Q. Further to the responses to CA-NP-086, CA-NP-222 and PUB-NP-120. As Newfoundland Power has never paid Fortis any issue costs for infusions of common equity, is the only reason to include 50 basis points for flotation costs and financial flexibility in the determination of the fair ROE the fact that there is regulatory precedent to do so?

A. No, regulatory precedent is not the only reason to include 50 basis points for flotation costs and financial flexibility in the determination of the fair ROE for Newfoundland Power. It is appropriate to allow regulated utilities to recover flotation costs through an adjustment to the authorized ROE. Dr. Roger Morin, a recognized expert in regulatory economics and finance, explains in his book New Regulatory Finance:

> *The costs of issuing these securities are just as real as operating and maintenance expenses or costs incurred to build utility plants, and fair regulatory treatment must permit recovery of these costs…. The simple fact of the matter is that common equity capital is not free….[Flotation costs] must be recovered through a rate of return adjustment.* [1]

According to Dr. Shannon Pratt, a published expert in cost of capital estimation:

> *Flotation costs occur when new issues of stock or debt are sold to the public. The firm usually incurs several kinds of flotation or transaction costs, which reduce the actual proceeds received by the firm. Some of these are direct out-of-pocket outlays, such as fees paid to underwriters, legal expenses, and prospectus preparation costs. Because of this reduction in proceeds, the firm's required returns on these proceeds equate to a higher return to compensate for the additional costs. Flotation costs can be accounted for either by amortizing the cost, thus reducing the cash flow to discount, or by incorporating the cost into the cost of capital. Because flotation costs are not typically applied to operating cash flow, one must incorporate them into the cost of capital.*[2]

Fortis Inc. issues common stock on behalf of its subsidiaries, including Newfoundland Power. In doing so, Fortis incurs issuance costs that reduce the amount of proceeds from the sale of common equity. Flotation costs are part of the invested costs of the utility, which are properly reflected on the balance sheet under "paid in capital." They are not current expenses, and, therefore, are not reflected on the income statement. Like investments in rate base or the issuance costs of long-term debt, flotation costs are incurred over time. As a result, the majority of a utility's flotation cost is incurred prior to the test year but remains part of the cost structure that exists during the test year and beyond. As such, these costs should be recovered through the authorized ROE. Newfoundland Power should be allowed to recover the issuance costs for common equity through the authorized ROE in the same way the Company includes costs associated with debt issuance.

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1 Roger A. Morin, New Regulatory Finance (Public Utility Reports, Inc., 2006), at 321.
2 Shannon P. Pratt, Cost of Capital Estimation and Applications, Second Edition, at 220-221.

With respect to financial flexibility, Canadian regulators have typically allowed regulated electric and gas utilities a sufficient authorized ROE so that companies have access to capital markets on reasonable terms under a variety of economic and capital market conditions. Many Canadian utility companies operate near the threshold for their credit ratings, because they are highly leveraged and do not generate sufficient cash flow to support their current rating. For that reason, Canadian regulators have adjusted the authorized ROE to provide additional financial flexibility so that utility companies have access to capital on reasonable terms and conditions.

Every province in Canada (except Manitoba and Saskatchewan for which no information is available) has accepted an adjustment for flotation costs and financing flexibility. The vast majority of these adjustments are 50 basis points, with only Quebec being somewhat lower at 30-40 basis points. The BCUC in its most recent decision elected to account for financial flexibility through an increase in the equity ratio. As explained in response to PUB-NP-120, the BCUC wrote "*the Panel finds that the appropriate way to account for required financial flexibility is to adjust the utility's capital structure*" and the BCUC adjusted FEI's equity ratio from 38.5 to 45.0 percent and FBC's equity ratio from 40.0 to 41.0 percent. In addition, the BCUC set the authorized ROEs for both utilities at 9.65 percent, representing increases from 8.75 percent (FEI) and 9.15 percent (FBC) in their prior cases.[3]

[3] BCUC Order G-236-23 at pp. 125, 134, 135.