

1 **Reference: Section 3: Finance**  
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3 **Q. Volume 1, page 3-45. Is it Newfoundland Power’s position that the current state of**  
4 **the financial market, specifically the low Canada bond yields, is the only reason for**  
5 **the proposed continued suspension of the automatic adjustment formula?**  
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7 A. Suspension of the Automatic Adjustment Formula (the “Formula”) was most recently  
8 approved by the Board in Order No. P.U. 2 (2019). In this order, the Board indicated that  
9 it was satisfied, based on the evidence, that continued suspension of the Formula was  
10 appropriate.<sup>1</sup>  
11

12 The Board first suspended use of the Formula in April 2013 following Newfoundland  
13 Power’s *2013/2014 General Rate Application*. In suspending use of the Formula for  
14 Newfoundland Power, the Board concluded in Order No. P.U. 13 (2013) that:  
15

16 *“While the Board continues to see the value of an automatic adjustment*  
17 *formula, the evidence is clear that the formula as it is currently structured*  
18 *may not result in a fair return for Newfoundland Power in the current*  
19 *circumstances. Long-term Canada bond yields are abnormally low which*  
20 *is particularly problematic in the operation of the automatic adjustment*  
21 *formula. In the absence of a clear relationship between the long-term*  
22 *Canada bond yield and the cost of equity it is difficult to see that the*  
23 *established return can be appropriately adjusted for 2015 without the*  
24 *exercise of further judgement.”*<sup>2</sup>  
25

26 The use of the Formula to establish a fair return on equity for Newfoundland Power  
27 continues to be problematic. This is due to low and volatile long Canada bond yields,  
28 which serve as a proxy for the risk-free rate used in the Formula.<sup>3</sup>  
29

30 The operation of the Formula continues to produce estimates of Newfoundland Power’s  
31 return on equity that are inconsistent with the fair return standard.<sup>4</sup> For example, if the  
32 Formula had been reinstated following Newfoundland Power’s *2019/2020 General Rate*  
33 *Application*, it would have resulted in a 2021 return on equity for Newfoundland Power  
34 of 7.21%.<sup>5</sup> This is materially lower than the 8.50% ratemaking return on common equity  
35 approved by the Board in Order No. P.U. 2 (2019).<sup>6</sup> It is also materially lower than the

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<sup>1</sup> See Order No. P.U. 2 (2019), page 15, lines 22-24.

<sup>2</sup> See Order No. P.U. 13 (2013), page 36, lines 38-44.

<sup>3</sup> For example, on March 9, 2020, at the onset of the COVID-19 pandemic, the 30-year long Canada bond yield reached a historic low of 0.71%. See the *2022/2023 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Section 3.3.4: Automatic Adjustment Formula*, Figure 3-5, page 3-44.

<sup>4</sup> To be considered fair, the Board requires that a regulated utility’s return be: (i) commensurate with return on investments of similar risk; (ii) sufficient to assure financial integrity; and (iii) sufficient to attract necessary capital.

<sup>5</sup> Attachment A provides the Company’s Automatic Adjustment Formula *Pro Forma* 2021 cost of equity.

<sup>6</sup> See Order No. P.U. 2 (2019), page 13, lines 15-18.

1           2021 ratemaking return on equity allowed for all other Canadian investor-owned electric  
2           utilities.<sup>7</sup>  
3  
4           The challenges inherent in using a formulaic basis to derive a return on equity have been  
5           recognized throughout other Canadian jurisdictions.<sup>8</sup> The consensus that existed at the  
6           time of the Board’s adoption of the Formula in 1998 does not exist today. In  
7           Newfoundland Power’s view, the current lack of consensus illustrates the difficulties in  
8           crafting a formula that can be expected to yield a fair result based upon current long  
9           Canada bond yields. Part of this difficulty is likely attributable to increased complexity.  
10          Part is also likely due to the inherent limitations of formula-based approaches.

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<sup>7</sup> See the *2022/2023 General Rate Application, Volume 3, Expert Evidence: Cost of Capital: Mr. James Coyne, Concentric Energy Advisors Inc.*, Figure 29: Allowed Electric ROEs, page 50.

<sup>8</sup> Most Canadian jurisdictions have abandoned use of a formulaic basis to determine returns on equity. See the *2022/2023 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Section 3.3.4: Automatic Adjustment Formula*, page 3-46, footnote 122.

**Automatic Adjustment Formula**  
***Pro Forma* 2021 Cost of Equity**

**Newfoundland Power Inc.**

**Automatic Adjustment Formula  
Pro Forma 2021 Cost of Equity**

3-Month Forecast of 10-year Government of Canada Bond Yield <sup>1</sup>	0.80%	A
12-Month Forecast of 10-year Government of Canada Bond Yield <sup>1</sup>	1.00%	B
Average 10-year Government of Canada Bond Yield	<u>0.90%</u>	C = (A + B)/2
 Add: Average Observed Spread between 10-year and 30-year Government Bonds <sup>2</sup>	 0.59%	 D
 Forecast Long Canada Bond Yield	 1.49%	 E = C + D
Long Canada Bond Yield <sup>3</sup>	3.10%	F
Change in Long Canada Bond Yield	<u>-1.61%</u>	G = E - F
Change in Forecast Cost of Equity <sup>4</sup>	-1.29%	H = G x 0.8
 Cost of Equity: Order No. P.U. 2 (2019)	 8.50%	 I
Change in Cost of Equity	<u>-1.29%</u>	H
2021 Forecast Cost of Equity	<u><u>7.21%</u></u>	J = I + H

<sup>1</sup> Yields are those reported in the *November 2020 Consensus Forecasts*.

<sup>2</sup> Average observed spread for all trading days in October 2020 between 10-year and 30-year Government of Canada Bonds as reported on the Bank of Canada website.

<sup>3</sup> Average forecast 30-year Government Bond Yield for 2019 and 2020 based on *April 2018 Consensus Long Term Forecast* and average observed spread between 10-year and 30-year Government Bonds in March 2018 as reported on the Bank of Canada website.

<sup>4</sup> Reflects an adjustment in the total risk premium by a factor of 0.20 as required by Orders No. P.U. 16 and 36 (1998-99).