Reference: Section 3: Finance

Q. Volume 1, page 3-23. Newfoundland Power states *"The principal risks to which Newfoundland Power is exposed have not changed materially since 2018."* And at page 1-8 Newfoundland Power states *"Expert evidence filed with this Application indicates that Newfoundland Power has above-average business risk in comparison to other Canadian utilities."* Is Newfoundland Power of the opinion that it has above average business risk compared to other Canadian utilities? If the answer is yes, explain the basis for this opinion.

A. **A. Introduction**

Newfoundland Power's cost of capital is the rate of return investors could expect to earn if they invested in securities of equal risk. In regulatory practice, the opportunity cost of capital is integral to the concept of a fair return. For this reason, cost of capital is a relative concept. The accepted relative measure for determining a business' cost of capital is risk.

The principal risks to which Newfoundland Power is exposed do not change materially over time. For example, forecast economic conditions in the Company's service territory are always a risk to be evaluated in determining its cost of capital. However, the degree of exposure related to each element of risk can change.

Newfoundland Power assesses changes in its business risks over time. The Company is of the opinion that its business risks increased at the time of filing its *2019/2020 General Rate Application,* and that risks have not materially changed since that time.

Newfoundland Power provides expert evidence assessing its business risk relative to other investor-owned utilities. The Company's cost of capital expert, Mr. James Coyne of Concentric Energy Advisors Inc., is of the opinion that Newfoundland Power has above average business risk relative to other Canadian investor-owned electric utilities.

B. Background

The Board has historically assessed Newfoundland Power to be an average risk Canadian utility.[1] The Company's capital structure has been part and parcel of that assessment.[2]

As part of its *2016/2017 General Rate Application*, Newfoundland Power filed evidence that its business risks had increased due to deterioration of the provincial economic

[1] See, for example, Order No. P.U. 19 (2003), page 33, where the Board indicated that the business risk profile of Newfoundland Power had not changed appreciably since 1998, and Order Nos. P.U. 43 (2009), page 13, and P.U. 13 (2013), page 17, where the Board found that Newfoundland Power continued to be an average risk Canadian utility.

[2] See, for example, Order No. P.U. 13 (2013), page 16 to page 17.

outlook and increased power supply risks resulting from the Muskrat Falls Project.[3] Expert evidence filed with the application determined that these risks had increased such that Newfoundland Power had become an above average risk Canadian utility.[4]

At that time, the Board found that Newfoundland Power continued to be an average risk utility.[5] The Board maintained the Company's 45% common equity ratio for ratemaking purposes, in part, due to uncertainty associated with the Muskrat Falls Project and the economic outlook for the province.[6]

As part of its *2019/2020 General Rate Application,* Newfoundland Power observed certain business risks had become more pronounced since its last application. The provincial economic outlook had further deteriorated, energy sales had declined, and costs related to the Muskrat Falls Project had increased.[7] Expert evidence filed with the application determined that the Company remained an above average risk utility.[8]

Newfoundland Power's capital structure formed part of the settlement agreement reached in relation to the Company's *2019/2020 General Rate Application*.[9] In Order No. P.U. 2 (2019), the Board maintained the Company's 45% common equity ratio for ratemaking purposes. In making its decision, the Board noted Newfoundland Power's capital structure is recognized by credit rating agencies as a strength, which positively impacts the Company's creditworthiness.[10]

C. Current Assessment of Business Risks

Newfoundland Power's Assessment

Newfoundland Power's *2022/2023 General Rate Application* includes an assessment of how the Company's business risks have changed since its last general rate application. The principal factors considered in this assessment are:

(i) Continued deterioration of the provincial economic outlook. Economic risks observed as part of the *2019/2020 General Rate Application* have persisted. Newfoundland and Labrador continues to lag behind the rest of Canada across

