4
5 Q: Referring to page 71 and 72 of his direct testimony, Dr. Cannon offers financial ratios
6 in support of his contention that his proposed return on equity for Newfoundland Power
7 will maintain the utility's financial integrity. With respect to these financial ratios,
8 please provide the following:
9
10 (i) An electronic spreadsheet with all formula intact used to develop these financial
11 ratios.
12
13 (ii) Published benchmarks for these financial ratios by credit rating agencies that
14 support Dr. Cannon's conclusion that the ratios will support NP's financial
15 integrity.
16
17 (iii) A discussion of how these ratios were calculated and state whether they were
18 calculated in a manner consistent with the credit rating agency methodology for
19 published ratio guidelines.
20
21 (iv) Has Dr. Cannon compared the financial ratios for NP he offers on page 72 of his
22 direct testimony to the same financial ratios of other Canadian utility companies? If
23 yes, please provide a copy of this comparison.
24
25
26 A: (i) There is no electronic spreadsheet. Please see Dr. Cannon's Response to NP-CA-69.
27
28 (ii) Dr. Cannon did not use "published benchmarks." Rather, Dr. Cannon relied on the
29 credit metric definitions and values provided by NP in its Application, in Volume
30 1, Section 3: pages 53-56, and especially footnotes number 31, 32, 33, 37, and 40.
31
32 (iii) See responses to (i) and (ii) above.
33
34 (iv) Dr. Cannon did not make an explicit comparative study of Canadian utility
35 financial ratios. However, in the OEB Decision referred to in Response to NP-CA-
36 38, Dr. Cannon notes that Enbridge Gas Distribution Inc.'s (EGDI) weather-
37 normalized EBIT interest coverage for 2006 was 2.10. EGDI testified that its
38 minimum target for its normalized allowed utility EBIT interest coverage is 2.2
39 times, which it would just achieve at an allowed common equity ratio (CER) of
40 38%. The OEB denied EGDI's request to go to a CER=38%, but rather set it at a
41 CER=36%, for 2008, presumably in the knowledge that EGDI's interest coverage
42 ratio might therefore fall below 2.1 times if EGDI were to under-earn its allowed
43 ROCE. The entire discussion can be found in the OEB's "Decision With Reasons
44 – Phase 1," EB-2006-0034, July 5, 2007, in the 2007 Rates case for EGDI, on
45 pages 57 through 66, which are attached on the following pages.

Ontario Energy Board

Commission de l'énergie de l'Ontario

EB-2006-0034

IN THE MATTER OF AN APPLICATION BY:

ENBRIDGE GAS DISTRIBUTION INC.

2007 RATES

DECISION WITH REASONS – PHASE 1

July 5, 2007

CAPITAL STRUCTURE AND COST OF CAPITAL

Issue 4.2 was whether the Company's proposed costs for its debt and preference share components of its capital structure appropriate. No party took issue with the Company's evidence, nor does the Board.

This section therefore addresses the remaining issue related to capital. Specifically, Issue 4.3 read "Is the proposal to change the equity component of the deemed capital structure from 35% to 38% appropriate?" There was no settlement of this issue.

The Company' evidence is that it has suffered a dramatic decline in its financial strength. As a result, Enbridge's ability to raise new long term debt has been constrained and there is a real risk of a further downgrade in the Company's credit rating. An increase in its common equity ratio from 35% to 38% is necessary to restore the Company's financial integrity to a level that will allow it to sustain access to long term capital on reasonable terms. An increase in the equity thickness to 38% is also warranted by reason of higher business risks now faced by Enbridge. This latter evidence was given on behalf of Enbridge by Paul Carpenter of the Brattle Group.

Enbridge attributed the erosion in its financial strength to a steady decline in the allowed ROE that has outpaced the effect of declining interest rates on the Company's financing costs. Long term debt is issued at fixed rates for fixed terms and the rates payable on this embedded debt do not change as interest rates decline and the ROE goes down. As ROE declines, and the cost of long term debt remains fixed until debt maturities occur, the Company's ability to cover the interest on the debt is limited.

A measure of a company's financial strength is the Earnings Before Interest and Taxes (EBIT) interest coverage the ratio which is the quotient of the company's earnings divided by its interest expense. Enbridge noted that lower interest rates lower the ROE immediately but it takes time for the interest expense element of the Company's interest

coverage ratio to decrease as interest rates decline, because Enbridge cannot refinance all of its long term debt in every year. The result is a lower EBIT coverage ratio which diminishes the Company's ability to issue new debt.

According to the Company, its weather-normalized EBIT interest coverage declined from a ratio of 2.38 in 1993 to 2.10 in 2006. Enbridge's margin above 2.0 times coverage for each of the years from 1993 to 2006 declined from $48.0 million in 1993 to $16.8 million in 2006.

