(9:30 a.m.)

MR. NOSEWORTHY, CHAIRMAN: Good morning everybody. A taste of winter out there unfortunately. Before we get started I'll ask, Mr. Kennedy, if there are any preliminary matters.

MR. KENNEDY: I don't believe so, not this morning, Chair.

MR. NOSEWORTHY, CHAIRMAN: Okay.

MR. HUTCHINGS: Mr. Chair, if I might by way of a preliminary matter. I didn't get the opportunity to speak to Mr. Kennedy before we started, but just to update the Board in respect of the evidence to be led on behalf of the industrial customers, as we indicated earlier, Mr. Coté is no longer associated with Abitibi Consolidated and he had pre-filed evidence in the matter. We are now anticipating that the Senior Vice-President of Manufacturing for Abitibi Consolidated Inc., Monsieur Denny Jean, that's J-e-a-n, will be available to give that evidence on behalf of the industrial customers. We may need to be speaking with other counsel with a view to perhaps assigning a specific date to hear Monsieur Jean's evidence as travel arrangements around the times that we're anticipating may be a bit troublesome, so we will have some discussions with counsel on that and we hope to, within the next ten days or so, be in a position to file the amended evidence, which will take into account the necessary change in who the witness is. Just for an update, Mr. Chair.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Mr. Hutchings. Good morning, Dr. Kalymon.

DR. KALYMON: Good morning, Mr. Chairman.

MR. NOSEWORTHY, CHAIRMAN: I'll go now to Ms. Butler, who I understand is completed with your cross ...

MS. BUTLER, Q.C.: Yes. I have no other ...

MR. NOSEWORTHY, CHAIRMAN: ... Ms. Butler, is that correct?

MS. BUTLER, Q.C.: ... questions. Thank you, Mr. Chairman.

MR. NOSEWORTHY, CHAIRMAN: Thank you very much. We'll proceed back to Mr. Hutchings now for his cross-examination, please.

MR. HUTCHINGS: Thank you, Mr. Chair. Good morning, Dr. Kalymon.

DR. KALYMON: Good morning.

MR. HUTCHINGS: I wanted just to discuss a couple of points briefly with you. The first one starts at **the bottom of page 34 of your pre-filed evidence and goes on to the top of page 35** where you deal with the issue of market pressure, and I'm interested to know what exactly you intend to include within the definition of market pressure, and if you could for us try to relate that to what Ms. McShane calls in her evidence, and specifically at page 43, the notion of financing flexibility?

DR. KALYMON: The 50 basis points which I have notionally included in my analysis for market pressure is ... I generally include, because in a, in the context of a market financed company, there are various costs associated with raising equity that relate to downward pressure on pricing when you try to raise funds, other costs of issue, and these are normally ... this normally can be assessed by suggesting that instead of targeting a one-to-one market to book ratio, which is, it's the definition of the cost of equity, by the way. It's a return that allows the investor to preserve exactly the amount of money they've invested and earn a fair return every year. The 50 basis points provides for a margin above that, and that is ... now, the reason it's included here is, you know, it could be well stated that this company does not face any market pressure and that is correct, or it could also be stated that it is not publicly financed, but I think the intent was to permit a company to earn a return that would be similar to those earned by such privately-owned companies, and if you make it in that reference context then fairness requires such a provision. That is why I included it. Now why Ms. McShane includes it, I'm not sure. Could you just give me the reference because there are aspects, I think, that were troubling me when I heard her testimony.

MR. HUTCHINGS: **Page 43 of Ms. McShane's pre-filed evidence**, starting at line four.

DR. KALYMON: Yes. I now recall what was troubling me. If you look at the paragraph starting on page four, Ms. McShane includes the reasons for the allowance are three aspects, flotation costs, a margin to cushion for unanticipated capital market conditions, and then, three, a recognition of the fairness principle in the sense that regulators should not seek to keep the market value close to book value. Well ...

MR. HUTCHINGS: If I can just interrupt you for a second, we don't have the right page on the screen here.

DR. KALYMON: Oh.

MR. HUTCHINGS: It's page 43, starting at line four.

DR. KALYMON: Oh, sorry. I was ...

MR. HUTCHINGS: Okay. We now have it.

DR. KALYMON: I was reading from the hard copy.

MR. HUTCHINGS: Yes. No, that's fine. I just wanted to make sure everybody else is following us.

DR. KALYMON: Okay. If you look on the screen now, I do remember what was bothering me about her allowance. It is traditional in establishing cost of capital to provide market pressure allowances for flotation costs. Unanticipated market conditions, I'm not as convinced about. And, three, a recognition of the fairness principle, I take strong objection to. It is, has absolutely nothing to do with fairness. In fact is has to do with unfairness to the consumer to allow companies to earn above their cost of equity. Companies are entitled to earn the cost of equity but this concept of (inaudible) allowing fairness by permitting excess returns, which is basically by theory, financial theory, if a regulated utility, if it was a pure regulated utility that was trading above its book value, it is consistently, and it is over-earning and it is basically being allowed returns above what it needs, and so I completely reject her point number three as a legitimate basis for providing any form of allowance.

MR. HUTCHINGS: Just to get back to your own view of the matter, we do agree though that the flotation costs, for instance, are not actually incurred and will not be incurred by Hydro in this case.

DR. KALYMON: Well, barring any changes in the way the Company is financed, that statement is correct. I think all of the assessments are done on the basis of imputing a parallel with a privately-owned market-traded equity, so, but in the absolute facts it will not.

MR. HUTCHINGS: Okay. And equally there is no market at the present time for Hydro's shares and hence there would be no market pressure even in the theoretical issuance of shares by Hydro.

DR. KALYMON: Well, if Hydro actually did move to a privately-owned and had to issue shares, then the pressure would be there, but ...

MR. HUTCHINGS: The pressure would be there then, yes.

DR. KALYMON: ... it is not there currently.

MR. HUTCHINGS: No. I accept that, okay. In your review yesterday of the changes to your evidence, again at one point, and I don't have the transcript reference, to refer to the change in some of the existing yields as being substantial, and you moved on then to in fact to refer to them as dramatic. And I was wondering if you could expand on that a little for us and see if we can put this in the context of whether this is a short-term type of knee jerk reaction to things that have happened over the past two months or whether this, in your mind, constitutes a trend or is part of a trend.

