

1 **Q. Reference Evidence of Dr. Sean Cleary dated September 25, 2018**

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3 **Page 26-28: Dr. Cleary compared Newfoundland Power's credit metrics for**  
4 **2017-2018 to those of other utilities. The response to PUB-NP-034 includes pro**  
5 **forma credit metrics for 2019 and 2020 at various capital structures and ROEs.**  
6 **In Dr. Cleary's opinion would any of the metrics in the response to PUB-NP-**  
7 **034 be of concern for Newfoundland Power's credit rating?**  
8

9 **A.** None of the reported metrics in the response to PUB-NP-034 would cause Dr.  
10 Cleary concerns as NP's metrics would remain healthy and well within the range  
11 for their current DBRS and Moody's debt ratings according to the credit metric  
12 ranges used by DBRS and Moody's, which are listed in the response to PUB-CA-  
13 021.  
14

15 Table 2 reports Cash Flow Interest Coverage ratios that range from 3.7 to 4.1, which  
16 fall in the upper half of the Moody's range for a Baa rating for this metric. Similarly,  
17 Table 3 reports Cash Flow to Debt ratios that range from 16.2% to 17.8%, also in  
18 the upper half of the Baa range used by Moody's, and on the border line between  
19 the A (12.5% to 17.5%) and AA (above 17.5%) ranges used by DBRS. All of the  
20 reported cash flow to debt ratios also exceed the average for Canadian regulated  
21 distributors reported in Table 10 of Dr. Cleary's evidence. So nothing here concerns  
22 Dr. Cleary.  
23

24 Table 1 reports Pre-tax Interest Coverage ratios that range from 2.2 to 2.6, which  
25 fall comfortably in the upper part of the 1.8 to 2.8 range for A –rated low business  
26 risk firms according to DBRS. So Dr. Cleary would be comfortable with these  
27 metrics if the calculations are correct. However, Dr. Cleary has issues with NP's  
28 calculations of this ratio, which are different than those provided by DBRS. This  
29 difference is obvious if we examine the most recent (October 4, 2018) DBRS debt  
30 rating report for NP. The EBIT gross interest coverage ratios that DBRS reports for  
31 NP for 2015, 2016 and 2017 are 3.22, 3.03 and 2.96 respectively. However, NP  
32 reports Interest Coverage ratios of 2.3, 2.4 and 2.5 for 2015, 2016 and 2017  
33 respectively – 15-29% below the DBRS estimates. DBRS makes certain  
34 adjustments in calculating the ratios so it is difficult to pinpoint the exact difference,  
35 and minor differences would be expected, but not this large. In "Attachment A –  
36 PUB-CA-20 Worksheet.xls", Dr. Cleary calculates an Interest Coverage ratio of  
37 2.78 for NP for 2017 using the data provided by NP in Exhibit 3, and using the  
38 DBRS definition of that metric. While his estimate is slightly below the 2.96  
39 estimate of DBRS, it is much closer than the NP estimate. So, Dr. Cleary is skeptical

1 of the Interest Coverage ratios provided by NP, which seem to be consistently well  
2 below that calculated by DBRS.

3  
4 Similar to the metrics reported in Table 1, Dr. Cleary does not have concerns with  
5 those reported in Table 4, since they all exceed the required minimum of 2.0.  
6 However, Dr. Cleary has even greater concerns about the estimates of this metric  
7 provided by NP than he did for the estimates NP reported in Table 1. In particular,  
8 Footnote 13 (page 7) of NP's 2017 annual report states the following:  
9

10 *"The issuance of first mortgage sinking fund bonds is subject to an earnings*  
11 *covenant whereby the ratio of (i) annual earnings applicable to common*  
12 *shares, before bond interest and tax, to (ii) annual bond interest incurred*  
13 *plus annual bond interest to be incurred on the contemplated bond issue,*  
14 *must be two times or higher."*

