their own business, regulatory and financial risks. As among the utilities shown on Ms. McShane's Schedule 3, page 1 of 2, she would not consider, for example, AltaGas Utilities, FortisBC Energy (Whistler), Gazifère, or the Pacific Northern Gas utilities to be comparable to Newfoundland Power. The utilities should have a reasonably supportive regulatory framework, with due recognition given, as noted above, to the trade-offs among fundamental business risk, regulatory framework and financial risk.

Ms. McShane considers the utilities that she selected to serve as proxies to estimate Newfoundland Power's cost of equity to possess the characteristics necessary to make them reasonable comparables to Newfoundland Power. As Newfoundland Power is not a publicly traded company, it does not have any equity market data. It does, however, have debt ratings, which provide an independent perspective on its overall (business, regulatory and financial) risk, consistent with Moody's ratings framework, permitting objective comparisons to be made with other utilities. The average and median Moody's debt ratings of Ms. McShane's U.S. utility sample is the same as Newfoundland Power's debt rating. The similar ratings support the conclusion that, from an overall risk perspective, the utilities are of comparable total (business, regulatory and financial) risk to Newfoundland Power.

As regards Canadian utilities, of those which are listed on Schedule 3, page 1 of 2, Ms. McShane would consider the following utilities to be of reasonably comparable total risk to Newfoundland Power at its existing capital structure: AltaLink, ATCO Electric Transmission and Distribution, FortisAlberta, FortisBC Inc., ATCO Gas, Enbridge Gas Distribution, FortisBC Energy Inc., Gaz Métro and Union Gas.