Section 3: Finance/Fair Return

Q. Provide the reduction in the proposed 2025 and 2026 revenue requirement and the impact on customer rates if the current approved rate of return on equity of 8.5% is maintained for 2025 and 2026 and the equity component in the capital structure is reduced to (1) 43% and (2) 40% and increased to (3) 46%, 4) 48% and 5) 50% with no other change from the proposals in the Application.

A. **A. *Pro Forma* Revenue Requirement and Customer Rate Impacts**

Table 1 provides *pro forma* impacts on proposed 2025 and 2026 revenue requirements and customer rates for the requested scenarios. The scenarios include both reducing and increasing the common equity component of Newfoundland Power's capital structure from the 45% currently approved by the Board.[1] To isolate the impact of these scenarios, the figures in Table 1 assume that proposed 2025 and 2026 revenue requirements are already reduced to reflect a rate of return on equity ("ROE") of 8.50%, as outlined in the response to Request for Information PUB-NP-065.[2]

Table 1:
2025 and 2026 *Pro Forma*
Revenue Requirement and Customer Rate Impacts

Equity (%)	2025PF ($millions)	2026PF ($millions)	Customer Rates (%)[3]
40	(2.7)	(5.5)	(0.7)
43	(1.1)	(2.3)	(0.3)
46	0.5	1.2	0.1
48	1.6	4.0	0.5
50	2.8	7.4	0.9

The *pro forma* impacts outlined in Table 1 are practically limited. Any change in capital structure would practically require the Company to refinance its business. As such, there are a number of related effects on the Company's overall cost of capital that would need to be considered when assessing a change in Newfoundland Power's common equity ratio.[4] While these impacts are uncertain and complex, it is expected that revenue requirements would change in each case as outlined below. These changes are not reflected in Table 1.

1 Changes in capital structure cannot be practically achieved in a single year, therefore, a phased-in approach is used to reach the targeted capital structure by 2026. In each scenario, the target capital structure change in 2025 is assumed to be 50% of the capital structure change being achieved in 2026.

2 As shown in the response to Request for Information PUB-NP-065, maintaining the Company's existing ROE at 8.50% would reduce the 2025 and 2026 proposed revenue requirement by approximately $12 million and $13 million, respectively, and would reduce proposed customer rates by approximately 1.6%.

3 Includes MTA impact but excludes elasticity changes related to *pro forma* change in customer rates.

4 The estimates in Table 1 are based on Newfoundland Power's current financial position and existing credit ratings. A change in capital structure could lead to a change in the Company's credit ratings, which could impact the Company's cost of borrowing.

B. Reduction in Common Equity

If the Board were to order a decrease in the Company's common equity ratio, it would require 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 average common share dividend would be approximately $60 million and $80 million, respectively, for 2025 and 2026. Newfoundland Power would effectively have to borrow these amounts to fund the dividend payment. This has a number of related effects.

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

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.[5] In addition, such an order of the Board could result in a re-evaluation of regulatory support by credit rating agencies.[6]

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.[7] Higher costs of debt cost associated with Newfoundland Power's short-term credit facility and subsequent first mortgage bond issues would increase revenue required from customers.

(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.[8]

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*

[5] See the responses to Requests for Information PUB-NP-061 and PUB-NP-064 for *pro forma* credit metrics and earnings test interest coverage calculations that include the scenarios in this Request for Information.

[6] See the response to Request for Information PUB-NP-063 for further information regarding the Company's creditworthiness and ability to maintain a sound credit rating.

[7] For example, under the Company's $100 million credit facility, a one-notch downgrade in credit rating would result in a 20 basis point increase in the acceptance fee and a 4 basis point 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.

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

> *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."*[9]

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 revenue requirements would increase by approximately $4 million in each of 2025 and 2026. The higher revenue required from customer rates would have an offsetting impact on the *pro forma* reduction in 2025 and 2026 revenue requirements shown in Table 1.[10]

In addition to the short-term effects on both the Company's cost of debt and cost of equity outlined above, it is uncertain what impact a reduction in common equity could have on cost of capital in the long term.

C. Increase in Common Equity

If the Board were to order an increase in the common equity ratio, it would require an equity injection from the Company's shareholder, which would in turn would be used to repay borrowings and lower debt financing costs.

In isolation, an increase in the common equity ratio would increase the Company's credit metrics, which include the equity ratio. A sustained increase in credit metrics could lead to a higher credit rating, which could decrease its cost of borrowing for its long-term investments.[11] Moody's has noted that:

> *"NPI's rating could be upgraded if CFO pre-WC to debt is forecast to be sustained above 18%. An upgrade of NPI's rating is unlikely without further clarity on the timing, size and implications of the increases in electricity rates related to the Muskrat Falls hydroelectric project."* [12]

Credit metrics resulting from an increase in the common equity ratio would generally be in line with the outlook on Newfoundland Power by rating agencies.[13] For example, in Moody's ratings outlook for the Company, it provides:

---

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

[10] For example, the higher revenue required for 2025 and 2026 of approximately $8 million (i.e. approximately $4 million in each year) would effectively equal the *pro forma* approximately $8.2 million in lower revenue requirement for 2025 and 2026 as shown in Table 1 for the 40% equity component scenario.

[11] A higher credit rating could result in a decrease in corporate credit spreads applicable to new issuances of first mortgage bonds. There would be no change in the cost of short-term borrowings.

[12] See the *2025/2026 General Rate Application*, *Volume 1, Application, Company Evidence and Exhibits, Exhibit 4, Moody's*, page 2.

[13] See the response to Request for Information PUB-NP-061 for *pro forma* credit metrics that include the scenarios in this Request for Information.

> *"The stable outlook reflects the PUB's regulation of NPI which we consider credit supportive. We expect the regulatory environment to remain supportive, with the company maintaining a suite of timely recovery mechanisms, along with our view that relatively stable cash flow generation and the capital structure of NPI will generate sustained CFO pre-WC to debt in the 16-18% range."*[14]

D. Conclusion

The long-term cost of debt and equity are fundamentally based on an entity's capital structure. 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."*[15]

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. Therefore, the *pro forma* revenue requirement and customer rate impacts provided in Table 1 to this response are practically limited.

Expert evidence filed with the Application indicates that the current common equity ratio of 45% remains the minimum appropriate level given the Company's relative risk.[16] The Company's capital structure has not changed in over two decades and has contributed to the Company's continued access to capital markets on reasonable terms.

[14] See the *2025/2026 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Exhibit 4, Moody's*, page 2.

[15] Supra. note 9, paragraph 135.

[16] See the *2025/2026 General Rate Application, Volume 2, Supporting Materials, Expert Evidence, Cost of Capital*, page 83.