15  
16 In "Attachment A – PUB-CA-020 Worksheet.xls," Dr. Cleary uses this definition  
17 and the data provided by NP in Exhibit 5 for 2020 (Proposed), which corresponds  
18 to a 9.5% ROE and a 45% equity ratio. He then calculates the ratio using four  
19 alternative definitions of interest, which is then added to both the numerator and  
20 denominator. These estimates range from 2.86 to 2.93, approximately 15-20%  
21 higher than the corresponding estimate of 2.48 provided by NP in Table 4. Finally,  
22 Dr. Cleary also provides an estimate for this ratio using the approach used by Grant  
23 Thornton as noted in the response to CA-PUB-003 during the 2016 proceedings. It  
24 is also well above NP's estimate of 2.48, sitting at 2.84.

25  
26 In short, Dr. Cleary is not concerned by any of the ratios reported in Tables 1-4 of  
27 NP's response to PUB-NP-034, but he does have serious concerns with the metric  
28 estimates provided by NP in Tables 1 and 4 of that response, and in Exhibits 3 and  
29 5 of their evidence. The reason for concern is that the reported metrics do not  
30 correspond to those provided by DBRS, or those that would be calculated using the  
31 specified equations. The response to PUB-CA-021 below provides further evidence  
32 suggesting the metrics provided in PUB-NP-034 are not a matter of major concern  
33 for alternative allowed ROEs (from 7.5% to 8.5%) and using an equity ratio of 40%.

