Q. Can NP confirm that currently Fortis' common equity ratio is 38.50% and significantly less than NP's current regulated 45%. Further that since Fortis 2017 ROE was 8.30% is it the judgment of NP that Fortis has lower business risk than NP given that it has approximately the same ROE, but significantly more financial risk? Please discuss why or why not.

A. **A. General**

This Request for Information is asking about the common equity ratios, returns on equity and relative risk of Fortis Inc. ("Fortis") and Newfoundland Power.[1]

The question does not recognize (i) the differences between book vs. market returns and (ii) other well accepted issues relating to comparisons of Fortis and Newfoundland Power for the purpose of estimating Newfoundland Power's cost of capital.[2] Both of these matters are addressed below.

B. Book vs. Market Returns

The question infers that the return on equity for Fortis is lower than that of Newfoundland Power. This is not correct. In order to understand why, it is necessary to understand the difference between a *market* return on an investment in a security (the share price) and a return on *book* equity.

Newfoundland Power is entitled to the opportunity to earn a fair return. One element of the fair return is that it be commensurate with returns on investments of similar risk. In the determination of whether a return is commensurate with returns on investments of similar risk, the appropriate perspective is the *market* return on investments of similar risk. Market returns are consistent with the concept of opportunity cost.

The return on average *book* common shareholders' equity of Fortis for 2017 was 7.31%.[3] This book return is an accounting rate of return based upon book values as opposed to *market* returns. An investor in Fortis stock would receive a *market* return on its investment in the stock. The *market* return of Fortis stock is comprised of (i) the capital appreciation of the stock and (ii) the dividend yield. For 2017, the *market* return on equity for Fortis stock was approximately 15.1%.[4]

[1] Newfoundland Power can confirm that Fortis' common equity ratio at the end of 2017 was 36.4% and that 36.4% is lower than 45%. Refer to Fortis Inc.'s 2017 Annual Report included in response to Request for Information CA-NP-098, Attachment R, Page 136.

[2] Refer to Undertaking 11 filed as part of Newfoundland Power's *2010 General Rate Application*.

[3] Refer to Fortis Inc.'s 2017 Annual Report included in response to Request for Information CA-NP-098, Attachment R, Page 136.

[4] Share price appreciation was 11.2% for 2017 (share price appreciation of $4.65 / $41.46 = 11.2%, from a share price of $41.46 at the end of 2016 to $46.11 at the end of 2017). Dividend yield was 3.9% (dividends paid of $1.625 / $41.46). 11.2% + 3.9% = 15.1%. Refer to Fortis Inc.'s 2017 Annual Report included in response to Request for Information CA-NP-098, Attachment R, Page 136.

As a matter of North American regulatory practice, the return ultimately determined by the regulator to be just and reasonable is applied to a regulated utility's book equity. When the allowed return on a regulated utility's book equity is set, a market-derived cost of attracting capital (that is a market return) is converted to a fair return on equity.

In the case of Newfoundland Power, it is entitled to the opportunity to earn a just and reasonable return on its book equity commensurate with the *market* return on investments of comparable risk. If Fortis was to be considered a comparable company to Newfoundland Power, the required return, based upon the calculated market return, would be in excess of 15%. However, as indicated below, it is not appropriate to consider Fortis a comparable company to Newfoundland Power for the purpose of estimating a fair return.

C. Issues with Comparisons of Fortis and Newfoundland Power

Relative Risk
Fortis is an unregulated utility holding company which primarily holds interests in a regulated utilities operating in different jurisdictions, including five Canadian provinces, nine U.S. states and three Caribbean countries. Fortis also holds investments in unregulated energy infrastructure. This diversity affects comparisons of the relative riskiness of Fortis and Newfoundland Power from an investor perspective.

Circularity
For a regulated utility, returns are determined by a regulator. For this reason, estimating a regulated utility's return by reference to the utility itself is, to a large degree, a projection of what returns the regulator will allow. This exercise has an inevitable element of circularity.

Returns achieved by Fortis, to a large degree, reflect the returns allowed by regulators in Canada and the United States for its regulated utility subsidiaries, including Newfoundland Power. Inevitably, therefore, comparisons of Fortis to Newfoundland Power for the purposes of estimating a fair return will also have a degree of circularity.

For this reason, use of Fortis as a comparable company for the purposes of estimating a fair return for Newfoundland Power is conceptually problematic.

Credit Ratings
Fortis has lower credit ratings than most of its regulated utilities, including Newfoundland Power.[5] This is because Fortis' credit requirements are different than those of Newfoundland Power.

5 Refer to Fortis Inc.'s 2017 Annual Report included in response to Request for Information CA-NP-098, Attachment R, Page 41.

Fortis' regulated subsidiaries operate on a standalone basis and raise debt on a standalone basis. This permits them to fund the ongoing capital expenditure required to discharge the regulatory obligation to serve. As an unregulated utility holding company, Fortis is not required to fund a continuing obligation to serve customers as Newfoundland Power is.

Fortis' assets predominantly consist of interests in other companies. Fortis has very limited physical assets. It does not issue secured financing as it has no physical assets to secure. So, Fortis has never issued secured bonds or been subject to the same type of debt issue conditions such as the trust deed requirements that apply to Newfoundland Power. These differences affect the credit requirements of Fortis.

D. Conclusion

Mr. Coyne has been retained in this proceeding as an expert in the estimation of utilities' cost of capital. This includes a selection of Canadian, U.S. and North American proxy groups with companies comparable to Newfoundland Power with respect to business and financial risks. Please refer to *Volume 2, Expert Evidence, Cost of Capital, Section IV. Selection of Proxy Companies* page 22 for Mr. Coyne's evidence in this regard.