Specifically, the Company noted that its existing trust indenture prohibits the issuance of new term debt if Enbridge's actual legal entity EBIT interest coverage ratio for any consecutive 12 month period out of the last 23 months does not exceed 2.0 times. In order for Enbridge to stay in compliance with the financial covenants in the trust indenture, the margins above normalized utility EBIT 2.0 times coverage must allow room to accommodate the effect on the Company's financial results of unexpected swings in the weather. EBIT margin above 2.0 times interest coverage had declined to $16.8 million by 2006. During the period since 1993, the average annual impact of weather on the utility's EBIT has been $35.0 million. The margin above 2.0 times interest coverage of $16.8 million is significantly less than what the Company needs to accommodate an average swing in the weather.

Enbridge testified that it must maintain a normalized allowed utility EBIT interest coverage ratio of at least 2.2. The requested equity ratio of 38.0% marginally achieves this minimum target. Given the magnitude of volatility in its earnings, the Company noted that even with 38% equity thickness and the minimum coverage at 2.2 on a weather-normalized basis, there is no assurance that Enbridge will always meet the new debt issuance test.

The Company indicated that, because of the considerably warmer than normal weather it experienced in 2006, it would not be able to meet the interest coverage test for any 12 month period that includes the period January-March 2006 to enable it to issue new debt. Actual weather in the first quarter of 2006 was considerably warmer than forecast. The warmer weather in the first quarter of 2006 alone reduced Enbridge's EBIT by

$33.3 million and the negative impact on its earnings because of weather was $57.7 million in impact for the full 2006 year.

The impact of a lower ROE in 2006 combined with actual results for January 2006 to March 2006 caused a significant decline in the actual interest coverage ratio, such that, as of January 2007, the ratio is about 1.85 times to 1.95 times depending on the 12 month period chosen from the previous 23 months. The Company noted that its ability to meet the new debt issuance test through 2007 and beyond will depend on the equity thickness allowed by the Board in this case and actual operating results for 2007, including any weather variances.

It is Enbridge's judgment that the ultimate costs to the ratepayer will almost certainly be higher if the Company's credit quality is allowed to decline further. Costs will rise due to constraints on accessing the long term debt as there is a risk for credit rating downgrades leading to suboptimal financing options.

Enbridge's evidence was supplemented by the evidence of Paul Carpenter of the Brattle Group. Dr. Carpenter provided evidence about changes in business risk that have occurred since 1993, when the appropriate level of equity thickness for Enbridge was last considered by the Board. Dr. Carpenter contends that equity investors would consider investment in Enbridge to be more risky than it was in 1993 because of a) changes in the commodity market for natural gas, b) increased risk of bypass, c) new gas-fired generation, and d) uncertainty as to the future rate regulation framework. Dr. Carpenter's remedy is also an increase in the common equity thickness but from the Company's business risk perspective, independent from the credit quality considerations advanced by the Company.

Dr. Booth, on behalf of CCC, IGUA and VECC, testified that Enbridge's current 35% allowed common equity is reasonable, if not generous. In support of that conclusion, Dr. Booth testified that Enbridge's short-term business risk is low and lower than that of Union Gas whose common equity thickness was negotiated at 36%. Furthermore, Enbridge's credit ratings have been quite stable, placing the Company among the premium group of regulated utilities in Canada.

Enbridge provided comparisons of its currently approved equity level to the equity levels in other Canadian jurisdictions and noted that it is apparent that Enbridge's equity ratio has fallen out of line during a period of years when the appropriate level of equity for the Company has not been considered by this Board, but equity levels for other Canadian utilities have been increasing.

Enbridge noted that Professor Booth's view of appropriate equity levels is not shared by Canadian regulators and is not reflective of what actually happens in the Canadian capital markets. According to Enbridge, there is clear trend in regulatory decisions towards higher levels of equity for Canadian regulated utilities. Professor Booth's views about debt/equity ratios of Canadian regulated utilities run counter to this trend and his recommendations are not aligned with what is actually happening in Canadian capital markets.

Positions of the Parties

Board Staff noted the testimony by the Company's witness that Enbridge's business risk is "pretty similar" to that of Union Gas' and that Union Gas' common equity was settled at 36%. On this basis, and on the basis that the Board has decided that a consistent debt-equity capital structure be implemented among electricity distributors, Board Staff stated that a common approach may be merited for the gas utilities and that a 36% common equity for Enbridge may be warranted.

