

Requests for Information

1996 Dominion Bond Rating Service (DBRS) Report

Newfoundland Light & Power Co. Limited

January 8, 1996

<u>Rating</u>	<u>Trend</u>	<u>Rating Action</u>	<u>Debt Rated</u>
A	Stable	Downgrade	First Mortgage Sinking Fund Bonds
Pfd-2	Stable	Confirmation	First Preference Shares

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Summary The ratings of Newfoundland Light & Power Co. Limited's ("NLP") First Mortgage Sinking Fund Bonds are reduced to "A" from "A (high)" and the First Preference Shares are confirmed at Pfd-2, both with a Stable trend. 1995 will mark the fifth straight year that NLP has not experienced any earnings growth, which is not indicative of an "A (high)" rating. The lack of earnings growth is due to the slow growth of the economy and the resulting sluggish growth in demand for power over the past several years, a trend which is expected to continue given the unfavourable economic outlook. The Province's economy is expected to remain weak as the construction stage of the Hibernia offshore oil project starts to wind down, given the sustained weakness in the fishery sector, and as the Provincial government continues its fiscal restraint. Adding to the problem will be the Federal government's cutback in transfer payments, particularly unemployment insurance payments. As a result, there is likely to be a continued trend of outward population migration and a slowing of job growth within the Province. NLP is also experiencing intense competition in the home space and water heating markets from oil companies. These factors are expected to translate into very slow growth in demand for electricity in the foreseeable future.

Rating Considerations Strengths: (1) NLP main source of power is low cost hydraulic power, produced by Newfoundland and Labrador Hydro. (2) NLP does not interconnect with other electrical utilities outside the province. Therefore, there is limited risk of competition from other electrical utilities selling excess power into the province at their marginal cost of production. (3) NLP is protected from self generation by industrial customers or independent power producers as the lack of natural gas supply prevents many of these projects from being economical. However, this could change if natural gas is discovered off Newfoundland's west coast. (4) NLP has a weather variance account to help smooth earnings, although it generally amounts to less than 1% of operating revenues. Challenges: (1) The provincial economy has suffered in recent years with a primarily resource based economy. With the severe depletion of the northern cod stocks, the outlook for the Newfoundland economy remains uncertain. As a result, NLP's sales growth is forecast to be slow for the foreseeable future. Given projected demand, there will be an adequate supply of power to meet projected demand well into the next century. (2) As a long-term strategic consideration, NLP does not have control over its own generating costs since it buys 91% of its power from Newfoundland Hydro. (3) Low oil prices and increased advertising by oil companies has created increased competition for NLP in the space and water heating market, which made up 53-54% of total kilowatt-hour sales in 1995.

Regulatory NLP appears to have a reasonable relationship with its regulator, the Board of Commissioners of Public Utilities ("P.U.B."). NLP's last regulatory decision resulted in an allowed rate of return on common equity of 13.25% for the test year 1992, with the range between 13.0% to 13.5%. In 1995, NLP expects to earn approximately a 12% ROE which is in line with returns

earned by other utilities. NLP has maintained its electricity rates at current levels which has allowed NLP to earn a reasonable rate of return. As a result, NLP did not make a General Rate Application (GRA) in 1995. However, in 1996 NLP will file a GRA in the first quarter which, if accepted, will likely result in a 4-6% annualized increase in rates. This increase is largely required to cover increased interest expense, resulting from less interest being capitalized due to a lower level of capital expenditures than in the past. This makes its treatment of interest more consistent with other utilities. The latest order of the P.U.B. allows a 50% equity component in the capital structure (including 5% to 10% preferred) and 50% debt. Despite the upper limit on the regulated equity component of 50%, NLP's total equity component is 50.7%. In order to stabilize the equity component in its capital structure, with a reduced level of capital spending in 1994, a special dividend of \$12 million was paid to Fortis Inc. NLP is permitted by the regulator to pass increases in power purchase costs on to the customer through increased rates, and has been permitted a weather normalization account to adjust for the effect of variations in temperature and hydro-electric power availability when measured against long term averages. These regulatory mechanisms remove much of the variability in earnings.

Earnings Nine month earnings declined slightly to \$24.8 million from \$25.9 million in 1994 as sales remained relatively constant at 3,294 GWH, while operating expenses increased by 2.6%. This increase in operating expenses is largely due to a change in accounting practice for overhead costs which were previously charged to capital. Costs of this nature will, in future, be expensed in the period incurred rather than deferred to future periods. Increased marketing efforts designed to retain market share for home heating also account for some of the increase. Demand for electricity is likely to remain weak due to poor economic conditions and the increase in competition in the heating market. The ongoing groundfish moratorium along with cuts in Federal transfer payments are expected to result in continued slow economic growth. With the weak demand outlook, rate base growth is expected to fall within the 0-0.5% range over the next 5 years. As a result, little earnings growth is expected in the foreseeable future. Opportunities for improved economic performance in the future include recent exploration activity in the mineral sector, high newsprint prices and the beginning of Hibernia's production phase.

Balance Sheet The balance sheet has remained relatively stable over the past several years. Common equity in the capital structure of 48.7% at September 30, 1995 is up slightly over year end 1994 when NLP paid a special dividend of \$12.1 million to Fortis so as to maintain the common equity component within its allowed range of 40-45%. Fixed charge coverage has remained relatively stable, falling to 2.63 times from 2.77 times at December 31, 1994. Currently there are no major capital projects planned, and capital expenditures are expected to remain low at about \$30-\$35 million per year. Therefore NLP should be able to fund its capital spending requirements largely through operating cash

flow (net of dividends) and build retained earnings so as to stay at the upper end of the range for its common equity component. With the percentage equity in the capital structure at its upper limit, NLP's dividend payout ratio is expected to increase. During 1994, Revenue Canada advised NLP that it proposes to disallow certain amounts which are capitalized for regulatory and accounting purposes but claimed as an expense for income tax purposes. Revenue Canada also proposes to record as income the value of electricity delivered in December but not billed to customers until

January. If NLP is unsuccessful in defending its position, this could result in a liability of \$33 million, offset by \$15 million that has already been paid (currently recorded as income tax receivable).

