Q. Re: p. 26, lines 20-22 Provide the basis for the statement that the upper limit on equity must remain at 45 % in order to maintain an "A" bond rating.

A. Mr. Perry's statement is based on both the past orders of the Board dealing with the required capital structure to maintain an "A" bond rating and the pre-filed testimony of Dr. Morin and Ms. McShane. Relevant references are provided below:

Board Orders

In 1990, the Board accepted a range of 42%-47%. The range established in 1991 for common equity was 40%-45%. Order P.U. 7 (1996-1997) reconfirmed the range of common equity of 40%-45%. And in the most recent order on this issue, P.U. 16 (1998-99), following the cost of capital hearing, the Board stated on page 58:

> *The Board believes that, in order to maintain an "A" rating and appropriate access to the capital markets, as a small utility, NLP will require a stable and strong capital structure.*

As a result, on page 59, the Board approved:

> *For the purposes of applying an automatic adjustment formula, the common equity ratio will be the lower of the forecast average common equity ratio for the test year and 45%. Where applicable, any common equity in excess of 45% will be treated as preferred equity.*

Expert Testimony

The importance of a strong equity component in the Company's capital structure is reviewed in the testimony of Roger A. Morin. As noted by Dr. Morin, at page 24 of his testimony, as the percentage of fixed charges, i.e. debt, increases in relation to the total income of the Company, the financial risk associated with investment in the Company is viewed as higher by equity investors. A strong equity component in the capital structure mitigates the impact of the Company's relatively small size and low growth potential.

The relationship between capital structure and bond ratings is reviewed in the pre-filed testimony of Kathleen C. McShane at pages 9 to 11. Ms. McShane's evidence indicates that the existing 45 per cent cap on the equity component in the Company's capital structure should be viewed as the lower end of the range compatible with an "A" bond rating.