DR. KALYMON: Well, I think when I used ... first of all, following the tragic events of September 11th, there has been a dramatic shift in the capital markets. Is this just a temporary aberration? The answer is no. Why can I say that with confidence? Well, the most dramatic changes are, occurred at the very short end of the money market, which saw a drop from four percent to 2.15 percent, so that change is temporary and will, you know, can be classified as temporary. It's a three month rate which may persist for a year but may not. However, the markets have moved down in not more, for more than just the short-term three month rate. I pointed out that the key index which I have always tracked is the ten year rate and in fact is the rate that is used in most, in many jurisdictions, I should say, for indicating the long-term or cost of capital. That moved down from 5.70 to 4.86 percent. Now that is a ten year rate. A ten year rate when it moves down means that investors, looking at the next ten years, believe that the conditions in the capital markets are such that they can afford to price their cost of capital services down by that much. That means that they do not expect the conditions to just be temporary. They expect them to persist through ten years, because if they were just temporary and the rates of August 1st were to revert, they would suffer major capital losses in the process, so, and in fact the same statement, and even more so can be made about the 27 year rate, which I quoted, which was the Province of Newfoundland trading yield of 6.21, down from 6.71. What I said about the 10 year rate is even truer for that case because there investors are committing for almost 30 years and therefore they're basically saying that our forecasted conditions for the next 30 years have now moved down. If that was just a temporary aberration, the investors would suffer dramatic losses in capital, if there was an immediate reversal. So these changes are most dramatic at the short end but are definitely, the conditions for capital provision in the markets have moved and have changed and not just a temporary aberration.

(9:45 a.m.)

MR. HUTCHINGS: And is it fair then to extrapolate on a longer-term basis the rush to safety, if you will, in the sense of investors now being more interested in the safer stocks like utility stocks?

DR. KALYMON: I'm sorry, I missed the front part of the question.

MR. HUTCHINGS: Okay. Is it fair to ... I believe you spoke yesterday of the fact that people tend to rush to safety in unstable times such as this and seek out less risks stocks overall out of the marketplace. My question is whether or not that can be perceived as part of the long-term trend that is illustrated by the fall in the long-term rates?

DR. KALYMON: The fall in the long-term rates, the most direct effect on utility shares is that the valuation of the dividends is increasing. Basically the cost of capital is falling. The valuation of any dividends, and these are normally dividend paying stocks that we're looking at, therefore the valuation goes up which effectively means that investors are willing to settle for less return because they are paying more for the capital for the same stream. In fact they're paying more for a stream which is forecasted to fall. I'll just use exhibits that was filed yesterday, the RBC latest ROE forecast for year 2002, pipelines and gas, electric utilities. I'm sorry, but I don't know the, what this was designated as.

MR. HUTCHINGS: It is **U-Hydro 24**.

DR. KALYMON: Sorry. Okay, sorry, it is here. U-24 is the reference, and the ... let me quote one piece that just illustrates the point most dramatically. If one looks at page nine of that report, this is an analyst's view of how things have changed or how things change as the cost of capital drops. At the top of that page it says, which is titled "Conclusions and Recommendations," it says, "We iterate our view that the net effect of lower interest rates on pipeline and gas utilities is positive. The negative impact that lower rates have on earnings due to lower allowed rates of return is more than offset by the positive effect that lower interest rates have on the valuations of these stocks." So if that's the effect that I was just trying to, that I was talking about, when the cost of the money comes down, the valuation of these types of shares, it goes up, now that's not flight to safety, that's simply the valuation impact of lower interest rates, but on top of that there is a flight to safety, which means that effectively risk premiums are dropping because there's a perception that it's more attractive relative to the more risky other investments available, and that has had the effect that utility shares have done extremely well over the past year. For example, it was, I'll use the same report just for convenience, but there was some discussion of what TransCanada Pipeline shares have done. Sorry, I can't use this. I was looking at another report, but TransCanada Pipeline shares, for example, are trading close to their historic high and they're up maybe 50 percent from where they were a year ago, and this is also true for Fortis, so it's an illustration of the flight to quality and safety and also the impact of lower interest rates combined making these types of investments extremely attractive. This is not a temporary phenomena. This is fundamental to how financial markets react.

MR. HUTCHINGS: Thank you, Dr. Kalymon. Those are all my questions, Mr. Chair.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Mr. Hutchings. Thank you, Dr. Kalymon. We'll move now to the Consumer Advocate, Mr. Fitzgerald, please.

MR. KENNEDY: I believe, Chair, it would be Board Counsel's turn to ask questions of the witness.

MR. NOSEWORTHY, CHAIRMAN: It's been a longer week than I thought. My apologies.

MR. KENNEDY: With your indulgence ...

MR. NOSEWORTHY, CHAIRMAN: Board Counsel.

MR. KENNEDY: Dr. Kalymon, I wanted to turn just first to **page 15 of your pre-filed testimony**. I'm about in the middle of the page. This is in the section where you deal with the cost of common equity and you note the, I guess, the principle principles of, which you have taken into account when assessing what an appropriate or fair and reasonable rate of return is for Newfoundland Power, and these are as listed at line 13 to 16, "Fairness to both shareholders and customers, financial integrity of the company and ability to attract capital." And as also noted in your pre-filed testimony and has been thoroughly canvassed in the testimony of other witnesses to date, the current capital structure of Hydro is approximately 85/15, the debt-equity ratio, and as we also know there's a provincial guarantee that supports the debt of Hydro, and I think it's your testimony as well as the other experts that it's this provincial guarantee which allows Hydro to maintain this, what I guess could be described as fairly leveraged capital structure. Is that correct?

DR. KALYMON: That is correct.

MR. KENNEDY: And if I gathered your, gathered correctly from your testimony as of yesterday, you indicated that you have absolutely no concerns with the financial stability of Newfoundland and Labrador Hydro.

DR. KALYMON: No, I don't have any concerns under the present arrangements.

MR. KENNEDY: And so am I gathering correctly then that, at least insofar as these three principles are concerned, that under the current scenario of just looking to the debt-equity ratio and its, and the, and in light of the presence of the provincial guarantee, what impact if any all that has on the financial integrity of Hydro is that there's no reason to be concerned, that it does have financial integrity as a company.

DR. KALYMON: It definitely has financial integrity under the arrangements and it has the ability to attract capital, so I'm not concerned on either of those dimensions.

MR. KENNEDY: Right. So, and that was my next question. So in addition to the fact that there's no evidence of financial distress, there's also no evidence of an inability to access debt on the market.

DR. KALYMON: That is correct.

MR. KENNEDY: And I believe there's also been some testimony, and I'm wondering whether you would agree, that there's also no evidence that at this point in time

Hydro's, that Hydro's finances have had any negative impact on the province's debt rating.

DR. KALYMON: I was present and I have reviewed the bond rating assessments and I concur that ... well, first of all, I am aware that they do not believe that the Hydro debt is impacting in any significant way on the province's debt rating, and, secondly, I concur there is no reason for it to have an impact because it is basically self-sufficient.

MR. KENNEDY: Now, in **your pre-filed testimony at page 11**, and this is the section which I believe it was counsel for Newfoundland Power may have asked you questions on, it's your recommendation there at line 14 to the Board that, "The capital structure of Hydro be allowed to gradually evolve over a number of years to the stand alone level of 40 percent equity and 60 percent debt, which would permit Hydro to achieve an investment grade rating on its bonds." And if I'm gathering correctly, that the rationale for this recommendation is found on line four on the same page, "That the revised mandate for the regulation of Hydro requires that it be treated similarly to a privately-owned utility."

DR. KALYMON: Yes, with that mandate and the notion that the financing of the Corporation should move towards a structure that is similar to a privately-owned utility.

