Volume 3, Section 1 – McShane, Cost of Capital

Q. (page 5, line 124, through page 6, line 171, and Statistical Exhibit, Schedule 13)

a. Please categorize the list of Canadian regulated utilities that appears in Schedule 13 into those that are approximately average overall investment risk (that is, in terms of combined business and financial risk) with respect to their regulated utility operations, those that are perceptibly less risky than the average group, and those that are more risky than the average group.

b. Please indicate where Newfoundland Power should be slotted in the categorization provided in response to part (a) of this request and why (with reference to both business risk and financial risk factors).

A. (a) and (b)

To a large extent the regulated operations of the companies listed in Schedule 13 operate in jurisdictions where the objective is to set a capital structure that "offsets" the business risk, i.e., to produce a combination of business and financial risk that results in a stand-alone utility that is by definition "average". For example, in Alberta, each of the utilities governed by the EUB's Generic Cost of Capital decision issued in July 2004 was assigned a capital structure that was deemed to be consistent with its business risk, so that each utility could be allowed to earn the same ROE. As a result, unless a utility's capital structure is materially inconsistent with its relative business risk, it will notionally have approximately "average" investment (business plus financial) risk.

The table below lists the major regulated operations of the companies listed on Schedule 13 in approximate order of their relative business risks in conjunction with its allowed capital structure.

COMPANY	UTILITY OPERATION	ALLOWED CAPITAL STRUCTURE
Canadian Utilities	ATCO Electric (Transmission)	33% Common + 6% Preferred
TCPL	Nova Gas	35% Common
TCPL	Mainline	40% Common
Canadian Utilities	ATCO Electric (Distribution)	37% Common + 7% Preferred
Fortis	FortisAlberta	37% Common
Canadian Utilities	ATCO Gas	38% Common + 7% Preferred
Enbridge	Enbridge Gas	35% Common + 3% Preferred (has applied for 38% Common)
Terasen Inc.	Terasen Gas	35% Common
Fortis	Newfoundland Power	45% Common + 2% Preferred
Fortis	FortisBC	40% Common
Enbridge	Enbridge Pipelines	Not Specified; actual Common Equity of "Older System" = 45%
Terasen Inc.	TransMountain	45% Common
Fortis	Maritime Electric	43% Common (Actual)
Emera	Nova Scotia Power	37.5% Common + 9% Preferred
Canadian Utilities	ATCO Pipelines	43% Common + 6% Preferred
PNG	PNG West	40% Common

In light of the regulatory approach to return on equity and capital structure taken by a number of Canadian regulators, the majority of the utilities listed in the table above are, given their capital structures, of approximately average total risk, including Newfoundland Power. Ms. McShane would consider TCPL to be of lower than average total risk given its lower than average business risk but highest common equity ratio of the eight (of the 16 listed) lower business risk companies. She would also consider FortisBC to be of higher than average total risk given its 40% common equity ratio. FortisBC's higher total risk is reflected in a higher equity risk premium than allowed for the benchmark BC utility (Terasen Gas). She would also consider the last four companies in the table to face higher than average total risk. Of the four, all but ATCO Pipelines are currently allowed higher common equity returns than their peers. With respect to Newfoundland Power, while the capital structure and the regulatory framework serve to mitigate the fundamental economic risks, its debt ratings (which provide a concrete measure of its relative total risk) are identical to the average of the operating companies listed in the table above. Consequently, Ms. McShane would place NP approximately in the "middle of the pack" in terms of total risk.