

1 **Volume 2: Cost of Capital: Expert Opinion of James Coyne-Return on Equity**

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3 **Q. With reference to capital structure and ROE (page 7) please confirm that C&T is**
4 **aware of the following passage from the Supreme Court of Newfoundland and**
5 **Labrador Court of Appeal (1998) that dealt with Section 101 of the Public Utilities**
6 **Act.**
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[137] An alternative to actual intrusion into the utility's financial affairs in the form of a direction as to how the enterprise should be structured is for the regulator, for the purpose of setting rates, to base its estimates of the cost of capital on a hypothetical appropriate capital structure, thereby disregarding the utility's actual capitalization [see footnote 94]. The justification for this approach is given by Phillips who, citing other authors, states:

"Locklin has argued that most commissions 'disregard actual capital structures and set up an ideal or normal structure for the purpose. To do otherwise would burden the public with the higher costs of obtaining capital that result from a capital structure that is something less than ideal, and may, in fact, be quite unsound'. And Rose argues: 'When a commission in determining cost of capital disregards the actual capital structure or a capital structure proposed by management it is no more invading the domain of management than when it disregards unreasonable expenses for labor, fuel, or other productive factors in prescribing rates'." [see footnote 95]

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10 **A.** Mr. Coyne and Mr. Trogonoski have not previously encountered this 1998 Court of
11 Appeal, nor are they lawyers. We are unsure of the point being made in the question, but
12 a more complete picture of the Court's 67 page opinion continues in para 137 highlighted
13 in the question, where the Court goes on to express:

It appears, however, that actual capitalization has also been used as a basis [see footnote 96]. Nevertheless, the arguments in favour of the ability of the Board to disregard the actual capital structure in an appropriate case and base its determinations upon a hypothetical structure are convincing. Indeed, this has occurred in Canada [see footnote 97]. Without such a power, the Board would not be able effectively to fulfil its mandate of promoting the delivery of reliable service to consumers at the lowest possible cost and at the same time maintaining a sound credit rating for the utility in the financial markets of the world. Having said that, in exercising that power, it goes without saying that the Board ought to have a healthy respect for managerial judgment [see footnote 98] in such matters since if a hypothetical capital structure is used that is too far off the mark of the actual structure, it may in practical terms make the utility unable to meet its actual commitments, thereby threatening its credit standing and possibly affecting service to customers.

14 On this matter, the Court further concludes (in para 141):

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16 *It does not, however, permit the Board to direct the utility to raise money in a*
17 *particular way or to maintain a particular debt-equity ratio. In other words, it cannot*

1 *be used as a springboard for an aggressive intrusion into the day to day financial and*
2 *managerial decision making of the utility with respect to the capital structure of the*
3 *enterprise. Nor can the general policies underlying the legislation justify such a*
4 *power. As indicated, financing is undertaken for considerations that are not*
5 *necessarily directly related to utility regulation. Furthermore, it has also been noted*
6 *that, within the regulatory context, the utility is still subject to business risks and the*
7 *effects of management decisions and the utility, other things being equal, ought to*
8 *have the power to respond to that zone of risk. To that extent, the utility must be able*
9 *to make financial decisions related to the overall health of the enterprise for reasons*
10 *other than strictly regulatory ones, provided that in so doing it does not trespass on*
11 *the objectives and policies of the legislation.*¹

¹ Supreme Court of Newfoundland and Labrador, Court of Appeal Section 101 of the Public Utilities Act (Newfoundland) (Re) Date: 1998-06-15.