The Company Newfoundland Light and Power Co. Ltd. distributes electricity across most of the island of Newfoundland, purchasing 91% of its power requirements from Newfoundland and Labrador Hydro Electric Corporation and Deer Lake Power Company Limited, and generating the balance in its own plants. ◀

Balance Sheet

(\$ millions)

	Sept. 30 1995	December 31 1994	1993		Sept. 30 1995	December 31 1994	1993
Assets				Liabilities & Equity			
Cash & mkt. sec's.	0.6	2.1	9.5	Bank borrowings	29.1	15.0	10.0
Accts receivable	38.4	36.3	31.9	Account payable	29.7	49.0	44.9
Other curr assets	10.8	12.0	12.7	Other current liabilities	13.5	10.7	13.1
Total current assets	49.7	50.4	54.1	L.t.d. due in 1 year	2.2	9.3	2.3
Deferred charges	13.7	13.2	11.8	Total current liabilities	74.6	84.0	70.3
Net fixed assets	488.0	489.4	483.2	Long term debt	207.7	207.7	216.6
				Deferred credits	23.0	25.2	25.3
				Preferred Shares	9.9	10.9	10.9
				Common equity	236.2	225.1	226.1
	551.4	553.0	549.2		551.4	553.0	549.2

Rating History as at December 31

	Current	1994	1993	1992	1991	1990	1989
Bond	A	A (high)	A (high)	A (high)	A (high)	A (high)	A (high)
Preferred Shares	Pfd-2	Pfd-2	Pfd-2	Pfd-2	-	-	-

Ratios (1)

	Sept. 30 1995	December 31 1994	1993	1992	1991	1990	1989
Current ratio	0.67	0.60	0.77	0.86	0.45	0.47	0.60
Asset coverage	2.03	2.02	2.04	2.02	2.05	2.06	2.02
Total assets/Long term debt	2.65	2.66	2.54	2.50	3.32	3.17	2.76
% net debt in capital structure	49.22%	49.35%	48.07%	48.62%	48.68%	48.59%	49.45%
Cash flow/Total debt	0.22	0.24	0.25	0.24	0.25	0.25	0.23
Depreciation/Gross fixed assets	3.63%	3.64%	3.63%	3.62%	3.58%	3.70%	3.57%
cash flow - divs/cap ex	1.01	0.69	1.16	0.93	0.85	0.51	0.49
Dividend Payout Ratio	68.7%	108.4%	59.2%	56.5%	60.2%	58.9%	59.3%

Coverage Ratios (1)

Int coverage-based on net interest	2.92	3.10	3.14	3.11	2.94	2.91	2.68
EBITDA net interest coverage	4.22	4.33	4.35	4.31	4.07	4.03	3.80
Fixed charges coverage	2.63	2.77	2.63	2.49	2.32	2.25	2.02
EBITDA fixed charges coverage	3.80	3.88	3.63	3.46	3.21	3.11	2.86

Profitability, Earnings Quality (1)

Return on common equity	11.3%	12.0%	12.6%	13.5%	13.2%	14.1%	13.9%
Allowed ROE - mid point	13.3%	13.3%	13.3%	13.3%	13.3%	14.0%	14.0%
Ach'vd reg. ROE as % of allowed	89.8%	90.6%	95.2%	102.9%	99.4%	81.4%	n/a
AFUDC as % of pre-tax income	0.47%	0.57%	0.86%	0.80%	1.55%	3.27%	3.20%

Operating Ratios (1)

Avg Rate Base (\$ millions)	n/a	465.3	459.6	450.4	435.0	402.1	364.6
Average Rate Base Growth	n/a	1.25%	2.04%	3.54%	8.18%	10.29%	7.68%
% growth in sales volume (2)	-0.1%	2.0%	1.0%	1.1%	0.5%	5.4%	5.0%
% Power purchased	n/a	90.9%	90.7%	90.7%	90.6%	90.7%	90.1%
% Sales - Domestic	n/a	59.3%	61.6%	61.5%	60.4%	58.6%	57.4%
Oper cost (ex D&A)/million kwh sold	\$55.90	\$54.84	\$55.13	\$55.92	\$54.91	\$53.33	\$51.15
Operating cost/employee (\$000's)	\$282.68	\$297.03	\$289.95	\$249.84	\$240.78	\$226.23	\$210.29
Annual degree days - % normal	n/a	101	107	108	107	102	101

Selected Results

	9 months ended Sept. 30 1995	1994	1993	1992	1991	1990	1989
Sales	254,695	254,895	338,367	333,569	344,293	328,695	276,823
Gross operating profit	53,985	59,464	70,519	70,343	67,031	63,950	50,185
Net income before extra	24,830	25,896	27,802	29,182	29,680	27,681	22,091
Net income after extras	24,830	25,896	27,802	29,182	29,662	27,799	24,448
Cash Flow	45,486	47,135	55,024	57,480	55,105	53,683	43,014

(1) Ratios for September 30, 1995 calculated on a twelve month trailing basis.

(2) Weather adjusted