Q. Assume a proposed average rate base of $597,232,000 and a proposed rate of return on rate base of 10.48% for 2003 (BVP-16, p. 1 of 1). Assume that 54.55% of the rate base is financed by debt (BVP-10, p. 1 of 1) with an embedded cost of 8.32% (BVP-12, p. 1 of 1), that 1.45% of the rate base is financed by preferred equity (BVP-10, p. 1 of 1) with an embedded cost of 6.31% (BVP-14, p. 1 of 1), and that 44.0% of the rate base is financed by common equity (BVP-10, p. 1 of 1). Does this imply a 13.30 ROE for the common equity funded portion of the rate base?

	%	Cost Rate	Weighted Cost Rate
Debt	**.5455**	**8.32%**	**4.54%**
Preferred	**.0145**	**6.31%**	**0.09%**
Common	**.4400**	**13.30%**	**5.85%**
	1.000		**10.48%**

If the answer is anything other than "yes", please provide a complete explanation and a corrected calculation of the above table.

A. ***1. General***

No, this does not imply a 13.30 per cent return on the common equity funded portion of the rate base for Newfoundland Power. This question appears to be premised on the assumption that the weighted average cost of capital and a just and reasonable return on rate base for Newfoundland Power are, or should be, the same. This assumption is inconsistent with the Board's current practice for calculating the return on rate base for Newfoundland Power.

2. The Current Method of Calculating Newfoundland Power's Weighted Average Cost of Capital

The calculation shown in this question is a calculation of weighted average cost of capital based upon the assumptions set out in the question, including a return on common equity of 13.30 per cent. The appropriate calculation of the weighted average cost of capital proposed for 2003 is shown in Exhibit BVP-18, line 23.

Assuming the capital structure and returns as described (or implied) in this question, the weighted average cost of capital is calculated to be 10.48 per cent. This is not the weighted average cost of capital proposed by Newfoundland Power in this proceeding as Newfoundland Power is proposing a return on common equity for ratemaking purposes of 10.75 per cent (as opposed to 13.30 per cent). The requested corrected calculation of the weighted average cost of capital based upon the assumptions in this question is set out in Table 1.

Table 1 Weighted Average Cost of Capital 2003 Proposed			
	%	**Cost Rate**	**Weighted Cost Rate**
Debt	54.28	8.54%	4.64%
Preferred	1.45	6.31%	0.09%
Common	44.27	10.75%	4.76%
	100.00		**9.49%**

This weighted average cost of capital is used to calculate a just and reasonable return on rate base.

3. The Current Method of Calculating Newfoundland Power's Rate of Return on Rate Base

The calculation of the rate of return on rate base for 2003 of 10.55 per cent as proposed by Newfoundland Power is made in accordance with the practice of the Board and is shown in Exhibit BVP-19, pages 2 of 2, lines 17-24. The calculation of the rate of return on rate base is reproduced in Table 2.

Table 2
Rate of Return on Rate Base
2003 Proposed

$$2003 = \left[\frac{\$668{,}416^{1}}{\$599{,}245^{2}} \times 9.49\%^{3} \right] + \frac{(\$66^{4} + \$30^{5} - \$304^{6})}{\$599{,}245^{2}}$$

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

[1] Forecast of Average Invested Capital for 2003 proposed as shown in Exhibit BVP-10, page 1 of 1, line 6.

[2] Forecast of Average Rate Base for 2003 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 23

[4] Forecast of Amortization of Capital Stock Issue expenses for 2003 as shown in Exhibit BVP-13, page 1 of 1, line 31.

[5] Forecast of Interest on customer deposits for 2003 as shown in Exhibit BVP-13, page 1 of 1, line 33.

[6] Forecast of Capitalized Interest for 2003 as shown in Exhibit BVP-13, page 1 of 1, line 32.

The calculation set out in Table 2 and Exhibit BVP-19 appropriately reflects differences between Newfoundland Power's rate base and invested capital. These differences are described in detail in the *Finance & Accounting Evidence* at page 40 *et. seq.* The method of calculation of the proposed 2003 rate of return on rate base is in accordance with the established practice of the Board and is appropriate for determining a just and reasonable return as provided for by section 80(1) of the *Public Utilities Act*.

4. An Alternative Pro Forma Calculation of Return on Rate Base

As is indicated by Ms. McShane in the response to Request for Information PUB-242, there are alternative regulatory approaches to calculating the rate of return on rate base which achieve the result of permitting the utility the opportunity to recover the actual costs of financing utility assets. One approach is that used currently by the Board to calculate Newfoundland Power's rate of return on rate base and is described above. The other is the approach used by the Board to calculate Newfoundland and Labrador Hydro's ("Hydro") rate of return on rate base in Order No. P.U. 7 (2002 – 2003).

Attachment A contains a pro forma calculation of return on rate base for Newfoundland Power for 2003 and 2004. It is based upon the assumption that deferred charges not currently included in Newfoundland Power's rate base (i.e. deferred pension costs, unamortized debt and capital stock issue expenses, and deferred regulatory costs) are included in the rate base for the purposes of calculating the return on rate base.

The approach used in Attachment A is similar to that used by the Board to allow recovery of the costs of financing Hydro's unamortized foreign exchange losses. It results in Hydro's weighted average cost of capital being equal to its allowed rate of return on rate base for rate making purposes. This equality appears to be a central assumption underlying this question.

The pro forma return on rate base calculated in Attachment A for 2003 is $63,657,000. This is not materially different from Newfoundland Power's 2003 proposed return on rate base of $63,209,000 calculated using the current method as set out in Exhibit BVP-16. Similarly, the pro forma return on rate base for 2004 is $65,949,000 which is not materially different from the 2004 proposed return on rate base of $65,668,000 as set out in Exhibit BVP-16.

5. Conclusion

Section 3(a)(iii) of the *Electrical Power Control Act, 1994* requires the Board to allow rates which provide sufficient revenues to permit Newfoundland Power to achieve and maintain a sound credit rating in world financial markets. Practically, this requires the return on rate base provided for by section 80(1) of the *Public Utilities Act* to be

sufficient to allow Newfoundland Power to maintain the appropriate financial benchmarks, such as interest coverage, necessary to, in turn, maintain creditworthiness.

Both the calculation of return on rate base contained in the *Finance & Accounting Evidence* and the calculation of return on rate base in Attachment A achieve this purpose.