MR. KENNEDY: Now, in the preparation of your expert testimony, would you have looked to the new regulatory environment of Hydro and specifically the provisions of *The Electrical Power Control Act* and *The Public Utilities Act*?

DR. KALYMON: I reviewed them. I obviously am not a lawyer and I cannot speak to the legalities, but as an expert witness on cost of capital, has to be done within a context, so I did review them and my understanding was that the mandate to this Board is that the Corporation be allowed or be treated similarly to a privately-owned utility. That was my reading of those mandates, yes.

MR. KENNEDY: Okay. And you were present, I believe, when I cross-examined Ms. McShane on her expert testimony.

DR. KALYMON: Yes, I was.

MR. KENNEDY: And I, in that cross-examination, I attempted to point out to Ms. McShane that neither in *The Electrical Power Control Act* nor in *The Public Utilities Act* is it stipulated that Hydro be treated as a, as if it was investor-owned or privately-owned utility, and we can turn to the sections if you wish. It's **Section 3 of the EPCA**, Mr. O'Rielly. Section 3. Scroll down, I think. You're in Section 2. Just keep scrolling down. Okay. So Section 3 says, "It's declared to be the policy of the province that the rates to be charged either generally or under specific contracts for the supply of power within the province should be reasonable and not unjustly discriminatory, should be based on forecast costs," and then, three, "Should provide sufficient revenue to the producer or retailer of the power to enable it to earn a just and reasonable return as construed under *The Public Utilities Act* so that it is able to achieve and maintain a sound credit rating in the financial markets of the world." If we could just turn to **Section 80**, now, Mr. O'Rielly, of ***The Public Utilities Act.*** I just want to make sure that you see both sections, Dr. Kalymon, before I proceed on. And Section 80, which is I'm sure a provision that you may have already referred to, which is what Section 3 of the EPCA just referred us to in turn, says that, "A public utility is entitled to earn annually a just and reasonable return as determined by the Board on the rate base of six and determined by the Board for each type of or kind of service supplied to the public utility," and then it goes on to provide for certain other possibilities or eventualities and they're not really relevant to the, to this hearing before us today or the issue here. So you'll agree with me, if you will, will you, that as far as the acts are concerned, *The Electrical Power Control Act* and its expressly stated objective of the policy of the province, and then Section 80 of *The Public Utilities Act*, that there's nothing in either one that expressly stipulates that Hydro is to be treated as if it is investor-owned or a privately-owned utility.

(10:00 a.m.)

DR. KALYMON: I think ... well again, I don't want to give a legal interpretation of it but from cost of capital perspective I believe that the wording in *The Public Utilities Act* with regards to just and reasonable return is basically the same wording that has been applied to privately-owned utilities and has been interpreted in that context, and I believe that the intent of that, my interpretation of the intent of the previous act was that this company be treated in the same fashion, and there is also a, it's reference not only to be entitled to earn a fair and reasonable return, but I think there was a reference, in the previous reference, there was reference made to achieve a credit standing as well. So I think on both dimensions I interpreted that ...

MR. KENNEDY: Okay.

DR. KALYMON: ... to imply that ...

MR. KENNEDY: And I guess that's what I'm trying to just make sure I understand, that the premise upon which you base your recommendation of that Hydro should move to a debt-equity ratio of 60/40 from its present 85/15 is based on the notion that Hydro is to be treated as a, as if it was a investor-owned utility.

DR. KALYMON: Well, Mr. Kennedy, if we could just put the previous reference up ...

MR. KENNEDY: Sure, **Section 3**, Mr. ...

DR. KALYMON: ... because I did review these, I guess, prior to my preparing my testimony as to have a bearing for what I was supposed to be, what context I was supposed to be making my recommendation, and I think what it says there is, "Should provide sufficient revenue to the producer to earn just and reasonable return as construed under *The Public Utilities Act*." That was my ... my interpretation was that implied, because the way that act has generally been interpreted, was that the return should be similar to returns earned by companies in the market, and then the second portion was, "So it is able to achieve and maintain a sound credit rating in the financial markets of the world." Now, that part, that interpretation, you can't achieve a sound credit rating in the financial markets of the world unless you have a better capital structure than you have, than is visible in the accounts of Newfoundland Hydro.

MR. KENNEDY: But it is the case, and we just established, I thought, that at least insofar as Hydro stands today with the presence of the provincial guarantee, that it is maintaining a sound credit rating in the financial markets of the world.

DR. KALYMON: I agree and I think that's what I testified to yesterday, that there is no urgency and even no absolute need or requirement to move in that direction because there is no concern about the financial stability, so the issue of whether it can achieve a sound credit rating, well, with the provincial guarantee it can but if you interpret this as, if I interpret it as suggesting that there was a desire to have the Company independently have a sound credit rating, then my recommendation is if that is the interpretation of the mandate of the Board, then they should be moving towards a higher equity component.

MR. KENNEDY: Sure, okay. So if the interpretation is that the acts are stipulating that Hydro is to be treated as if it's investor-owned, then it's your recommendation that it should operate on a stand alone basis and that would imply no provincial guarantee, and if it's going to maintain a financial credit rating under that scenario, it needs to move towards a debt-equity ratio closer to 60/40.

DR. KALYMON: There is a lot in your statement, Mr. Kennedy, but if I could dissect it into two parts, I think it's clear that it's, that, to me it's clear that it says that should be, should provide sufficient revenue and to enable it to earn a just and reasonable return. Without a reference to the markets, I don't know what that means. I think all the precedents that I'm aware of refer to that as if a company was in the private capital market, so if that's not there, I really wouldn't know how to interpret that at all.

MR. KENNEDY: Okay. So ...

DR. KALYMON: But the second part, just to dissect the statement, the second part, so that it is able to achieve and maintain a sound credit rating, again if one wanted a sound credit rating for the Company without the provincial intervention of a guarantee, then it would need to move, but I guess I, here's where the, my legal knowledge stops as to whether one wants to interpret that ...

MR. KENNEDY: No, and I understand that ...

DR. KALYMON: ... that they should have a stand alone, because I'm not concerned as a financial witness, I'm not concerned about their existing situation.

MR. KENNEDY: I understand that, Dr. Kalymon, and I guess I'm not asking you for a legal interpretation per se but more of your interpretation of the acts as then forming a premise for your recommendations in your expert report itself, and I just wanted to be very clear that it was your interpretation of the acts that this, that Hydro was to be treated as if it was investor-owned and therefore needed to operate on a stand alone basis and so on and so on, leading to a 60/40 debt-equity ratio.

DR. KALYMON: Well, I think the, saying that it should be treated as an investor-owned, I don't think I ever make that statement in my testimony. I think my testimony only refers to what should be a fair and reasonable return ...

MR. KENNEDY: Well ...

DR. KALYMON: ... and what should, what would achieve a sound credit rating.

MR. KENNEDY: I'm looking at line four of page 11 of your testimony. You go, "The revised mandate for the regulation of Hydro requires that it be treated similarly to a privately-owned utility."

DR. KALYMON: The statement is maybe too broad than I intended. I mean, I was only ... I only ... I was only testifying to a limited aspect of that, which is the revenue requirement and the capital structure that might allow it to achieve sound credit ratings, and ...