Figures taken from NP Exhibit 3 (and Exhibit 5 for Proposed) page 1

Newfoundland Power	Exhibit 3 NP		Existing Figures		Exhibit 5	
	2017	2018E	2019E	2020E	2019Proposed	2020Proposed
Revenue	665681	656803	649504	650715	665068	669767
Purchased Power	440249	432443	430627	430644	429949	429144
Contribution	225432	224360	218877	220071	235119	240624
Other revenue	6283	6380	5584	5375	5612	5594
Operating expenses	59915	61620	64682	66571	62679	64610
Employee future benefit costs	17039	14029	9080	7566	9080	7566
Deferred Cost recoveries and amortization	-1032	-1032	0	0	649	-324
Depreciation	57487	59801	62314	64797	62350	64908
Finance charges*	<u>34894</u>	<u>35768</u>	<u>35948</u>	<u>37034</u>	<u>36232</u>	<u>37442</u>
	<u>168303</u>	<u>170186</u>	<u>172024</u>	<u>175968</u>	<u>170990</u>	<u>174202</u>
Earnings Before Income Taxes	63412	60554	52437	49478	69741	72016
Income taxes	<u>19424</u>	<u>18137</u>	<u>15814</u>	<u>14985</u>	<u>20320</u>	<u>21078</u>
Net Earnings	43988	42417	36623	34493	49421	50938
Preference share dividends	555	552	552	552	552	552
Net Earnings Applicable to Common Shares	43433	41865	36071	33941	48869	50386
Finance Charges breakdown according to Exhibit 3 page 7						
Interest on long-term debt	35013	35789	35374	37080	35374	37080
Other interest	659	715	1354	755	1662	1189
Amortization of bond issue expenses	234	232	224	219	224	219
AFUDC (Interest during construction - according to Table 14 on page 25 of Grant Thornton report)	-1025	-984	-1021	-1039	-1046	-1064
Total Finance charges	34881	35752	35931	37015	36214	37424
Note slight discrepancy from the numbers provided in page 1 of Exhibit 3 (and Exhibit 5) - I will use the numbers from page 7, since a breakdown is provided.						
	<u>2017</u>	<u>2018E</u>	<u>2019E</u>	<u>2020E</u>	<u>2019Proposed</u>	<u>2020Proposed</u>
EBITv1 (Approx = EBT+ Finance Charges)	98293	96306	88368	86493	105955	109440
EBITv2 (Approx = EBT+ Interest expenses only)	99084	97058	89165	87313	106777	110285
EBITv3 (Approx = EBT+ Interest expenses + Bond issue amortizations only)	99318	97290	89389	87532	107001	110504
	<u>2017</u>	<u>2018E</u>	<u>2019E</u>	<u>2020E</u>	<u>2019Proposed</u>	<u>2020Proposed</u>
Net Earnings (from page 4 of Exhibit 3 (and 5)) slight difference from page 1 of Exhibit 3 - not sure why...	41526	40132	34483	32272	47282	48716
CFO Pre-WC (from page 4 of Exhibit 3 and 5)	110112	110899	101919	103473	114515	120170
CFO Total (from page 4 of Exhibit 3 and 5)	109968	98155	106742	103186	118613	116647
Debt (average) - page 6 of Exhibit 3 and 5	586726	609381	623801	637582	623660	640297
Common Equity (average) - page 6 of Exhibit 3 and 5	486557	494517	512346	526936	514206	530413
Preferred shares (average) - page 6 of Exhibit 3 and 5	8924	8917	8917	8917	8917	8917
	1082207	1112815	1145064	1173435	1146783	1179627
Deferred Income Taxes from page 3 of Exhibit 3 and 5	157935	155920	156550	155922	156427	155961
Common Share Dividends from page 2 of Exhibit 3 and 5	38419	27246	12384	25594	21466	42520
Payout ratio (common shares) - calculate using NI avail to CS (from cell C20)	0.8846	0.6508	0.3433	0.7541	0.4393	0.8439
Moody's Metrics - calculated						
	<u>2017</u>	<u>2018E</u>	<u>2019E</u>	<u>2020E</u>	<u>2019Proposed</u>	<u>2020Proposed</u>
(CFO pre-WC + Interest)/Interest	4.0868	4.0380	3.7750	3.7348	4.0920	4.1401
CFO pre-WC/Debt	0.1877	0.1820	0.1634	0.1623	0.1836	0.1877
(CFO pre-WC - Dividends) /Debt	0.1222	0.1373	0.1435	0.1221	0.1492	0.1213
Debt/Capitalization (where Cap includes Deferred taxes)	0.4731	0.4803	0.4793	0.4796	0.4786	0.4794
	ROE	ROE	ROE			
	7.50%	8.00%	8.50%			
DBRS Metrics - calculated						
	<u>2017</u>	<u>2018E</u>	<u>2019E</u>	<u>2020E</u>	<u>2019Proposed</u>	<u>2020Proposed</u>
Cash flow to debt	0.1877	0.1820	0.1634	0.1623	0.1836	0.1877
Debt to Capital	0.5422	0.5476	0.5448	0.5433	0.5438	0.5428
EBIT to Interest	2.7842	2.6652	2.4338	2.3135	2.8891	2.8876
Earnings Test (page 22 Annual Report 2017 = (EACS + Bond Interest + Taxes)/(Bond Interest + accrued new Bond Interest)						
	<u>2017</u>	<u>2018E</u>	<u>2019E</u>	<u>2020E</u>	<u>2019Proposed</u>	<u>2020Proposed</u>
Earnings Test Calculations (using LT interest only)	2.80	2.68	2.47	2.32	2.96	2.93
Earnings Test Calculations (using LT interest + Other interest only)	2.76	2.64	2.41	2.29	2.87	2.87
Earnings Test Calculations (using LT interest + Other interest + Bond Amortiz. only)	2.75	2.63	2.40	2.29	2.86	2.86
Earnings Test Calculations (using Total Finance Charges)	2.80	2.68	2.44	2.32	2.91	2.91
Earnings Test Calculations (using approach in CA-PUB-004 during 2016 proceedings)	2.74	2.62	2.39	2.27	2.84	2.84
where EBIT = EBT + LT interest + Interest during construction + Other Interest + Amortization of Debt discount expense and Interest = LT interest + Other Interest + Amortization of Debt discount expense						