Q. Further to PUB-CA-014, if the Board decides to increase the equity component in the capital structure for Newfoundland Power to higher than 45% to a % within the range of 46% - 50%, how would this increase influence the determination of the approved ROE and how, in Dr. Booth's opinion would such an approach be perceived by the financial markets?

A. Normally Dr. Booth would not find this acceptable, since NP would be an outlier in any comparative tables of allowed ROEs and common equity ratios. Even with asterisks to indicate special considerations, such a table, for example, could be used to inflate average common equity ratios allowed by Canadian regulators. However, the following is a broad analysis of the current situation and two alternatives: reducing the common equity ratio to 40% with the current allowed ROE, and increasing the equity ratio to 50% with a restriction that Fortis earns the same net income on rate base. In all cases Dr. Booth assumes the same embedded debt cost of 5.1% with a 30.5% corporate tax rate.

With the current situation, 55% debt at a cost of 5.1% means that debt has a 2.8% contribution to the utility weighted average cost of capital. With 45% common equity earning 8.5% (ignoring persistent over-earning), the pre-tax cost of equity is 12.2%, and the equity share of the utility weighted average cost of capital is 5.5%. This means a pre-tax weighted average cost of capital inclusive of income taxes of approximately 8.3% of rate base, an interest coverage ratio of 2.958, and equity income to Fortis of 3.83% of rate base, which is less than the 5.5% share due to the income tax that ratepayers pay but Fortis does not receive.

	Current			
		cost	pre tax $	Share
Debt	55%	5.10%	0.051	0.028
Common	45%	8.50%	0.122	0.055
Tax rate				0.305
Utility weighted average cost of capital				8.31%
Interest coverage				2.96
Equity income in rate base				3.83%

If the Board simply reduces the common equity ratio to 40%, but still allows an 8.5% ROE we get the following:

	40% common equity			
		cost	pre tax $	Share
Debt	60%	5.10%	0.051	0.031
Common	40%	8.50%	0.122	0.049
Tax rate				0.305
Utility weighted average cost of capital				7.95%
Interest coverage				2.60
Equity income in rate base				3.40%

In this case the utility cost of capital is decreased to 7.95%, so there is rate relief for ratepayers, but the interest coverage ratio is still 2.6, which is consistent with a good A bond rating. The cost of this is borne by the lower equity income to Fortis of 3.40%, but this is still higher than the 3.3% Fortis earns from Fortis Alberta.

If the Board allows 50% common equity, it depends on the reduction in the allowed ROE. Assuming the same 3.4% equity income to Fortis, this means a 6.8% allowed ROE and the following:

	50% common equity			
		cost	pre tax $	Share
Debt	50%	5.10%	0.051	0.026
Common	50%	6.80%	0.098	0.049
Tax rate				0.305
Utility weighted average cost of capital				7.44%
Interest coverage				2.92
Equity income in rate base				3.40%

The interest coverage ratio goes up, so NP would continue to have the strongest bond rating of any Canadian utility and the utility cost of capital goes down to 7.44%. This is because the equity cost remains the same 4.9% pre-tax, while there is a reduction in debt cost due to the lower debt ratio. The loser is Fortis, since while it generates the same net income it now has more equity capital invested in NP. If the Board wants to do this so that NLH also earns a 6.8% ROE, it could continue the range around NP's return on rate base and continue to allow NP to over earn by 30 basis points so the actual ROE exceeds 7.0%, which would be Dr. Booth's fair ROE minus the issue costs that NP has admitted it does not incur.

For information, Hydro Quebec Transmission and Distribution have in the past been allowed ROEs under 7.0%, but they are both provincially owned.