MR. KENNEDY: Because your next line is, "Thus, it is important to establish the capital structure which would be appropriate for Hydro in the absence of a provincial guarantee." So one would follow the other, right, that if it is in fact the revised mandate of the regulation of Hydro that it be treated as a privately-owned utility, then that would necessarily mean that then it would need to operate without the provincial guarantee, and if it's going to operate without the provincial guarantee, then it needs to move to a 60/40 capital ratio in order to maintain a financial integrity.

DR. KALYMON: There was two purposes in what I'm stating there. First of all, to establish a fair and reasonable return is basically impossible unless you have some comparables, and you just don't find comparable utilities that, in the traded private market that have an 85/15 capital structure, so one has to work with proxies which say what is a, what would be appropriate in the absence of the guarantee because you need proxies to establish reasonable returns, and so I need to have a proxy for what the Company structure would look like if for that purpose alone. I also needed to get a, to make, to formulate a recommendation of what would be appropriate if it was interpreted that the provincial guarantee should not constitute the basis of the capital structure. So I need it for both purposes. Even if the provincial guarantee is to stay, which I, nowhere in my testimony do I say that it is to be removed or assume that it is being removed. I need a premise on which to assess the capital structure, I need to observe, so I need to observe what are effective capital structures used by utilities of this type of, with this type of business risk.

MR. KENNEDY: You've heard the evidence of Dr. Vilbert concerning the impact of a change in capital structure on the recommended rate of return on equity, and I'm wondering would your recommended rate of return for Hydro be changed if in fact this Board were to order that Hydro was to maintain its present debt-equity ratio of 85/15?

DR. KALYMON: No, it wouldn't change because my page 13 essentially assumes the existing environment. It assumes the presence of a guarantee, it assumes that the actual observed capital structure is as it is, and I am simply suggesting that a fair and equitable return would then be achieved by a deeming process, say, treating effectively portion of the debt as pseudo equity, and through the deeming process arrive at a reasonable target for the return on rate base, return on total rate base. So my recommendation there does not require the change to an actual 60/40. It's a deeming process that is just and reasonable. It's a process that is not inconsistent with some of the theory that Dr. Vilbert proposes. I find it unnecessary to bring in the complication of taxes which belaboured a tremendous amount of attention and I find not really productive. This is a company that is non-taxable and the theory, very simple theory says non-taxable situations basically means that before-tax ... I don't want to get into ... the after-tax weighted average cost of capital, which is effectively the return on rate base, is essentially stable across a wide range of capital structures. I found that the introduction of the taxes just complicating the situation unnecessarily, but essentially that is what I'm doing on page 13. I'm basically saying regardless of how the actual appears, because of the guarantee, it is effectively, and the Board could reasonably deem it to be effectively a capital structure as I suggest here, and a fair return, and assess a fair return, and that return on rate base is essentially stable over whatever shifts on capital structure the Company actually uses. So first bases on the premise that a company should be operating at an efficient capital structure and get a fair return. If it is there because of the guarantee, okay, that's the way it is, but the return is what I'm concerned about because I'm trying to make sure that the total returns are not excessive to the customers of this Company.

(10:15 a.m.)

MR. KENNEDY: Would you agree with the statement that in order to be, in order to be entitled to be treated as if it was investor-owned, that a utility should also act as if it was investor-owned?

DR. KALYMON: Well, like I said, the context of being an investor-owned maybe has a lot more implications than the term in which, sense in which I intended it in my testimony, so ...

MR. KENNEDY: For instance, I'll give you an example, Dr. Kalymon. There's been extensive evidence led about dividend payment that Hydro intends to make in 2002 of some $70 million, and that this was a, I think it's fair to say, an unusual dividend pay-out, and that I think it's, I would suggest to you, also been established that in that sense it's not a dividend pay-out that you would normally see in a normal investor-owned utility, and that in turn I've asked Ms. McShane questions concerning the inherent value in the ability of this shareholder to call upon dividends in amounts and timing which is at its discretion, and that that would entail also an unusual aspect to this utility as opposed to a pure investor-owned one. And I'm wondering if you could comment on how you see that or whether you see that as having any impact on the regulatory treatment of Hydro in whether it should be treated as a pure investor-owned utility.

DR. KALYMON: Well, let me make a couple of comments. First of all, the paying out of a dividend as substantial as it was, was actually, and I think I made this comment earlier, was actually then effectively replaced by the same amount of debt that the effect, the effect is it was replaced by the same amount of debt with a guarantee. Now in the private, in the world of private financial investment, when you guarantee a loan, you are effectively putting up equity if your guarantee is credit worthy. So all that really happened on the dividend is a removal of cash and a replacement of cash with a debt guarantee by the shareholder. You know, it's like a shareholder's loan. If you look at how bankers treat shareholders' loans, they treat them as equity essentially because they're ... so in a sense that is the special way that is being, this is being done. Only a very credit-worthy institution like the province could do such and be treated and have that treated as equity, but that is the fact, that the dividend is not the same as a divided disappearing from a private corporation without any guarantee on the replacement of funds. That would be a true withdrawal. So this is really a dividend of convenience, if you like, because the actual equity backing has not changed because effectively the guarantee replacing that money is still there. So the discussion of the dividend, I think, you know, does this make it different? It is different but there are transactions like that in the private financial world. For example, there are leverage investment opportunities that sometimes face investors in which they are asked to put up very minimal amount of equity money but have to guarantee the loans. In effect, that is equity. So that's what's happening here at a more senior level but, therefore, I don't see this as a dividend (inaudible) the same way it could be treated in another corporation. It is replacement of one type of equity with another type of equity.

MR. KENNEDY: Okay. Well, what of Hydro, what of the Government's intervention in the management of Hydro in furthering social policies in the Province of Newfoundland? For instance, you've had some questions about the issue of the cross-subsidization among ratepayers and on rural rate subsidy initiative, and there's been some evidence led during the hearing about other initiatives of Hydro which may or may not be ultimately characterized as a social policy driven directive, but do those types of interventions by the Government have an impact on how this Board should treat the Utility?

DR. KALYMON: I think some of this pushes me beyond areas of my direct competence but I will comment in the following way. The Board, I believe, has a responsibility in these types of hearings to scrutinize the cost of service in totality. That means looking at every aspect of cost of service and normally whether it's a privately-owned or a publicly-owned utility, aspects that are, aspects of the cost of service beyond cost of capital now, can be disallowed, and in that context it effectively affects the cost of capital but it isn't the cost of capital that's at issue. The issue is whether a particular expenditure is a just and reasonable expenditure in the context of the full cost of service, so regulatory boards normally scrutinize every aspect of the cost of service beyond cost of capital to see whether a particular cost is justified or not. If it isn't part of the cost of providing service, then it can be disallowed. Whatever impact that has on return is just a tangential issue. The same comment could be made about cross-subsidization in the same context. One could say the Board has the power to review the rate design and rate structure and the degree of cross-subsidization that is implied. I'm after testifying on some rate design issues as well in the past and you cannot avoid all cross-subsidization. It's impossible. Somebody is sitting next door to the power station and somebody is sitting ten miles away. There's going to be cross-subsidization of some sort but it may be minor as opposed to more major. So at some point one has, the Board has the responsibility to decide whether a particular cross-subsidization is socially justified, whether it's sufficient, etc. Those may have tangential impacts on the cost of capital but, sorry, tangential impacts on the effective returns, but I think they're in a different domain than what I'm testifying to. Those decisions have to be made and I guess the final comment would be that, again as a legal matter, how do you sort out the legislative power of the Government from its powers as its shareholder? I mean, shareholders should not have ... a shareholder in the normal context does not have power to dictate social policy. Boards often take on some aspect of social policy responsibility as part of their own mandate, and so it effectively does affect the rates of many privately-owned utilities, but then sorting out the legality between the legislative power and the owner is one that I can't really help you with very much.

