Reference: Volume 3, Cost of Capital Report by James Coyne

Q. Volume 3, Cost of Capital Report by James Coyne, page 79. Further to PUB-NP-029 in which Newfoundland Power provides information on its financial position at different common equity ratios and returns on equity than those proposed in the Application, provide Mr. Coyne's opinion why no common equity ratio other than 45% is appropriate given the credit metrics shown in the response to PUB-NP-029 at certain common equity ratios.

A. Credit metrics are not the only consideration for either debt or equity holders. For example, 40% of Moody's credit rating for regulated utilities depends on financial metrics, including capital structure, while 50% of Moody's rating is based on regulatory considerations such as the regulatory framework (25%) and the ability to recover costs and earn returns (25%). Similarly, DBRS considers Newfoundland Power's stable and supportive regulatory environment and strong financial profile as key credit strengths. Financial strength is important for regulated utilities at all times because these companies operate in a capital intensive industry and must have the ability to raise capital under a variety of economic and financial market conditions. Financial strength is particularly important when the market is under stress, such as what occurred in March and April 2020 when certain utility companies were unable to raise debt capital, while other utility companies paid a substantially higher credit spread over government bond yields to issue debt.

Higher leverage increases the financial risk of a Company, and equity investors require a higher return under those circumstances. The response to PUB-NP-029 indicates that a reduction in the Company's deemed equity ratio would lead to lower cash flow and interest coverage ratios. Rating agencies tend to have a less favorable view of a debt issuer when the credit metrics do not provide sufficient financial flexibility to withstand unforeseen circumstances, such as an economic recession. Further, as explained in the response to PUB-NP-088, the deemed equity ratio of 45% for Newfoundland Power is supported by Mr. Coyne's risk analysis, which demonstrates that the Company is an above average risk electric utility. The 45% equity ratio has also been an important factor that has enabled the Company to maintain its credit rating for many years.