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FAIR RETURN FOR NEWFOUNDLAND POWER (NP)

EVIDENCE OF

Laurence D. Booth

BEFORE THE

Board of Commissioners of Newfoundland and Labrador.

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EXECUTIVE SUMMARY

1) This report comes 2 ½ years after my last report and events have progressed largely as I anticipated at that time in that Canada has used up its remaining spare capacity. On most objective criteria Canada is reaching the peak of the business cycle. This is largely the result of a booming US economy with an unemployment rate 0.7% below the natural or normal rate and an economic growth rate significantly exceeding its trend line.

2) The problems that were evident in 2016, a technical recession, weak commodity prices, widening credit spreads, tightening loan standards and a stock market 14% off its highs, have all dissipated. Instead, credit spreads have tightened from 1.90% down to 1.35%, the stock market has boomed, the KCFSI and the Bank of Canada's loan survey both indicate easier credit, and commodity prices have strengthened.

3) By all objective criteria the financial system has returned to health in the US and now both the US and Canada have fully recovered from the financial crisis. The most obvious indicator is the persistent increases in the policy rates targeted by both the US Federal Reserve and the Bank of Canada. In fact, the US Fed anticipates increasing the Federal Funds rate to slow down the US economy in 2020.

4) The conundrum is that although the headline CPI inflation rate is above 2.0% in both the US and Canada, the core rates are not, while wage growth is anaemic. This seems to be leading President Trump to push the envelope with both trade and tax policy designed to increase demand and boost production in the US and not China. Canada again seems to be suffering potential collateral damage in terms of the renegotiation of NAFTA.

5) The absence of the expected inflation for this stage in the business cycle coupled with the huge amount of bonds taken off the market through quantitative easing in the US, Europe, the UK and Japan means that long term bond yields are yet to be determined by private purchasers and are instead still largely determined by central banks. Paradoxically, the expected long Canada bond yield is lower today at 3.0% than it was in 2016 at 3.65% which in turn is lower than it was in my 2012 report at 4.55%.

6) If NP were still on a formula ROE the decline in A credit spreads of 0.45% since 2016 coupled with the drop in forecast long Canada bond yields of 0.65% would together indicate a significant drop in the allowed ROE. However, I do not judge the resulting ROE to be fair since I do not believe that equity markets are keying off these very low government bond yields. In particular, I continue to believe, though with some misgivings, that the allowed ROE should not be changed from 7.5% until the forecast long Canada bond yield exceeds 3.8%. Consequently, I continue to recommend a 7.5% allowed ROE, but would point out that there is increasing evidence that the current 8.50% allowed ROE is generous.

7) In terms of business risk I judge NP to be a typical Canadian utility. The addition of three more years of data has not changed that assessment, since NP over-earned in each of those years. Risk is the probability of incurring a loss and in the last 25 years it is difficult to see any material losses. Consequently, I tend to believe that NP is being allowed a risk premium for risks that it is not bearing

8) In 2016 I entered extensive business risk and capital structure evidence recommending a gradual reduction in NP's common equity ratio. The Board rejected that recommendation and awarded NP a 45% common equity ratio, which exceeds that of its Canadian peers. The main justification seemed to be the possibility of increasing electricity prices from the pass through of Muskrat Falls costs. NP is now justifying its increased revenue requirement on an increased ROE and higher risk due to those *same* increased costs.

9) The only way that higher electricity prices can increase NP's risk is if they increase the likelihood of NP failing to earn its allowed ROE as customers shift to alternative fuels. I do not think this risk is significant for two reasons. First, the province will in all likelihood reallocate some of those costs to other entities to reduce rate shock as I am sure it knows of the experience of the Liberal government in Ontario. Second, electricity costs in the province can absorb higher costs without becoming so large as to encourage people to drop off the system. So in my judgement the death spiral risk is non-existent.

10) I regard a 7.5% ROE for NP on 40% common equity as satisfying the fair return standard. However, since the Board heard full business risk and capital structure evidence in 2016 and fixed NP's common equity ratio at 45% I have not entered full evidence on the common equity ratio again. For this reason, I strongly recommend that the Board reduce the allowed ROE, since all the normal indicators point to a lower ROE than the 8.50% set by the Board in 2016.[1]

[1] My understanding is that if the ROE is maintained at 8.50% there is no material increase in NP's revenue requirement. A reduction to a fair rate of return will then decrease rates and somewhat cushion rates from potential increases in electricity costs.