Union Gas submitted that the OEB must consider capital structure in the context of well settled principles governing return on investment to equity holders. This includes a consideration of comparable risk, ensuring financial integrity and the attraction of capital on reasonable terms. Business risks have increased for utilities in Canada and interest coverage ratios are barring Ontario utilities from access to capital markets at a time when infrastructure investment is as important as it has ever been. Union Gas also noted that there has been a trend to increased equity thickness awarded to energy utilities across Canada.

CCC submitted that Enbridge has not demonstrated that it requires an equity component of 38%. CCC argued that Enbridge has not demonstrated that either its business risk or its regulatory risk has increased. CCC noted Dr. Booth's evidence that Enbridge's inability to access debt in the form of unsecured Medium Term Notes (MTN), is only temporary. It has been the result of the combination of warmer weather and decline in interest rates which affect return on equity pursuant to the Board's adjustment formula. As existing debt issues mature and are replaced with new ones at current interest rates, Enbridge's interest coverage ratio will naturally increase. It would not make sense to implement a longer term costly solution to address a temporary problem. CCC submitted that Enbridge has not demonstrated that its credit ratings are in jeopardy. CCC also submitted that Enbridge has effectively put itself into this temporary situation by flowing amounts to its parent during 2006 beyond what was approved by the Board. CCC noted that Union Gas has an equity level of 36% and that Enbridge's own witness, Dr. Carpenter, acknowledged that Union Gas is riskier than Enbridge. CCC noted that while it is acceptable for the Board to consider whether or not Ontario distributors should be subject to weather risk, this was not on the issues list in this proceeding. Had this been the case, parties, including Union Gas, may have filed evidence. It would be premature for the Board to make this determination in this case without the benefit of an appropriate forum for this issue to be aired.

IGUA argued that Enbridge's business risks have always been and remain low. Any recent changes in business risks facing Enbridge are immaterial and do not justify an equity ratio greater than 35%. IGUA argued that an equity ratio greater than 35% cannot be justified by comparing Enbridge to other utilities. Regulatory decisions of other tribunals do not assist Enbridge in satisfying the threshold requirement of objective and independent evidence that a material change in risk has occurred. Existence of weather risk cannot prompt an increase in Enbridge's equity ratio. The regulatory tools which should be used to respond to the weather risks Enbridge faces are the rate design measures and/or the removal of the weather risk from the Company through a deferral account as it is done by the British Columbia Public Utilities Commission. However, any consideration by the Board of a weather adjustment mechanism should take place in the context of a generic proceeding. With respect to

Enbridge's claims regarding the challenges in interest coverage and access to debt capital, IGUA argued that this is only temporary and will disappear as the Company's long term debt issues mature. IGUA termed Enbridge's proposal as a "base year stuffing" measure before the long-term incentive regulation is implemented. IGUA argued that Enbridge's actual normalized EBIT interest coverage ratio for the "stand alone" utility is more than adequate. IGUA particularly noted that the exclusion from normalized actual earnings of the sums paid by Enbridge to its parent and affiliates in excess of Board-approved amounts.

Energy Probe supported IGUA's arguments. It further noted that the Company is far from facing a crisis. The Company's proposal is in effect a request for costly insurance, to the tune of $9.5 million annually, which does not represent the least overall cost solution.

VECC submitted that Enbridge's problem of access to the MTN market is temporary and should be addressed by short-term solutions that provide access to needed capital until existing debt is retired. The best and least cost solutions according to VECC are either using commercial paper swapped into medium term debt or a medium term preferred share issue. Either one of these solutions would allow Enbridge to access capital on reasonable terms until its high coupon debt gets refunded over the next few years. Since 2008 is likely to be the first year of incentive regulation, establishment of a deferral account would allow Enbridge the opportunity to recover any prudently incurred incremental costs of maintaining access to the MTN market. In VECC's view, Board Staff's regulatory symmetry with Union Gas is not appropriate, since it does not take into account the fact that Enbridge has lower business risk than Union Gas, or that Union Gas' equity was the result of a negotiated settlement.

Board Findings

The Company's proposal for a thicker common equity in the deemed capital structure is grounded on business and financial risk considerations as well as its deemed common equity has fallen out of line with other Canadian utilities.

While the Board is of the view that Enbridge has presented credible evidence of a trend among Canadian regulators in finding thicker common equity for utilities, the Board does not generally find a comparison of Enbridge's common equity ratio with those in other jurisdictions to be necessarily determinative of the issue. An applicant must still satisfy the threshold requirement of independent evidence that material changes have occurred to justify a thicker common equity. Moreover, the hazard in doing so is that it engages issues of oversimplification and circularity, which downgrade the specificity that is required to make decisions pertaining to a particular utility. With those caveats, the Board nevertheless is mindful of the increasing trend and has factored this in its deliberations.