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3 See the *2016/2017 General Rate Application, Volume 1, Application and Company Evidence, Section 4.3.2: Risk Assessment,* page 4-23 *et seq.*
4 See the *2016/2017 General Rate Application, Volume 3, Expert Evidence and Studies, Tab 1, Cost of Capital, Appendix A,* page 24.
5 See Order No. P.U. 18 (2016), page 19.
6 Ibid., page 25.
7 See Newfoundland Power's *2019/2020 General Rate Application, Volume 1, Company Evidence, Section 3.3.2 2018 Risk Assessment,* page 3-20 *et seq.*
8 See the *2019/2020 General Rate Application, Volume 3, Expert Evidence, Tab 1, Cost of Capital,* page 63.
9 See Order No. P.U. 2 (2019), page 12.
10 Ibid.

key economic indicators, including GDP, labour force, household disposable income, and housing starts.[11]

(ii) Continued uncertainty with respect to Nalcor Energy's Muskrat Falls Project. The Provincial Government has taken steps to mitigate customer rate increases associated with the project. However, uncertainty remains regarding the recovery of Muskrat Falls Project costs and the requirement for additional investments to improve supply reliability.[12]

(iii) Other longstanding factors that continue to define the Company's risk profile. These factors include the Company's small size, service territory demographics, operating environment, regulatory mechanisms, and limited cost flexibility. The Board previously determined that a strong equity component is needed to mitigate the impact of the Company's relatively small size and low growth potential.[13]

Based on these factors, Newfoundland Power assessed that its business risks have not materially changed since its *2019/2020 General Rate Application.*

Expert Assessment

Newfoundland Power's *2022/2023 General Rate Application* includes an expert assessment of the Company's business risk relative to other Canadian investor-owned electric utilities. Mr. James Coyne of Concentric Energy Advisors Inc. compared the Company's business risk to 5 other investor-owned electric utilities in Canada.[14] Factors considered in this assessment include:

(i) Newfoundland Power's small size, dependence on one supplier, weaker macroeconomic and demographic trends in the province as compared to the remainder of Canada, and weather and storm related risks.

(ii) Newfoundland Power's higher power supply risk relative to other Canadian investor-owned electric utilities due to the cost of the Muskrat Falls Project, potential effects on customer demand, and uncertainty regarding reliability.

Based on his assessment, Mr. Coyne concluded that Newfoundland Power has above average business risk compared to other Canadian investor-owned electric utilities.[15]

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[11] See the *2022/2023 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Section 3: Finance,* page 3-23, Table 3-13.

[12] See response to Request for Information PUB-NP-037 for an assessment of risks related to the Muskrat Falls Project.

[13] See Order No. P.U. 19 (2003), page 45.

[14] The utilities included in the assessment are ATCO Electric, FortisAlberta, FortisBC Electric, Maritime Electric, and Nova Scotia Power. See the *2022/2023 General Rate Application, Volume 3, Expert Evidence,* page 68.

[15] Ibid., page 74.

D. Conclusion

Based on his assessment, Mr. Coyne concluded that the current common equity ratio of 45% is the minimum appropriate level for Newfoundland Power.[16] Mr. Coyne agrees with the Board's previous decisions approving the current common equity ratio of 45%. Mr. Coyne noted:

> *"Maintaining the Company's current equity ratio sends a signal to investors and rating agencies that Newfoundland and Labrador remains a supportive regulatory environment. This is particularly important amid fluctuating capital market conditions and economic and demographic trends in Newfoundland and Labrador that are among the weakest of any Canadian province."*[17]

Newfoundland Power determined that its risks have not materially changed since its last general rate application. The provincial economic outlook remains weak, the Muskrat Falls Project continues to pose a risk to the least-cost delivery of reliable service, and longstanding factors continue to define the Company's risk profile.

Based on this assessment, Newfoundland Power's opinion is that it is appropriate to maintain its 45% common equity ratio for ratemaking purposes.

Maintaining Newfoundland Power's common equity ratio of 45% in the current circumstances is consistent with the Board's findings in Order Nos. P.U. 18 (2016) and P.U. 2 (2019).

[16] Ibid., page 79.
[17] See response to Request for Information PUB-NP-088.