11) I INTRODUCTION AND OVERVIEW

Q. PLEASE DESCRIBE YOUR NAME, QUALIFICATIONS AND EXPERIENCE.

A. Laurence Booth is a professor of finance in the Rotman School of Management at the University of Toronto, where he holds the CIT Chair in Structured Finance. Dr. Booth appeared before the Board of Commissioners most recently in a 2016 hearing, as well he has appeared before most of the major utility regulatory boards in Canada including the CRTC, the National Energy Board, the Ontario Energy Board (OEB), the BCUC, the Alberta Utility Commission (AUC), the Nova Scotia Utilities and Review Board, the New Brunswick Public Utilities Board, the Manitoba Public Utilities Board, the Regie de l'Energie du Quebec and the Prince Edward Island Regulatory and Appeals Commission. He has also filed testimony before the Ontario Securities Commission and in a variety of civil suits pertaining to financial matters. A detailed resume is filed as Appendix A. Further information and copies of working papers by Dr. Booth can be can be downloaded from his web site at the University of Toronto at http://www.rotman.utoronto.ca/~booth.

Q. PLEASE DESCRIBE THE PURPOSE OF YOUR TESTIMONY

A. The Consumer Advocate of the Province of Newfoundland and Labrador has asked me to offer an opinion on the fair rate of return on common equity (ROE), and to recommend an appropriate common equity ratio for Newfoundland Power.

Q. DO YOU HAVE SOME OVERALL REMARKS?

A. Yes. It is just over two and a half years since I last filed a report with the Board and quite generally economic events have progressed much as I anticipated. At that time I pointed out that it was three years since the Board last reviewed NP's ROE and capital structure and we were in a "long drawn out recovery." I also felt that I was surprised at how slowly the global economy had taken to recover from the financial crisis and that we were very much in a "holding pattern" waiting for the US and Europe to work their way through the after effects of their Great Recessions. Consequently, I continued to recommend a 7.5% ROE since forecast long Canada (LTC) bond yields were still slightly below my 3.8% trigger point for changes in the ROE.

Now the situation is at last changing. The US and Canada economies are both getting close to the top of the economic cycle and on conventional statistics have little excess capacity left, whereas Europe and Japan still have a way to go. However, the after effects of massive monetary easing and fundamental demographic changes have left long term interest rates at extremely low levels. By now we should be seeing inflationary pressures building and higher interest rates, but we are not. We have seen the Bank of Canada increase its target overnight rate to 1.50% with expectations of further increases with similar forecasts for the US Federal Reserve. However, despite increasing short term interest rates, forecast LTC yields are actually *lower* now than in 2016. In its January 8, 2016 forecast, for example, the Royal Bank of Canada was forecasting an LTC yield for the end of 2018 of 3.65%. In contrast, its current forecast (September 12, 2018) for the end of 2019 is only 3.0%. The result is that my 3.8% trigger for the LTC yield to indicate changes in the allowed ROE has still to be met.

In terms of business risk, I accept that the implication of Muskrat Falls for electricity prices in Newfoundland may appear to increase risk, however I judge there to be two offsetting factors. First, I see little chance of a significant change in electricity prices during the test period as Muskrat Falls will only be fully online in 2021, beyond the end of the test period. Second, the provincial government has options in how to deal with the escalating costs of Muskrat Falls. In Ontario we have seen the defeat of a Liberal government partly due to its mishandling of the energy file.[2] I suspect that the Newfoundland and Labrador government is well aware of this and will use similar techniques to avoid the worst of the forecast for future electricity prices. Regardless, I do not see NP's shareholders as bearing any increased risk resulting from higher electricity prices. Ultimately the core risk borne by utility shareholders is that of the death spiral where its distribution network is by-passed due to the emergence of other supply sources or alternative distribution mechanisms. Neither of these risks seems to be significant for NP even should the provincial government allow it.

In my judgment, NP's case for an increase in its allowed ROE is non-existent since there is no significant increase in LTC yields and capital market conditions remain benign with enormous

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[2] See Gordon Kaiser, "Ontario cancels wind and solar contracts," Energy Regulation Quarterly 6-3, 2018.

liquidity. Further, I continue to judge NP as warranting the same 40% common equity ratio as other Canadian electric distribution utilities with similar low business risk. However, I generally recommend that common equity ratios only be changed in the face of significant changes in business risk or when they are clearly out of line. Since the Board heard full evidence on NP's common equity ratio in 2016 and decided to maintain it at 45% I have not revisited this topic in detail. However, since the "electricity price risk" has already been taken into account by the Board the case for decreasing the allowed ROE is stronger.