MR. KENNEDY: No, but it's ... you'll agree with me that, I mean, it's stated openly on the record by Hydro in its pre-filed testimony of the President of the Company that Hydro itself recognizes that it is sometimes a vehicle for Government in furthering social policy in the Province of Newfoundland and Labrador.

DR. KALYMON: Yes, I think that's correct.

MR. KENNEDY: And so, and that's not Government acting through its legislative powers in a separate role; that's Government as shareholder giving directions to Hydro as a company to carry out certain social objectives, social policy based objectives.

DR. KALYMON: As a general comment one would hope that those sort of issues are explicit and clear. I think there is legislated mandate with regards to the rural subsidies. You know, I presume that would be the cleanest way to try to separate out the two issues.

MR. KENNEDY: And I believe, I'm not sure if you were here when Mr. Hall testified, but that was his testimony that it would be the capital market's preference if the shareholder was carrying out social policy objectives through Hydro that it do so expressly so that everyone could see what it was that Hydro was carrying out as opposed to it being done indirectly or implicitly.

DR. KALYMON: I think that would move the Company closer to a, the context of a, let's say a stand alone economic entity.

MR. KENNEDY: And so in that regard it (inaudible) insofar as that Hydro is subject from time to time to Government's intervention and carrying out social policy based objectives that that departs from the normal pure investor-owned utility and how it would operate.

DR. KALYMON: Well, that's where I don't think I agree, because there are many mandates that get implemented by privately-owned investor utilities, but those aren't at their own shareholders' initiatives. They are at the direction of the boards or the directions of governments which can mandate different effects, so the instrument of implementation can be a privately-owned utility, just like it can be a Crown-owned utility, but it should be clear as to who's running the show.

MR. KENNEDY: So is there, hypothetically then, if we were to treat Hydro as something other than an investor, pure investor-owned utility, that we were to take into account the fact that the shareholder of Hydro is the Government of Newfoundland and Labrador, and that at times Hydro is subject to the Government's direction on implementing socially, social based policy directives, is there, in your opinion, another model that can be employed? Is there another proxy that you're aware of that this Board could look to in determining what then would be a fair and reasonable rate of return for such an entity?

DR. KALYMON: Well, I think you would lose your bearings if you didn't stay with the issue of fair and reasonable return from a capital market perspective. I think that's the only compass that there exists out there in terms of what is fair and reasonable return, and it's a meaningful compass because it has economic implications, so I would loathe to recommend abandoning that compass, but at the same time I think all of the other questions and issues that you raise are fair issues of discussion as to what is a suitable cost within the cost of service. You know, privately-owned utilities do not get penalized in their rate of return just because they are being asked to implement a particular rate design. The telephone companies, effectively, were cross-subsidizing the retail consumer for many years but their return on equity was not being penalized because of that mandate that was basically coming from the boards. So I think in the same context there is no particular ... I mean, there are precedents for mandates coming from other than the Government, I guess, but I wouldn't say the mandate should be from the shareholder. The shareholder should not have the right to make that mandate. The confusion here is the two are the same, the legislative power of the Government and the owner is the same. That's the only confusion that we have here.

MR. KENNEDY: That's all the questions I have, Chair, panel members. Thank you, Dr. Kalymon.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Mr. Kennedy. We will move now to Mr. Fitzgerald on re-direct, please.

MR. FITZGERALD: Mr. Chairman, we have no questions arising on re-direct.

MR. NOSEWORTHY, CHAIRMAN: Okay. I haven't ... I didn't anticipate this to go as quickly this morning. I'll take some guidance from the Board. Mr. Powell, are you prepared to begin or do you want to take a ten-minute break?

COMMISSIONER POWELL: It's up to you. I only have a couple of questions.

MR. NOSEWORTHY, CHAIRMAN: Yes, please, if you could continue.

COMMISSIONER POWELL: Thank you, Dr. Kalymon. I enjoyed your presentation. Just a couple of questions. You're recommending a rate of return of 7.94 percent now, I think, revised.

DR. KALYMON: 8.75, as a mid point.

COMMISSIONER POWELL: Okay. So normally when, if we were to accept that recommendation and we were to approve a rate of return, we would, we wouldn't peg it precisely at that. That would be within a range, upper and lower limit?

DR. KALYMON: Correct. I think you have to have a specific target to set the specific rates within the ... the Company has a specific target on which the rates are set.

COMMISSIONER POWELL: Yes.

DR. KALYMON: And then the permitted return would then be in a range.

COMMISSIONER POWELL: And what would be an acceptable range?

(10:30 a.m.)

DR. KALYMON: Well, in this case the acceptable ... normally my acceptable range would be the top part of my range. I suggest a range from 8.5 to 9.

COMMISSIONER POWELL: 50 basis points.

DR. KALYMON: Correct, as a reasonable range. The complication here is twofold. First of all, the Company has asked for the rates to be targeted at a three percent return, which puts the effective base well below the range. The second complication is that ... I'm suggesting in my testimony that because of the peculiarity of the capital structure, I'm not suggesting, I'm suggesting that you focus on the return on rate base through a deeming process and permit the Company to earn up to, and I believe the number is 7.945 under my revised testimony. The Company is applying for something in the order of 7.3. I forget what the revised numbers were but they're lower, substantially lower than my recommended return on rate base, so I think because they're so much lower, I think the number coming from my mid point is probably adequate enough for, if conditions are so changed, I think they should get triggered at probably the mid point and a review should be looked at, so my suggestion for range would be the Company has applied for a certain level, as an upper bound, rate of return on rate base should be monitored and a 7., if a 7.945 level is exceeded, that means that conditions have changed quite substantially and a review might be justified.

COMMISSIONER POWELL: You also mentioned, talked about the Rate Stabilization Plan. You talk about that it could impact because it could be excessive. Excessive, what's your definition of that in terms of this? Is that a dollar amount or is that a percentage of something that you would ...

DR. KALYMON: Well, it's definitely a percentage of overall revenue because, I mean, dollar amounts obviously would differ across different companies, but if the percentage of that relative to the overall capitalization becomes high and then one would get concerned about it, because then it'd have a major impact on the revenue requirements in trying to collect it and therefore it ultimately can create risk. So as that number gets larger, one has some concerns.

