Q. Further to the response to PUB-NP-030, rates of return on equity (ROE) ranging from 8.5% to 9.80% with common equity ratios of 45%, 44%, 43% and 42% all generate cash flow to debt coverage within the range the response states at page 3, line 5-11 that Moody's expects. At lines 27-28 on page 3 Newfoundland Power states that "reducing the 45% common equity ratio represents a risk to maintaining its existing credit ratings". Given the credit metrics shown in PUB-NP-029 at the existing 8.5% ROE and higher ROEs with common equity ratios of 44%, 43% and 42% as well as the existing 45%, explain what, in Newfoundland Power's view, is the degree of risk that would arise for maintaining its credit rating if the common equity ratio is reduced slightly to say 43% and the existing approved ROE of 8.5% is maintained for setting rates based on the 2023 test year.

A.

A. Introduction

Newfoundland Power maintains investment grade credit ratings from Moody's Investors Service ("Moody's") and DBRS Limited ("DBRS"). The Company's existing credit ratings contribute to its ability to access capital markets on reasonable terms.

Newfoundland Power's credit ratings are underpinned by its supportive regulatory environment and its stable financial performance. The Company's capital structure, which includes a 45% common equity component, is fundamental to both an assessment of the Company's regulatory support and its financial performance.

In Newfoundland Power's view, even a slight reduction in its 45% common equity ratio would pose a reasonably high degree of risk to the Company's existing credit ratings. This includes the illustrative scenario of a reduction in common equity to 43% while maintaining the existing ROE of 8.5%. The degree of risk reflects the broad extent to which Newfoundland Power's capital structure affects the factors considered by credit rating agencies in determining the Company's credit ratings.

B. Assessment of Risk to Credit Rating

Credit rating agencies apply both qualitative and quantitative considerations in their rating assessments. Qualitative considerations include the predictability of Board orders, allowed returns, and the timeliness of cost recovery. Quantitative considerations are the mathematical calculation of credit metrics.

Moody's provides a rating methodology that clearly defines the weight applied to qualitative and quantitative considerations. While DBRS considers factors similar to Moody's, its methodology is less structured. Accordingly, to assess the degree of risk in maintaining the Company's credit rating, Newfoundland Power analyzed the illustrative scenario using Moody's rating methodology.[1]

[1] See the *2022/2023 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Exhibit 4, Moody's*, page 8.

Table 1 provides Moody's rating methodology for regulated electric and gas utilities, including Newfoundland Power.[2]

Table 1:
Moody's Rating Methodology

Factor 1: Regulatory Framework (25%)

a) Legislative and Judicial Underpinnings of the Regulatory Framework
b) Consistency and Predictability of Regulation

Factor 2: Ability to Recover Costs and Earn Returns (25%)

a) Timeliness of Recovery of Operating and Capital Costs
b) Sufficiency of Rates and Returns

Factor 3: Diversification (10%)

a) Market Position
b) Generation and Fuel Diversity

Factor 4: Financial Strength (40%)

a) CFO pre-WC + Interest / Interest
b) CFO pre-WC / Debt
c) CFO pre-WC – Dividends / Debt
d) Debt / Capitalization

In Newfoundland Power's view, there are 3 factors that could be reassessed by Moody's if the Company's common equity ratio was reduced to 43% and its ROE was maintained at 8.5%. These are:

(i) Regulatory Framework

The illustrative scenario could result in a reassessment of the consistency and predictability of regulation for Newfoundland Power. This qualitative consideration accounts for 12.5% of Moody's rating methodology.

Newfoundland Power's 45% capital structure has not changed in over 2 decades. The Board's view of the appropriateness of the Company's longstanding capital structure has remained consistent since it was first approved in 1996.

[2] See response to Request for Information CA-NP-095, Attachment A, page 4 of 51, for Moody's rating methodology, including the weighting of each sub-factor.

The Board has reviewed and maintained the Company's capital structure in each general rate application since that time.[3] Most recently, in Order No. P.U. 2 (2019) the Board observed:

> *"In terms of capital structure, the Board has accepted a capital structure of 45% equity for rate setting for Newfoundland Power since 1996. Newfoundland Power's capital structure is recognized by credit rating agencies as a strength, which positively impacts its credit worthiness."*[4]

Newfoundland Power has maintained reasonably consistent credit ratings since 1996. DBRS has maintained its 'A' bond rating for Newfoundland Power since 1996 and Moody's has maintained its 'A2' bond rating since 2009.[5] The 45% common equity ratio has supported these ratings and is considered a credit strength by both rating agencies. For example, in its most recent rating report for Newfoundland Power, Moody's states:

> *"We view the Newfoundland and Labrador Board of Commissioners of Public Utilities (PUB) as one of the more supportive regulators in Canada because regulatory decisions are timely and balanced, deferral accounts reduce risks from factors beyond management's control and NPI's 45% equity capital is among the highest authorized levels in Canada."*[6]

A reduction in Newfoundland Power's common equity ratio could be viewed by rating agencies as a departure from past orders of the Board, particularly in light of current credit challenges associated with the Muskrat Falls Project.[7] In the Company's view, this could result in a reassessment of the consistency and predictability of the regulation of the Company.

