YUKON UTILITIES BOARD
EXHIBIT C2-14
DAY | ENTERED BY City of Whse | DATE Oct 8/08

THE PUBLIC UTILITIES BOARD

OF THE

NORTHWEST TERRITORIES

DECISION 13-2007 **August 29, 2007**

IN THE MATTER OF the Public Utilities Act, being Chapter 110 of the Revised Statutes of the Northwest Territories, 1988(Supp.), as amended.

AND IN THE MATTER OF an application by Northwest Territories Power Corporation for changes in the existing rates, tolls and charges for electrical energy and related services provided to its customers within the Northwest Territories.

repaid over 30 years and 6.74% equity at the allowed rate of return on equity minus 25 basis points. Since the 9.6% debt to NWT Energy is being repaid by DPC over 30 years, the cash flow profile of the lease payments by NTPC to DPC differs from the cash flow profile of DPC's debt repayments to NWT Energy. Given this mismatch in cash flow profiles, the Board considers there may be potential for DPC to reduce its cost of capital by substituting some of the higher cost debt included in its capital structure with lower cost debt as the 9.6% debt is being amortized over 30 years. The Board directs NTPC to address the potential for better matching the carrying cost of the lease to DPC with the cost of the lease to NTPC over the 65-year term of the lease, at the next GRA.

4.3 Capital Structure

The NTPC proposed capital structure for the two test years is as follows:

	2006/07	2007/08
Common Equity	45.53%	48.59%
Long Term Debt	44.53%	41.65%
Capital Lease Obligation	10.86%	10.61%
No Cost Capital	-0.92%	-0.85%
	100.00%	100.00%

The above capital structures reflect the Corporation's forecast capital structures, as opposed to deemed capital structures, in each of the test years.

In support of the proposed capital structure, Ms. McShane, expert witness for NTPC, stated NTPC would need a more conservative capital structure compared with a typical investor owned utility, in order to achieve a similar debt rating in light of its small size, higher business risks and non taxable status. Ms. McShane stated that in her opinion, a common equity ratio in the range of 45-50% would

be adequate to allow NTPC to achieve a BBB rating on a stand-alone basis and NTPC's actual equity ratios are forecast to be in that range. Ms. McShane defined a benchmark utility as an A-rated utility and indicated NTPC's risk would remain higher than that of the benchmark which would suggest an incremental equity risk premium is required for NTPC. (Ex 12; McShane Evidence, p.18)

Among the business risks the utility is exposed to, Ms. McShane discussed market risks, supply and physical risks as well as regulatory risks.

With respect to market risks Ms. McShane stated the reliance on a small number of cyclical industries with a sparse population results in a higher level of market risk.

> "...While the outlook is one of strong growth in the near to medium term, the reliance of the NWT on a small number of cyclical industries, in conjunction with the sparse population, results in a higher level of market risk for NTPC relative to the typical Canadian utility which operates in a more diverse economic environment with higher population density." (Ex. 2, Appendix B, McShane Evidence, p. 12, *ll.* 323 - 327)

Ms. McShane indicated NTPC faces an inherently higher level of risk relative to other integrated Canadian electric utilities with respect to supply and physical risks.

> "With respect to supply and physical risks, NTPC faces an inherently higher level of risk relative to other integrated Canadian electrical utilities. The level of risk is in large part a function of the severe climate, the vast geographic expanse and rugged terrain of the service area, and the lack of a system grid to connect the communities served." (Ex.2, Appendix B, McShane Evidence, p.12, *ll.* 329 - 333)

Ms. McShane indicated the regulatory environment in the NWT has been even-handed in its approach and the use of rate stabilization funds mitigates risks.

> "With respect to regulatory risk, the regulatory environment in the NWT has been even-handed in its approach. The authorization and maintenance of the rate stabilization funds, which mitigate risks beyond the control of the utility, are an indication of that even-handedness." (Ex.2, Appendix B, McShane Evidence, p.13, *ll.* 354 - 357)

With regard to financial risks, Ms. McShane indicated in comparison to the interest coverage ratios of the major Canadian electric utilities, NTPC's 2003/2004 to 2005/2006 average of 1.7 times interest coverage ratio has been considerably weaker. The average (pre-tax) interest coverage for the major Canadian electric utilities with rated debt over the same period was 2.5 times. She indicated a key reason for the difference is the taxability of the major Canadian utilities because the income tax allowance provides a cushion that enhances interest coverage ratios.