COMMISSIONER POWELL: What would be an upper percentage, 10 percent, 12 percent, 15, 20?

DR. KALYMON: I must confess I haven't given that enough thought to be very definitive, but ...

COMMISSIONER POWELL: You're aware that they're asking to increase the ceiling to $100 million from 50?

DR. KALYMON: Correct, and that's where it starts becoming visible in the capital structure. I mean, there is 1.2 billion of debt and 100 million is starting to be ... nine percent, I guess, of that. It starts to become visible as opposed to being what it should normally be, which is just a fluctuating account which moves up and down from year to year.

COMMISSIONER POWELL: That's all, Mr. Chairman. Thank you, sir.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Commissioner Powell. Commissioner Saunders, please.

COMMISSIONER SAUNDERS: Thank you, Mr. Chair. Good morning, Dr. Kalymon.

DR. KALYMON: Good morning, Mr. Saunders.

COMMISSIONER SAUNDERS: I'm just wondering, and I guess I've been caught kind of short here too, but I would have looked this up in the break, and I changed notebooks yesterday so my old notebook is out in my desk. Did you testify yesterday in respect of ... well, let me ask you the question this way. Did you have an opinion on the elimination of the RSP? I have a note here in respect of the RSP, but I don't see anything in your evidence relating to that.

DR. KALYMON: No. There is nothing in my evidence because I wasn't specifically asked to review that aspect of the case, and my evidence is written on the assumption that the Rate Stabilization Program is in place. I think I did testify yesterday that if it was removed with nothing being, nothing replacing it, it could affect my recommendations towards the upper end of my range, but I did not have a specific recommendation on it except for being concerned, as I think we just discussed, about the size of that amount, that ultimately if it becomes large, there's issues of recovery that should be considered.

COMMISSIONER SAUNDERS: That was the point, I guess, that you did express concern with respect to the size of it yesterday.

DR. KALYMON: That is correct.

COMMISSIONER SAUNDERS: Yes.

DR. KALYMON: Because it becomes a financial liability in effect. It has to be recovered.

COMMISSIONER SAUNDERS: Yes, but giving regard to the way in which it is recovered, which I'm sure you're familiar with ...

DR. KALYMON: Yes.

COMMISSIONER SAUNDERS: ... how does that become a concern of yours?

DR. KALYMON: From the point of view of ... well, from the point of view of the financing of a company, one doesn't want to see situations where there's a potential for the recovery being threatened. In other words, if something becomes very large, then the current rates are not effectively servicing all of the costs. That is effectively what happens if you keep accumulating it in an upward direction, and so then there becomes a concern as to when the day of reckoning comes, will the rates be able to take that shock, okay, so if it gets too large, then it becomes a concern about what happens when you actually try to recover it and will the company be able to recover it. That becomes the financial risk if some of the, if some, if too many costs become deferred.

COMMISSIONER SAUNDERS: Are we talking rate shock here in terms of ...

DR. KALYMON: Rate shock and therefore the, you know, ultimate impact of rate shock in ...

COMMISSIONER SAUNDERS: If I recall, the Consumer Advocate at the opening of this hearing, I think it was to the press and not at the, or not in the room here, indicated that he believed the RSP should be eliminated.

DR. KALYMON: I believe that is his position, yes.

COMMISSIONER SAUNDERS: And you recall that?

DR. KALYMON: Yes, I read the testimony. I believe that is ...

COMMISSIONER SAUNDERS: Now if it is eliminated, then what kind of rate shock are we talking of here, because I don't know if you're familiar with the background or not, but back, I think it was in '85 when the RSP came about, there was quite a public concern with respect to the volatility, I guess, in the price of electricity being impacted by the high or the, the price of oil? The RSP came about from that kind of pressure and tended to level off that impact to the satisfaction of the consumer, I think, because the demonstrations in the streets subsided, put it that way. Now the Consumer Advocate is saying let's eliminate the RSP and have the consumer face the reality of the price of oil and its impact on his electrical rates. I think that's what he's saying. Do you understand that to be what he's saying?

DR. KALYMON: Well, I've read the testimony and I believe that is the direction ...

COMMISSIONER SAUNDERS: Yes.

DR. KALYMON: ... but the impact on rates, I guess, from the financial point of view will depend a lot on the treatment of the existing pool, for example. You know, if it's, if you amortize it over a longer period than it's currently being amortized, then you reduce the rate shock of removal. There are ways to cushion the removal of the system that would not necessarily have rate shock. Now, it may have other negative implications. That's why I was commenting earlier that I'd really like to see the actual replacement before ...

COMMISSIONER SAUNDERS: Yes. So your, in your evidence, you're not coming out and saying I advocate the elimination of the RSP.

DR. KALYMON: No, I'm not, but I believe that is the position of Mr. Bowman and ...

COMMISSIONER SAUNDERS: Yes.

DR. KALYMON: ... what the position will be of the Consumer Advocate I presume will come in the final argument.

COMMISSIONER SAUNDERS: Yes. I've read Mr. Bowman's evidence but I wondered what you ... I wanted to question you on that comment of yesterday ...

DR. KALYMON: Correct.

COMMISSIONER SAUNDERS: And thank you, Dr. Kalymon.

DR. KALYMON: Thank you.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Commissioner Saunders. Commissioner Whalen?

COMMISSIONER WHALEN: Good morning, Dr. Kalymon.

DR. KALYMON: Good morning.

COMMISSIONER WHALEN: Keep this out of the way so I can actually see you when you're ... I just have one question, I think, and Ms. McShane has recommended in her evidence a fair return for Hydro of, I think it's 11 to 11 1/2 percent. Your recommendation is, I think the revised number is 8 1/2 to 9 percent.

DR. KALYMON: Correct.

COMMISSIONER WHALEN: I wonder if you could just briefly describe for me where your or on what points your opinions diverge so that you both as expert witnesses, I guess, come up with such different numbers?

