

Manitoba Hydro Undertaking #68

Mr. Rose, in your paper to the Bonbright Conference of 2009, you commented on the financing of utilities. In the September 2009 report to Manitoba Hydro, you suggest that it would be reasonable to review the capital structure of Manitoba Hydro. First, are those references fair? In your view, would lenders considering financing utilities' major capital spending plans that, if completed, would more than double the utilities assets and borrowings, would such lenders seek substantial assurances that the plans would lead to profitable future results?

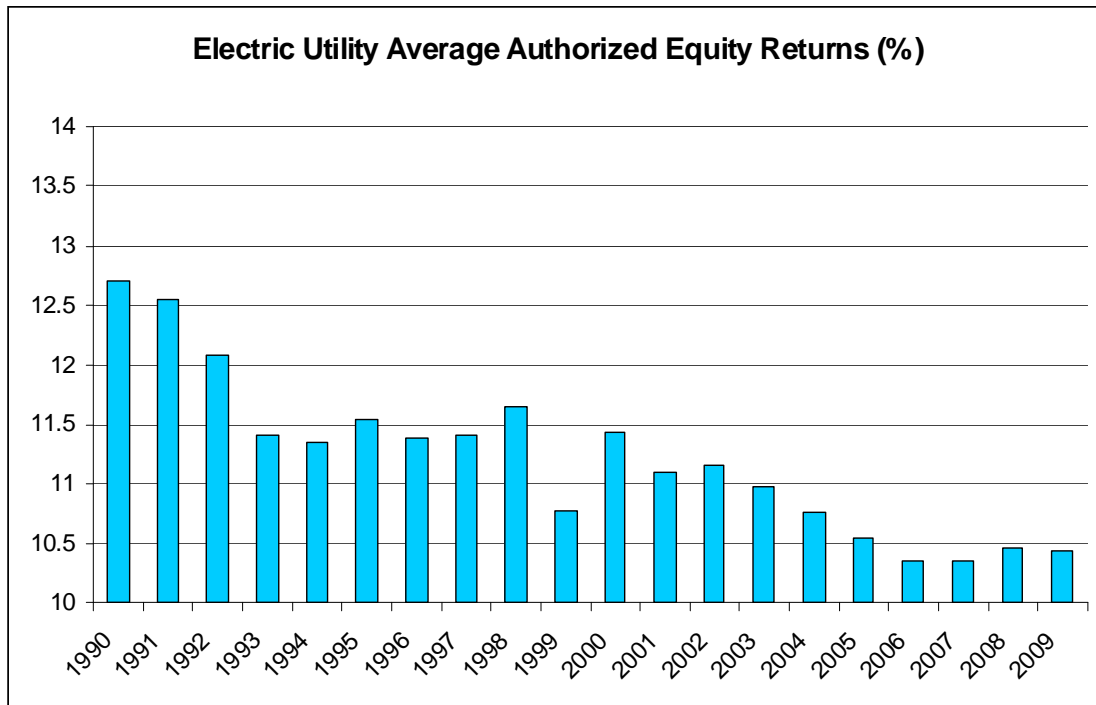
ICF Response:

In my Bonbright conference address, I indicated that utility investing can be challenging if support from regulators is lacking, and that over time U.S. regulators have become less supportive. In particular, state regulators have lowered allowed returns on equity to levels that are low relative to required rates of return on equity, and other aspects of regulatory process have worsened as well. I specifically highlighted the fact that demand growth has been slowing and economies of scale have been offset by rising costs. Thus, it is harder to simply fix rates at a given level, and allow higher returns via lagging rate cases in the face of demand growth faster or higher than expected (so that returns can be higher than the allowed rates). I also expressed the concern that CO₂ regulations would raise costs and lower demand growth, and hence, exacerbate the challenges facing the U.S. utility industry.

The following chart from my 2009 Bonbright Conference address is critical and illustrates the fact that the average authorized return on equity has been declining.

Finally, my Bonbright address (pages 26-27) also emphasizes the problems created by CO₂ regulations for most U.S. companies. I indicated that companies might avoid CO₂ related investments by purchasing power. In the case of MH, CO₂ regulations create opportunities. Indeed, favorable contract terms and strong interest in MH hydro power may be related to poor regulations in the U.S. Thus, the impact of CO₂ regulations is the opposite for MH compared to typical U.S. utilities; it benefits from higher prices for and greater interest in its power exports.

Exhibit 2
Declining Authorized Returns on Equity



Source: Judah Rose (2009), Financing for the Future – Can We Afford It?, Bonbright Conference, p.15

The lenders of MH, and lenders in general, are not as much interested in the size of the investment per se as they are first and foremost in the risk of return of and on the investment. For regulated utilities with franchise territories, the risk is to a large degree determined by the regulator. If the regulator is not supportive of the utility's activities, the concern of financial stakeholders is larger and heightened by the investment, especially if it is big. Conversely, if the regulator is supportive, then the financial stakeholders' interest increases with the size of the investment. Larger investments create more opportunities and the upside of above average growth.

One consequence of an unfavorable regulatory environment is the financially inappropriate preference for generation that has high fuel costs or purchase power contract costs rather than a financially prudent cost minimizing combination of capital and variable costs. This is because fuel costs and net purchase power costs are almost immediately and automatically passed through via fuel and purchased power clauses. These clauses exist and are automatic to avoid financial problems for the utilities – e.g., inability to pay fuel and power purchases can almost immediately lead to insolvency. This contrasts with frequent rate cases and the associated regulatory risks related with large capital investments.

The size of the investment on a percentage basis is a function of a utility's current rate base which can be low if the utility has highly depreciated legacy assets. Usually, this causes rates to be low. Eventually, sole reliance on legacy assets ends for utilities with positive load

growth. Hence, the concern is more related to the overall regulatory environment, and not the size of the investment alone.

In the ICF September 2009 report, I indicated that the level of equity is important in consideration of the impacts of a drought. The availability of equity cushions the impacts of adverse hydrology and facilitates financing. While we believe that the level targeted for equity is reasonable because it is set based on a reasonable stress test and is comparable to other utilities, we did recommend planning exercises to consider the rate and financial impacts during a drought of having different levels of equity (or considering mitigation plans as retained earnings are depleted in the event of a prolonged drought).¹

¹ See ICF report, p.22, p.25.