Reference: Section 3: Finance

Q. Provide the reduction in the proposed 2022 and 2023 revenue requirement and the impact on customer rates if the current approved rate of return on equity of 8.5% is maintained for 2022 and 2023 and the equity component in the capital structure is reduced to (1) 43% and (2) 40% with no other change from the proposals in the Application.

A. Table 1 provides *pro forma* impacts on proposed 2022 and 2023 revenue requirements and customer rates if the common equity component of Newfoundland Power's capital structure was reduced to 43% and 40%.[1] To isolate the impact of this reduction, the figures in Table 1 assume that proposed 2022 and 2023 revenue requirements are already reduced to reflect a rate of return on equity ("ROE") of 8.50% as outlined in response to Request for Information PUB-NP-032.[2]

Table 1:
***Pro Forma* 2022 and 2023 Revenue Requirement and Customer Rate Impacts**
Capital Structure at 43% and 40%

Capital Structure (%)	2022 PF ($millions)	2023 PF ($millions)	Customer Rates (%)
43.0	(0.8)	(1.9)	(0.3)
40.0	(2.2)	(4.8)	(0.7)

The *pro forma* impacts outlined in Table 1 are practically limited. There are a number of related effects on the Company's overall cost of capital that need to be considered when assessing a reduction in Newfoundland Power's common equity ratio. While these impacts are uncertain and complex, it is expected that revenue requirements would increase in each case as outlined below. None of these increases are reflected in Table 1.

(i) *Increases in cost of debt in the short-term.*

The estimates in Table 1 are based on Newfoundland Power's current financial position and existing credit ratings.

[1] Assumes a phased-in approach to reach the targeted capital structure of 43.0% and 40.0% by 2023. In each scenario, the target capital structure is reduced in 2022. This results in an average common equity for 2022 of approximately 44% and 42.5% in the respective scenarios. The average capital structure for each scenario of 43% and 40% is then achieved in 2023.

[2] As shown in response to Request for Information PUB-NP-032, maintaining the Company's existing ROE at 8.50% would reduce the 2022 and 2023 proposed revenue requirement by $9.0 million and $11.6 million, respectively, and would reduce proposed customer rates by approximately 1.6%.

If the Board were to order a reduction in the Company's common equity ratio, it would practically require Newfoundland Power to refinance its business to reflect the reduced common equity.

This refinancing would include the payment of a common share dividend equal to the difference between 45% and the reduced common equity ratio. At common equity ratios of 43% and 40%, the common share dividend would be approximately $25 million and $65 million, respectively. It would also include the issuance of long-term debt to fund the dividend.

A reduction in the Company's common equity ratio and additional debt financing would have a number of consequences. Newfoundland Power's financial risk would increase. The Company's credit metrics, which include the equity ratio, would decrease.[3] In addition, such an order of the Board could result in a re-evaluation of regulatory support by credit rating agencies.[4]

If Newfoundland Power's credit ratings were downgraded, it would increase the Company's cost of borrowing for both its day-to-day operations and its long-term investments.[5]

Higher costs of debt cost associated with Newfoundland Power's short-term credit facility and its 2022 debt issue would increase revenue required from customer rates.

(ii) Increases in cost of equity in the short-term.

Any reduction in the Company's equity ratio, which would increase its financial risk, would require consideration of an increased ROE when applying the fair return standard. The Board has acknowledged that a fair return cannot be determined independently of a utility's capital structure.[6]

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[3] See responses to Requests for Information PUB-NP-029 and PUB-NP-031 for *pro forma* credit metrics and earnings test interest coverage calculations that include the scenarios in this Request for Information.

[4] See response to Request for Information PUB-NP-030 for further information regarding the Company's creditworthiness and ability to maintain a sound credit rating.

[5] For example, under the Company's $100 million credit facility, a one-notch downgrade in credit rating would result in a 20 basis points increase in the acceptance fee and a 4 basis points increase in the standby fee. Additionally, a lower credit rating would also result in an increase in corporate credit spreads applicable to new issuances of First Mortgage Bonds.

[6] See Order No. P.U. 18 (2016), page 11, lines 4-5.

Balancing the effects of changes in capital structure and ROE has also been recognized by the Newfoundland and Labrador Court of Appeal:

> *"[131] It is too simplistic, however, to say that in all cases, the higher debt equity ratio, the lower will be the overall costs of capital. As deGrandpré[89] points out: It is often argued that if utilities increased their debt ratio, their cost of capital would be reduced since the cost of debt is less than the cost of equity. This may be true, but then the rate of return would have to be increased under the risk factor since the interest has to be paid before dividends and the investor might find himself deprived of dividends because of insufficient earnings. The debt equity ratio can, therefore, have a complicated effect."*[7]

For illustrative purposes, if Newfoundland Power's ROE was increased by 50 basis points in conjunction with a reduction in the Company's equity ratio, its 2022 and 2023 revenue requirements would increase by approximately $2 million and $4 million, respectively.

In this example, the higher revenue required from customer rates would largely offset the pro *forma* reduction in 2022 and 2023 revenue requirements in the scenarios shown in Table 1.[8]

(iii) *Increases in overall cost of capital in the long-term.*

The long-term cost of debt and equity are fundamentally based on an entity's capital structure. In addition to the short-term effects on both the Company's cost of debt and cost of equity outlined above, costs over the long-term could also increase.

The uncertainty of the long-term effects of changing an entity's capital structure has been recognized by the Newfoundland and Labrador Court of Appeal:

> *"[135] In approaching these questions, it has to be remembered that there is no such thing as one ideal capital structure. It is a function of economic conditions, business risks and "largely a matter of business judgment." Furthermore, a given capital structure cannot be changed easily or quickly. As well, the long-term effects of changes on capital structure on the enterprise and on the future cost of capital may not be easily predictable."*[9]

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7 See *The Stated Case*, June 15, 1998, Newfoundland and Labrador Court of Appeal, paragraph 131.

8 For example, in 2023, the approximate $4 million increase in revenue requirement is double the impact of the $1.9 decrease in revenue requirement million in the 43% scenario and is approximately 80% of the $4.8 million decrease in revenue requirement in the 40% scenario.

9 See *The Stated Case*, June 15, 1998, Newfoundland and Labrador Court of Appeal, paragraph 135.

Due to the uncertain and complex nature of possible long-term effects, Newfoundland Power cannot practically determine what effect a change in capital structure would have on the Company's future cost of capital and future customer rates.