DR. KALYMON: Yes. To summarize why we're different, the use of comparable earnings test is a procedure which creates a very large upward bias to the estimation of the cost of capital. If you actually scrutinize Ms. McShane's evidence, she effectively acknowledges that it isn't the cost of cap (phonetic), so if you are basing a recommendation on something which is upwardly biased from the cost of capital, one shouldn't be surprised that you'll get results that are higher, and if you look at Ms. McShane's suggested returns under that test, they are very high and they pull her entire recommendations up, and the reason I consider it unfair to customers to pay that is because it isn't a cost. I think the cost of capital should be assessed and companies should not be permitted to earn returns that are above the cost. I interpret the mandate as fair and reasonable to be the cost of equity capital. If you grant returns based on the comparable earnings test, which essentially looks at returns on book and ignores the fact that investors are paying substantially above book for those investments, then I think that creates a very upward bias to your results and it is a major problem I have with Ms. McShane, and one of the major reasons why one gets different results, so that's one reason. The second reason is, I think I was asked in testimony whether I used the same techniques. Well I don't use an adjusted comparable earnings. I look at the price that investors are paying for earnings, so that's one big difference. But the second one, I was asked whether I used the same techniques and whether I used DCF approach, and the answer again is, well, the answer in that case is a little different. The reason for differences is that the DCF technique is a technique which I accept the principles of it are that you try to, you observe the dividend yields and then you try to assess what are the expected growth rates that investors have for a particular situation, and in principle that's growth and dividends, in principle. Now we analysts often use a lot of proxies for that. We look at growth and shares growth and earnings growth and book value, but in principle it's actually growth in dividends that one is actually seeking and one should at least start from the growth in dividends as a taking-off point, but basically the, in that particular test, the reasons my results differ substantially from Ms. McShane's is, Ms. McShane uses almost exclusively forecasts of growth by analysts. Now, I have two different problems with that. Number one, analysts have, mostly analysts quoted are what's called (unaudible) analysts, which are the analysts working for investment banks, and they're growth estimates tend to be optimistic, let me put it that way. Certainly if you look at what they're forecasting and what the actual results were, if you look at the reality of growths, you'll see quite a big discrepancy, and they tend to be upwardly biased, so I tend not to use ... now, the second reason the forecasts are not the right place to start in my opinion, if you want an objective assessment of expectations, is that most of those analysts, when they make their growth forecasts, are really forecasting only growth for the next year, and in principle what you need in a model to get a reasonable result is expected growth over many years, in principle infinite, but certainly not just a one year estimate. So, and most analysts don't look at it more than a year. They really ... when they publish a number they're just saying, you know, one year out. So in principle it's the wrong forecast to use. So I think that would be the quickest way I could summarize why my DCF test comes out very differently than the, than what Ms. McShane has in her results. The third test is the risk premium test and in that particular test the challenge is ... it's one of the most stable tests in the sense that the most of that test is determined by the bond rates. The bond rates determine the core, because dividend yields, as you know, are quite low relative to the total cost and the growth estimate is very material to that exercise, but a risk premium test starts from the base cost of capital, which is reflected in risk-free bonds, and I use a 10 year rate. Ms. McShane focuses on 30year rates. That's not my particular concern. I think you can base it on whichever one as long as you're consistent. However, now I got a problem again. Ms. McShane doesn't look at the actual performance of equity markets in the past relative to bonds. She does in one of her tests, but one of her major tests and one of her major conclusions comes from again using analysts' forecasts of growth on the entire index instead of actual performance of index. I say let's have a look at what equity has actually done. She says, oh, let's just look at the forecast of what it's supposed to be doing. So basically she brings at least portion of her risk premium test right back to the problems I just discussed with the DCF test, upwardly biased or optimistic. I maybe shouldn't use the word "biased," but optimistic, let's say, numbers, and the other portion of the risk premium test that gives me a lot of problems is that Ms. McShane selectively picks the US market, which happens to be one of the best performing markets but unfortunately is different than the Canadian market in so many different ways, and chooses to pick premiums coming out of US market over very long periods of time rather than the experiences of the Canadian capital market as investors have actually experienced it and for which they're going to be more sensitive to, so I take objection to the selective choice of the best market in the world to set those premiums. They happen to have out-performed just about every other market. Secondly, it isn't indicative of our market. Our markets tend to be different for many different tax reasons and many different legal frames that tend to create some barriers between our markets and other markets. I think that would be, well, a sort of quick summary.

(10:45 a.m.)

COMMISSIONER WHALEN: Thank you. That was quite helpful.

DR. KALYMON: Okay.

COMMISSIONER WHALEN: I only have one other question, or looking for your opinion, I guess, on Hydro. Obviously they're not asking for an 11 or 11 1/2 percent return to be set in this hearing but they are asking the Board to send a signal to the, I think the financial markets in an all-inclusive term on what the, under different circumstances, what the normal and fair rate of return would be for Hydro. Do you have an opinion on whether or not we have to send that message?

DR. KALYMON: Well, it's quite clear that in the short-term there is no issue of equity in the market, traded equity for this company, so being owned by the province there is no public equity and there's no signals to be received in that regard. There are some signals in terms of the bond market because setting different levels of returns ultimately has some impact on the way the bonds get treated and the degree to which they are treated as being non-impacting on the provincial debt, so there is some issue in that regard that one, if Hydro became deficient all of a sudden in some fashion of earnings, then there could ultimately be a repercussion. Now, so there is some need to send some signal in that context, but the other one, I guess the other aspect that I think I testified to yesterday was that despite the fact that Hydro is asking for the rates to be set at three percent, I think a signal could be sent as to an upper limit on that process if there is no re-hearing of this situation for an extended period of time, so indirectly I think there could be a signal sent by setting a boundary on the return on rate base which I suggested 7.945 as a ... it's well above the current so I don't expect it should be triggered in the very short-term but I don't think it's necessarily very, very important for signalling but it gives some indication of the direction and thinking of the Board, yes.

COMMISSIONER WHALEN: Thank you. Thank you very much. That's all I have, Chair.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Commissioner Whalen. I have just one question and it's really a follow-up to Commissioner Whalen's last question, Dr. Kalymon. Ms. McShane seemed to indicate that the signals that you refer to here could be sent out by way of principles and whether they're the same principles or not that you would espouse, I would, that's not necessarily germane at this point in time, but could those messages be sent out, in your estimation, by way of principles and indeed if Hydro were not coming back of their volition in two years time, which they've indicated certainly they intend to do, that rather than establish an upper limit at this stage, given the volatility of what's happening, that indeed the entire issue would be best revisited at that time? A two-part question, if you will, I guess.

DR. KALYMON: Well, I agree that the issue can and should be revisited when it becomes more pressing in the sense of actually setting directly the rates, but whether, but I think some sense of balance should be set in any case and even in the interim, whether it's done from a complete statement of what the perception is of reasonable returns or from, on another basis, but I can't think of another basis, so I would say that there is some obligation to maintain a ceiling for this return. That would be the normal context for a private utility. They wouldn't be permitted to set rates and then allowed to go off and fire a quarter of their staff and earn returns of 200 percent. You know, I'm being obviously sort of joking about it, but that's ... the point I'm making is that you need to have something ...

MR. NOSEWORTHY, CHAIRMAN: Some framework ...

DR. KALYMON: ... and if that's the case then why not set it on a rational basis?

MR. NOSEWORTHY, CHAIRMAN: Okay. Dr. Kalymon, that's all I have. Thank you very much for your clear and concise testimony. I enjoyed it. It is 5 to 11 now. I think we'll break for 15 minutes and then we'll return with ... well, I could go around. I'm anticipating some questions on matters arising. It probably won't be finished in five minutes, but I certainly could ... Hydro, do you have ...

MS. GREENE, Q.C.: I have no questions arising.

MR. NOSEWORTHY, CHAIRMAN: Okay. Newfoundland Power?

MS. BUTLER, Q.C.: Mr. Chairman, I have no questions arising but I wonder if I just might make a point with respect to Commissioner Saunders' question because it related to, I think, a point I made yesterday with Dr. Kalymon on the RSP.

MR. NOSEWORTHY, CHAIRMAN: Sure.