Drs. Kryzanowski and Roberts, expert witnesses for the HC, recommended a deemed equity ratio of 42% for the two test years. The HC summarized the expert witnesses view with respect to business risk as follows:

> "In summary, NTPC's business risk is at an acceptable level with regard to the major factors causing business risk for a regulated electric utility in Canada. Drs. Kryzanowski and Roberts base this assessment on their view that the regulatory process and prudent management practices will combine to mitigate the potential risks discussed in their evidence. Two further favorable factors are the lack of competition and reliance on hydro generation which shields the company from the risk of rising energy prices. On the other side of the ledger, NTPC is smaller than the sample companies investigated by Drs. Kryzanowski and Roberts and faces challenges due to the geography of its service area. On balance, the Hydro Communities' view is that the business risk faced by NTPC is somewhat higher than that faced by the average integrated electric company or the average utility in Canada. ..." (HC Argument, p. 42)

Drs. Kryzanowski and Roberts formed four estimates of the appropriate equity ratio for NTPC. The first two benchmarks represent measures of the average common equity ratio for utilities in Canada. The third benchmark captures equity

ratios deemed appropriate for utilities of above-average risk by the Alberta Energy and Utilities Board. The fourth benchmark measures the equity levels approved for NTPC by this Board in the past.

The witnesses indicated that the benchmark equity ratios all fall in a range of 38% - 43%. Based on the analysis of the business risk faced by NTPC, the witnesses assessed NTPC's business risk as somewhat higher than that of the average shareholder-owned electric utility in Canada. Drs. Kryzanowski and Roberts considered a 42% equity ratio, just below the top end of the range, would be sufficient to result in a stand alone bond rating of BBB for NTPC.

With regard to NTPC's non-taxable status and its impact on coverage ratios and financial risks alluded to by Ms. McShane, the HC stated although bond rating agencies pay attention to ratios, there is no formula which translates ratios into bond rating. Considerable judgment comes into play. Simply having a key ratio (interest coverage, for example) below a certain level is not by itself grounds for a downgrade in practice. (HC Argument, p.47)

Views of the Board

The Board notes the expert witnesses' view that NTPC's business risk is higher (McShane) or somewhat higher (Kryzanowski and Roberts) than that of an average risk utility. The Board also notes Ms. McShane's view that the Corporation's non-taxable status has an impact on its coverage ratios and therefore the financial risk. The Board considers that although the coverage ratios do not necessarily dictate bond ratings, it would appear that the rating agencies include coverage ratios, among other factors, in their rating considerations and, to that extent, coverage ratios would appear to be relevant to the determination of capital structure for NTPC.

The Board notes NTPC's effective cost of long term debt somewhat exceeds the requested cost rate on equity. The Board sees this as an atypical cost structure because, for a typical utility, the cost of debt is generally less than the cost rate on equity. [Schedule 3.5] The relatively high debt cost appears to be largely the result of reflecting sinking fund earnings and investments in the effective cost of long term debt for NTPC and it would appear this situation may continue for some time until a substantial portion of the sinking fund debt instruments are retired. In the Board's view, any consideration of the appropriate capital structure for NTPC for the test years must take into account the reality of the presence of high cost debt in the capital structure since it has an impact on coverage ratios. The Board notes the capital structure recommendations of the HC witnesses reflect an equity ratio taking into consideration NTPC's business risks only. However, in the Board's view the Corporation's financial risk, as measured by indicators such as the coverage ratios, is also a relevant consideration in establishing an appropriate capital structure. The Board notes the HC calculated the coverage ratios excluding lease finance costs. (BR.HC-2) In the Board's view, the lease finance costs are a fixed contractual obligation by NTPC to DPC and should therefore be included in the calculation of coverage ratios.

For the purposes of this Decision, the Board accepts the capital structure proposed by NTPC as it appears to give due recognition to the relatively high cost of debt in relation to cost of equity in 2006/07 and 2007/08 and results in an acceptable level of interest coverage ratios for the test years.

The Board considers, with the eventual retirement of the high cost sinking fund debt, the coverage ratios and the financial risk of the utility would likely improve. Therefore, the capital structure accepted by the Board should not be viewed as solely reflecting NTPC's business risks but rather as one that takes into account NTPC's particular circumstances with respect to high cost debt.