There is some value in considering evidence on the relative risk profile of the two large Ontario gas utilities. While Union's current 36% common equity was the result of a negotiated settlement, Enbridge's proposal for a 38% common equity level is materially higher than Union's, which is not consistent with the relative business risk profile of the two utilities. In fact, there was no dispute that Enbridge is a lower risk utility than Union Gas.

The Company claims that its business risk has increased over the last 10 to 15 years on several fronts. These are addressed below.

The Board agrees with parties who argued that the regulatory and legislative risks which Enbridge currently faces are not greater than they were last year or in prior years, at least not materially greater.

With respect to the risk of bypass noted by the Company, the Board is of the view that the Company has under-estimated the risk mitigation through the development and approval for rate options to specifically address the need of gas fired generators and mitigate any potential for bypass risk.

With respect to the claim by Enbridge that incentive regulation could lead to increased regulatory risk, Enbridge has operated under a performance based mechanism before. Moreover, the tenet behind an incentive regime is that the utility can reap the benefits of

newly found efficiencies and it is only upon rebasing that these efficiencies will be shared with or passed on to ratepayers. From these perspectives, an incentive rate reqime is not necessarily an arrangement that negatively affects the risk of the utility.

From the market reports that were filed in the proceeding, there is no evidence on balance that Enbridge no longer enjoys a reasonably stable legislative and regulatory environment.

Even if there was some recognition of increased business risk in the totality of the Company's arguments, this must be weighed against other positive considerations. For example, the Company's evidence indicates that customer growth continues to be strong and natural gas remains the predominant fuel of choice in Enbridge's franchise area. Enbridge's customer base is consistently growing year after year. The Board does not see this as indicative of increased business risk.

In the result, the Board finds that the evidence presented by Enbridge does not warrant an increase in the common equity thickness to 38% on account of increased business risk, but the evidence on the trend of common equity thickness suggests that the 35% level in existence since 1993 should be considered as a floor.

This leaves the Company's proposal to also be evaluated on the basis of its claimed inability to raise capital, at least on reasonable terms.

The Board accepts that decreases in interest rates in 2006 have impacted the Company's EBIT adversely as there is a lag between the reduction in ROE and reductions in the total debt interest liability. The warmer than normal weather in 2006 contributed to the impact on EBIT. To worsen matters, the Company has paid out considerably more to its affiliates than what was reflected in the Board's 2006 revenue requirement decision. Whether or not the Company will be able to raise long term debt in the 2007 test year will very much depend on weather and its overall performance going forward.

The Board accepts that there may not be a practical way to circumvent the interest rate covenants in the current trust indenture. To alter these covenants would require

agreement by current debt holders and this will likely come at a cost. To be clear, the Company is not suggesting that this would be a reasonable remedy. It is unfortunate that these covenants pose such a high restriction. The Board notes that the Company is considering ways by which the existing covenants may be replaced in the longer run. The Board encourages the Company to pursue this initiative.

The Board agrees with the many intervenors who argued that the problem is or may be temporary. On the assumption of a continuing low interest rate environment, as debt matures and is replaced the lower interest charges would provide some relief. If interest rates increase, the relief may be quicker. Relief may well even come from weather.

In any event, like many intervenors the Board is not convinced that the Company's proposed remedy to what is or may be a temporary problem represents the least cost solution. The common equity component of Enbridge's capital structure is and should be a matter that is reviewed infrequently. The Company's proposal to increase the common equity thickness from 35% to 38% carries an annual cost of about $10 million to ratepayers. In view of that substantial cost, the Board must consider other remedies.

In consideration of all of the above, and on balance, the Board finds an increase in the common equity thickness from 35% to 36% to be reasonable. While this finding should alleviate somewhat the financial pressure currently experienced by the Company, it alone might not fully address the immediacy of the problem, if the problem continues indeed to exist. The Company therefore might need to engage in financing alternatives other than issuing of long term debt in the shorter term. This may involve a number of market instruments that are available to the Company, if indeed the Company cannot issue long term debt when it needs it. The Company must also be more wary of the impact of excessive payments to its affiliates on EBIT.

The Company's evidence was that, in the period 1993 to 2006, the Company lost $107 million in EBIT due to warmer-than-forecast weather and that the average impact of weather in either direction on EBIT was $35 million, which is two times more than the $16.8 million currently reflected in rates according to the Company's evidence. The

Board is of the view that, given the large influence of weather on EBIT, this risk may need to be removed from the utility.

The Board recognizes that a move to removing weather risk from the Company is a decision that has implications for all regulated gas utilities regulated by the Board, and perhaps for electricity utilities as well. The Board considers this to be worthy of evaluation in the near future.