(ii) Ability to Recover Costs and Earn Returns

The illustrative scenario could result in a reassessment of the sufficiency of Newfoundland Power's rates and returns. This qualitative consideration accounts for 12.5% of Moody's rating methodology.

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3 Newfoundland Power's capital structure has been reviewed and maintained by the Board following 7 general rate applications since 1996. See Order Nos. P.U. 7 (1996-97), P.U. 19 (2003), P.U. 32 (2007), P.U. 43 (2009), P.U. 13 (2013), P.U. 18 (2016), and P.U. 2 (2019).

4 See Order No. P.U. 2 (2019), page 12, lines 20-22.

5 See response to Request for Information CA-NP-167 for Newfoundland Power's bond ratings since 1990. Moody's has rated the Company since 2005.

6 See the *2022/2023 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Exhibit 4, Moody's*, page 1.

7 Credit challenges noted by Moody's in its most recent report for Newfoundland Power include upward pressure on rates due to the Muskrat Falls Project and increased risks of delayed cost recovery upon completion of the project. See the *2022/2023 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Exhibit 4, Moody's,* page 2.

As part of this consideration, Moody's examines outcomes of general rate applications as compared to the utility's proposals, prior applications of the utility, and recent decisions for a peer group of utilities.[8]

The Board has acknowledged that a fair return cannot be determined independently of a utility's capital structure.[9] Any reduction in the Company's common equity ratio would require consideration of an increased ROE when applying the Fair Return Standard.[10] In Newfoundland Power's view, the illustrative scenario of a reduction in common equity ratio, while maintaining the existing ROE, could result in a reassessment of the sufficiency of its rates and returns.

(iii) Financial Strength

The illustrative scenario could result in a reassessment of Newfoundland Power's financial strength. This quantitative consideration encompasses the Company's credit metrics and accounts for 40% of Moody's rating methodology.

According to Moody's:

> *"Financial strength, including the ability to service debt and provide a return to shareholders, is necessary for a utility to attract capital at a reasonable cost in order to invest in its generation, transmission and distribution assets, so that the utility can fulfill its service obligations at a reasonable cost to rate-payers."*[11]

Moody's methodology for assessing financial strength includes 4 credit metrics, one of which is the debt to capitalization ratio. The other 3 credit metrics relate to cash flows and interest coverage. Newfoundland Power's approved capital structure has a direct impact on the Company's ability to generate cash flows sufficient to service its debt obligations.

A reduction in the Company's common equity ratio would reduce the debt to capitalization credit metric. It would also decrease each of the 3 cash flow and interest coverage metrics. In Newfoundland Power's view, a reduction in its common equity ratio could result in a reassessment of the Company's financial strength and related credit metrics.

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8 See response to Request for Information CA-NP-095, Attachment A, page 13 of 51.
9 See Order No. P.U. 18 (2016), page 11, lines 4-5.
10 See, for example, response to Request for Information CA-NP-202.
11 See response to Request for Information CA-NP-095, Attachment A, page 20 of 51.

C. Conclusion

Determining credit ratings involves the exercise of judgment on the part of rating agencies using a combination of qualitative and quantitative factors. The Company cannot predict precisely how rating agencies would assess a reduction in its common equity ratio, including the illustrative scenario.

However, based on Newfoundland Power's assessment of Moody's rating methodology, the illustrative scenario could affect factors with a combined weight of 65% in determining the Company's credit rating. This demonstrates the broad extent to which Newfoundland Power's capital structure affects its creditworthiness and indicates that the illustrative scenario would pose a reasonably high degree of risk to maintaining the Company's credit ratings.

If Newfoundland Power's credit ratings were downgraded, it would increase the Company's cost of borrowing in the short term.[12] It is uncertain what impact changing the Company's capital structure could have on its overall cost of capital in the longer term.[13]

Newfoundland Power is proposing that its existing capital structure be maintained, including its 45% common equity ratio. Maintaining the Company's capital structure will support its creditworthiness and its ability to access capital markets on reasonable terms. The proposal to maintain Newfoundland Power's capital structure is supported by an assessment of its current business risk, including a comparison of its business risks to peer utilities. For further information, including an expert assessment of the Company's capital structure, see response to Request for Information PUB-NP-035.

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[12] See response to Request for Information PUB-NP-033.
[13] See *The Stated Case*, June 15, 1998, Newfoundland and Labrador Court of Appeal, paragraph 135.