Section 3: Finance/Fair Return

Q. Volume 1, Section 3, page 3-22. Newfoundland Power states: "Newfoundland Power's business risks in 2023 remain largely consistent with those described in 2021 during Newfoundland Power's 2022-2023 General Rate Application," and at Section 1, page 1-6 Newfoundland Power states: "Expert evidence filed with this Application indicates that Newfoundland Power has above-average business risk in comparison to other Canadian utilities." Is Newfoundland Power's opinion the same as its expert that it has above-average business risk compared to other Canadian utilities? Please explain the basis for Newfoundland Power's opinion on this issue.

A. **Introduction**

Newfoundland Power's cost of capital is the rate of return investors could expect to earn if they invested in securities of equal risk. In regulatory practice, the opportunity cost of capital is integral to the concept of a fair return. For this reason, cost of capital is a relative concept. The accepted relative measure for determining a business' cost of capital is risk.

The principal risks to which Newfoundland Power is exposed do not change materially over time. For example, forecast economic conditions in the Company's service territory are always a risk to be evaluated in determining its cost of capital. However, the degree of exposure related to each element of risk can change.

Newfoundland Power assesses changes in its business risks over time. The Company is of the opinion that its business risks increased at the time of filing its *2019/2020 General Rate Application* and that risks have not materially changed since that time, including through the time period associated with its *2022/2023 General Rate Application*.

Newfoundland Power relies on its cost of capital expert, Concentric Energy Advisors Inc. ("Concentric"), for an assessment of its business risk relative to other investor-owned utilities. Concentric is of the opinion that Newfoundland Power has above average business risk relative to other Canadian investor-owned electric utilities.[1]

Background

The Board has historically assessed Newfoundland Power to be an average risk Canadian utility.[2] The Company's capital structure has been an integral part of that assessment.[3]

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[1] See Newfoundland Power's *2025/2026 General Rate Application, Volume 2, Supporting Materials, Tab 1, Expert Evidence,* page 78.

[2] See, for example, Order No. P.U. 19 (2003), page 33, where the Board indicated that the business risk profile of Newfoundland Power had not changed appreciably since 1998 and Order Nos. P.U. 43 (2009), page 13 and P.U. 13 (2013), page 17, where the Board found that Newfoundland Power continued to be an average risk Canadian utility.

[3] See, for example, Order No. P.U. 13 (2013), pages 16 and 17.

As part of its *2016/2017 General Rate Application,* Newfoundland Power filed evidence that its business risks had increased due to deterioration of the provincial economic outlook and increased power supply risks resulting from the Muskrat Falls Project.[4] Expert evidence filed with the application determined that these risks had increased such that Newfoundland Power had above average business risk compared to other Canadian utilities.[5]

At that time, the Board found that Newfoundland Power continued to be an average risk utility.[6] The Board maintained the Company's 45% common equity ratio for ratemaking purposes, in part, due to uncertainty associated with the Muskrat Falls Project and the economic outlook for the province.[7]

As part of its *2019/2020 General Rate Application,* Newfoundland Power observed certain business risks had become more pronounced since its last application. The provincial economic outlook had further deteriorated, energy sales had declined and costs related to the Muskrat Falls Project had increased.[8] Expert evidence filed with that application determined that the Company's business risk remained above average.[9]

Newfoundland Power's capital structure formed part of the settlement agreement reached in relation to the Company's *2019/2020 General Rate Application*. In Order No. P.U. 2 (2019), the Board maintained the Company's 45% common equity ratio for ratemaking purposes. In its decision, the Board noted Newfoundland Power's capital structure is recognized by credit rating agencies as a strength, which positively impacts the Company's creditworthiness.[10]

As part of its *2022/2023 General Rate Application,* Newfoundland Power observed that its risks had not materially changed since its previous general rate application. Longstanding factors continued to define the Company's risk profile. The provincial economic outlook remained weak and the Muskrat Falls Project continued to pose a risk to the least-cost delivery of reliable service. Expert evidence filed with that application maintained that Newfoundland Power has above average business risk compared to other Canadian investor-owned electric utilities.[11]

Newfoundland Power's capital structure formed part of the settlement agreement reached in relation to the Company's *2022/2023 General Rate Application*. In Order No.

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4 See Newfoundland Power's *2016/2017 General Rate Application, Volume 1, Application and Company Evidence, Section 4, Finance,* pages 4-23 to 4-30.

