Q. P. 42 Common Equity Calculate the impact on the 2004 revenue requirement of seeking a 10.71% return on an average balance of $8,904,000 of “notional equity”, representing the accumulated disallowed expenses.

A. The impact of seeking 10.72% return on an average equity balance of $8,702,500 increases 2004 Revenue Requirement by $1,403,000.

The calculation of average regulated common equity is appropriate for ratemaking purposes under the current practice of determining return on rate base for Newfoundland Power. The adding back to the net earnings of the Company of non-regulated expenses provides regulatory continuity to the calculations of common equity used for ratemaking purposes.

The calculations supporting the reduction in 2004 revenue requirement of $1,403,000 are shown in Tables 1-5 below.

If the current practice of calculating the average regulated common equity was not established, the Company would have requested a return on equity for 2003 and 2004 of 11.05 and 11.02 respectively instead of 10.75% and 10.72% respectively. Details of this calculation are included in the response to Request for Information NLH-236. This would have resulted in the same 2004 revenue requirement as provided for in Exhibit BVP-28, based on the requirements of creditworthiness that have been established by the credit rating agencies, and the financial targets that the Company requires in order to maintain it’s A bond rating. These targets include a revenue requirement that maintains interest coverage of 2.5 to 2.7 times.

The higher return on equity would be justified in combination with the Company’s proposed capital structure to allow the Company to generate a sufficient return on rate base to maintain its current bond rating as required by section 3(a)(iii) of the *Electrical Power Control Act, 1994*. A just and reasonable return on rate base as described in section 80(1) of the *Public Utilities Act* must be sufficient to maintain a utility’s creditworthiness.

Table 1
Forecast Weighted Average Cost of Capital
2004 Proposed [1]

	%	Cost Rate	Weighted Cost Rate
Debt	54.06	8.39%	4.54%
Preferred	1.39	6.31%	0.09%
Common	44.55	10.72%	4.77%
	100.00		**9.40%**

[1] As shown in Exhibit BVP-18, page 1 of 1, line 26.

Table 2
Forecast Weighted Average Cost of Capital
Using Book Common Equity
2004 Pro Forma

	%	Cost Rate	Weighted Cost Rate
Debt	54.75	8.39%	4.59%
Preferred	1.40	6.31%	0.09%
Common	43.85	10.72%	4.70%
	100.00		**9.38%**

Table 3
Rate of Return on Rate Base
Using Average Regulated Equity
2004 Proposed
(000s)

$$2004 = \left[\frac{\$700{,}244^{1}}{\$622{,}650^{2}} \times 9.40\%^{3} \right] + \frac{(\$66^{4} + \$30^{5} - \$246^{6})}{\$622{,}650}$$

$$= \mathbf{10.55\%}$$

[1] Forecast of Average Invested Capital for 2004 proposed as shown in Exhibit BVP-10, page 1 of 1, line 6.
[2] Forecast of Average Rate Base for 2004 proposed as shown in Exhibit BVP-9, page 1 of 2, line 27.
[3] Weighted Average Cost of Capital as calculated in Table 1 above and as shown in Exhibit BVP-18, page 1 of 1, line 26.
[4] Forecast of Amortization of Capital Stock Issue expenses for 2004 as shown in Exhibit BVP-13, page 1 of 1, line 31.
[5] Forecast of Interest on customer deposits for 2004 as shown in Exhibit BVP-13, page 1 of 1, line 33.
[6] Forecast of Capitalized Interest for 2004 as shown in Exhibit BVP-13, page 1 of 1, line 32.

Table 4
Rate of Return on Rate Base
Using Book Equity
2004 Pro Forma
(000s)

$$2004 = \left[\frac{\$691{,}541^{1}}{\$622{,}650^{2}} \times 9.38\%^{3} \right] + \frac{(\$66^{4} + \$30^{5} - \$246^{6})}{\$622{,}650}$$

$$= \mathbf{10.40\%}$$

[1] Forecast of Average Invested Capital for 2004 using book equity comprised of Average Invested Capital for 2004 proposed as shown in Exhibit BVP-10, page 1 of 1, line 6 less difference between book equity and regulated average common equity for 2004 of $8,702,500.
[2] Forecast of Average Rate Base for 2004 proposed as shown in Exhibit BVP-9, page 1 of 2, line 27.
[3] Weighted Average Cost of Capital as calculated in Table 2 above.
[4] Forecast of Amortization of Capital Stock Issue expenses for 2004 as shown in Exhibit BVP-13, page 1 of 1, line 31.

[5] Forecast of Interest on customer deposits for 2004 as shown in Exhibit BVP-13, page 1 of 1, line 33.
[6] Forecast of Capitalized Interest for 2004 as shown in Exhibit BVP-13, page 1 of 1, line 32.

Table 5
Impact on 2004 Revenue Requirement of
Using Book Equity
2004 Pro Forma
(000s)

	Average Rate Base[1]	Rate of Return on Rate Base[2]	Return on Rate Base[3]
2004 Proposed	$622,650	10.55%	$65,668
2004 Pro Forma	$622,650	10.40%	64,756
Reduction In 2004 Revenue Requirement Due To Reduction In Rate Of Return On Rate Base[4]			912
Reduction In 2004 Revenue Requirement Due To Reduction In Taxes[5]			491
Total Reduction In 2004 Revenue Requirement Due To The Removal of $8,702,500 in Equity From Average Invested Capital[6]			$1,403

[1] Forecast of Average Rate Base for 2004 proposed as shown in Exhibit BVP-9, page 1 of 2, line 27.
[2] Rate of Return on Rate Base For 2004 proposed as shown in Exhibit BVP-16, page 1 of 1, line 21 and 2004 Pro Forma Rate of Return on Rate Base with $8,702,500 reduction in Average Invested Capital as shown in Table 4 above.
[3] Return on Rate Base For 2004 proposed and 2004 Pro Forma. It is equal to the Average Rate Base multiplied by the Rate of Return on Rate Base.
[4] Reduction in revenue requirement for 2004 due to a reduction in required Return on Rate Base equal to $65,668,000 minus $64,756,000.
[5] Reduction in revenue requirement for 2004 due to a reduction in taxes associated with a reduced return on rate base, calculated as $912,000 * (.35/.65). The reduction in taxes assumes no tax impact from a change to the pro forma average debt.
[6] Total reduction in 2004 revenue requirement due to the reduction in Average Invested Capital of $8,702,500.