Q. The Grant Thornton LLP report on Newfoundland and Labrador Hyrdo's 2001 General Rate Hearing, commented on Hydro's interest coverage calculations at page 13. Explain and comment on the appropriateness (i.e., inclusion vs. exclusion of various items, and when to use the calculations) of Hydro's interest coverage calculation.

A. In responding to this request it is important to review the historical significance of interest coverage in the setting of rates for Hydro. Prior to 1996, Hydro's cost of service and revenue requirement were established by reference to an appropriate interest coverage ratio. Consequently, calculations of "regulated interest coverage" or "cost of service gross interest coverage" were very important as were definitions of "gross interest" (i.e. what was included/excluded).

Since 1996 Hydro has been regulated based on return on rate base and the significance and relevance of the interest coverage calculations has fundamentally changed. Interest coverage is now used as a tool in assessing the credit risk associated with the Company's debt and its overall credit worthiness. From a regulatory perspective the appropriateness of the interest coverage calculation should be based on what is relevant and appropriate to the financial markets.

The various credit rating agencies and financial market analysts all use their own methods of calculating interest coverage or fixed charges coverage. We believe that the calculation of gross interest coverage based on Hydro corporate non-consolidated financial results is the most appropriate from a regulatory perspective. For clarity, the corporate non-consolidated results would include non-regulated as well as regulated profit of Hydro but would exclude the results of its subsidiaries.

The interest coverage calculations on page 13 of our report essentially represent gross interest coverage calculated on the basis described above. This is the way in which Hydro's interest coverage has been historically reported to the Board. Based on further review we believe that two changes may be appropriate to the calculations as presented: (1) the guarantee fees should be included in gross interest, and (2) the interest earned on sinking funds should be deducted from gross interest.

Recalculating the forecast interest coverage for 2001 and 2002 incorporating these changes results in coverage ratios of 1.37 and 1.34 respectively, as compared to 1.39 and 1.36.