5 See Newfoundland Power's *2016/2017 General Rate Application, Volume 3, Expert Evidence and Studies, Tab 1, Cost of Capital, Appendix A*, page 24.

6 See Order No. P.U. 18 (2016), page 19.

7 Ibid., page 25.

8 See Newfoundland Power's *2019/2020 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Section 3, Finance,* pages 3-20 to 3-30.

9 See Newfoundland Power's *2019/2020 General Rate Application, Volume 2, Supporting Materials, Expert Evidence, Cost of Capital*, page 63.

10 See Order No. P.U. 2 (2019), page 12.

11 See Newfoundland Power's *2022/2023 General Rate Application, Volume 3, Expert Evidence*, *Tab 2, Cost of Capital,* page 74.

P.U. 3 (2022), the Board maintained the Company's 45% common equity ratio noting that it will provide Newfoundland Power with the opportunity to earn a just and reasonable return on rate base consistent with the fair return principle and the provision of least-cost reliable service.[12]

Current Assessment of Business Risks

Newfoundland Power's Assessment

Newfoundland Power's *2025/2026 General Rate Application* includes an assessment of how the Company's business risks have changed since its last general rate application. The principal factors considered in this assessment are:

(i) Longstanding factors that continue to define the Company's risk profile. These factors include weak service territory demographics, a harsh operating environment, the Company's small size and limited cost flexibility. The Board previously determined that a strong equity component is needed to mitigate the impact of the Company's relatively small size and low growth potential.[13]

(ii) The weak provincial economic outlook. Economic risks observed as part of the *2022/2023 General Rate Application* have persisted. Newfoundland and Labrador continues to lag behind the rest of Canada across key economic indicators, including GDP, labour force, household disposable income and housing starts.[14]

(iii) Continued uncertainty with respect to the Muskrat Falls Project and electricity supply. The Provincial Government has taken steps to mitigate customer rate increases associated with the project. However, uncertainty remains regarding the recovery of Muskrat Falls Project costs. The outlook for electricity supply on the Island Interconnected System changed materially in 2022. This is largely due to lower reliability assumptions for the Labrador-Island Link (the "LIL") and the subsequent need to maintain backup generation in the event of a LIL outage. Costs associated with additional investments to ensure supply reliability are expected to put additional pressure on customer electricity rates.[15]

Based on these factors, the evidence shows that the business risks facing Newfoundland Power are largely consistent with those outlined in the Company's *2022/2023 General Rate Application*.

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12 See Order No. P.U. 3 (2022), page 5.

13 See Order No. P.U. 19 (2003), page 45.

14 See Newfoundland Power's *2025/2026 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Section 3, Finance,* page 3-23, Table 3-12.

15 See Newfoundland Power's *2025/2026 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Section 3, Finance,* pages 3-30 to 3-34.

Expert Assessment

Newfoundland Power's *2025/2026 General Rate Application* includes an expert assessment of the Company's business risk relative to other Canadian investor-owned electric utilities. Concentric compared the Company's business risk to five other investor-owned electric utilities in Canada.[16] Factors considered in this assessment include:

(i) Newfoundland Power's small size, dependence on one supplier, weaker macroeconomic and demographic trends in the province, as compared to the remainder of Canada, and weather and storm related risks.

(ii) Newfoundland Power's higher power supply risk, relative to other Canadian investor-owned electric utilities, due to the cost of the Muskrat Falls Project, combined with additional costs associated with bulk electricity supply that were not previously anticipated.[17]

Conclusion

Based on its assessment, Concentric concluded that the current common equity ratio of 45% is the minimum appropriate level for Newfoundland Power.[18]

Newfoundland Power determined that its risks have not materially changed since its last general rate application. Longstanding factors continue to define the Company's risk profile, the provincial economic outlook remains weak and the Muskrat Falls Project continues to pose a risk to the least-cost delivery of reliable service.

Based on this assessment, Newfoundland Power's opinion is that it is appropriate to maintain its 45% common equity ratio for ratemaking purposes and that doing so is consistent with past orders of the Board.

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16 The utilities included in the assessment are ATCO Electric, FortisAlberta, FortisBC Electric, Maritime Electric and Nova Scotia Power. See Newfoundland Power's *2025/2026 General Rate Application, Volume 2, Supporting Evidence, Tab 1, Expert Evidence, Cost of Capital,* page 70.

17 Ibid., page 78.

18 Ibid., page 83.