MS. BUTLER, Q.C.: And I was concerned only because the notebook is back in the office, but the point that I was pursuing, as I understand it, as I remember it, was that Dr. Kalymon did in fact refer to the RSP at page eight of his testimony, pre-filed, and that was relative to its effect on Hydro's risks which I thought he was making a point relevant to the return on equity, etc., and because Dr. Bowman had recommended the elimination of the RSP, the line of questioning I was pursuing yesterday was with Dr. Kalymon, some questions on the effect of the elimination of the RSP on Hydro's risk and therefore the rate of return on equity, so I have no question for Dr. Kalymon arising from Commissioner Saunders' questions but I wanted to make sure that Commissioner Saunders doesn't close off without, you know, sort of refreshing his memory on the point I was pursuing on that issue.

MR. NOSEWORTHY, CHAIRMAN: Okay. Do you have any comment, Commissioner Saunders?

COMMISSIONER SAUNDERS: No, I'm just reading it now and thanks for pointing that out, Ms. Butler. I'll have a look at that over the break.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Butler. Mr. Hutchings?

MR. HUTCHINGS: Thank you, Mr. Chair. I just wanted to try to clarify something that I wasn't clear on when Mr. Kennedy was questioning Dr. Kalymon. I had thought that I heard Dr. Kalymon refer to the ATWACC as being the return on rate base, whereas, in my understanding of Dr. Vilbert's evidence is, in fact in the case of Hydro, the BTWACC, which is the return on rate base, and I don't know whether that was an off-the-cuff remark or misstated or intended to be that way.

DR. KALYMON: Yeah. I was ... I had forgotten in my own mind which way Dr. Vilbert had characterized it, so the before-tax WACC would be the rate base return.

MR. HUTCHINGS: Yes. That was my understanding. I just wanted to ...

DR. KALYMON: Yes, and I might, I may have mis-spoken.

MR. HUTCHINGS: Thank you. Thank you, Mr. Chair.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Mr. Hutchings. Mr. Kennedy?

MR. KENNEDY: Nothing arising, Chair.

MR. NOSEWORTHY, CHAIRMAN: Thank you.

MR. FITZGERALD: Mr. Chairman, I have a couple of questions and it might sort of evolve into a lengthier sort of questioning so perhaps we could ...

MR. NOSEWORTHY, CHAIRMAN: That's fine. We'll break now for 15 minutes and we'll come back for those questions and I'll ask Ms. Greene, would Mr. Roberts be ...

MS. GREENE, Q.C.: Yes, he is, Mr. Chair, and I was just hoping it would be at the break because he has to get organized and bring some books with him, so we may need to break again for five minutes. He may be able to do it, as long as we're patient as he comes up to the stand with his briefcases with him.

MR. NOSEWORTHY, CHAIRMAN: Could I ... do you need the break to prepare, Mr. Fitzgerald, for your questions or ...

MR. FITZGERALD: Well ...

MR. NOSEWORTHY, CHAIRMAN: ... could I ask you to ...

MR. FITZGERALD: ... I think it would be prudent for us to do that.

MR. NOSEWORTHY, CHAIRMAN: Okay. We might need to take five minutes again later. Thank you.

(break)

(11:15 a.m.)

MR. NOSEWORTHY, CHAIRMAN: Thank you. I'll ask Mr. Fitzgerald now if he could conclude on his redirect, please?

MR. FITZGERALD: Yes, thank you, Mr. Chairman. I know I reserved the right prior to, the right to do some redirect or questions arising, but I thought the better wisdom was just to leave Dr. Kalymon's evidence intact, so I don't intend to ask any further questions.

MR. NOSEWORTHY, CHAIRMAN: Okay. Thank you, very much, Mr. Fitzgerald. Thank you, Dr. Kalymon for your testimony. Thank you, sir.

DR. KALYMON: Thank you. I'm excused?

MR. NOSEWORTHY, CHAIRMAN: Yes, you are. Ms. Greene?

MS. GREENE, Q.C.: Mr. Roberts is ready to testify, and we have ...

MR. NOSEWORTHY, CHAIRMAN: Oh, I see.

MS. GREENE, Q.C.: Not in quite the spot we wanted, but it won't take very long.

MR. NOSEWORTHY, CHAIRMAN: Thank you.

MS. GREENE, Q.C.: So our next witness is John Roberts, the corporate controller for Newfoundland and Labrador Hydro, and if Mr. Roberts could have a moment to get settled away?

MR. NOSEWORTHY, CHAIRMAN: Sure. Good morning, Mr. Roberts. How are you this morning? Once again, your name has been bandied high and wide throughout this hearing. Welcome, sir.

MR. ROBERTS: Thank you.

MR. NOSEWORTHY, CHAIRMAN: Do you have the Bible in your hand?

MR. ROBERTS: Yes, I do.

MR. NOSEWORTHY, CHAIRMAN: Do you swear on this Bible that the evidence to be given by you shall be the truth, the whole truth and nothing but the truth, so help you God?

MR. ROBERTS: I do.

MR. NOSEWORTHY, CHAIRMAN: Thank you, very much, Mr. Roberts. You can be seated, please. I'll ask Ms. Greene to begin with her direct, please?

MS. GREENE, Q.C.: Mr. Roberts, evidence was pre-filed in your name on May 31st of this year. Do you accept this pre-filed evidence as your evidence for the purpose of this hearing?

MR. ROBERTS: Yes, I do.

MS. GREENE, Q.C.: As well, supplementary evidence dated October 31st was also filed on October 31st in this proceeding in your name. Do you accept your supplementary evidence of October 31 for the purposes of this hearing?

MR. ROBERTS: Yes, I do.

MS. GREENE, Q.C.: Thank you. That concludes the direct examination.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Greene. We'll move now to Ms. Butler, Newfoundland Power and cross-examination, please?

MS. BUTLER, Q.C.: Thank you, Mr. Chairman. Good morning, Mr. Roberts.

MR. ROBERTS: Good morning.

MS. BUTLER, Q.C.: Could you tell the panel first, please, as corporate controller what are you primary responsibilities?

MR. ROBERTS: I have responsibility for maintaining the general ledger system where all source documents end up being recorded. I have responsibility for maintaining a fixed asset system. I have responsibility for maintaining a job costing system where capital work orders are recorded and the costs are tracked. I also maintain a miscellaneous accounts receivable system. I provide accounting services to CF(L)Co. I have responsibility for the accounts payable section of Hydro. I maintain the budgets of the corporations, all within the general ledger system but in separate fields. I prepare documents for boards of directors and for management committee for forwarding to the vice-president of finance. I also provide taxation related services in the areas of, as an example, non-resident withholding tax, HST, GST on occasions. (inaudible). I'm also responsible for monthly financial reporting through reports through the vice-president of finance for Hydro's management committee and its boards of directors. I have responsibilities for the preparation of annual financial statements, coordination of all aspects of external audits by our external auditors, as well as the responsibility of coordination with the board's auditors that are appointed to conduct annual audits.

MS. BUTLER, Q.C.: Thank you, and throughout and in relation to all of these various duties you would report consistently to Mr. Osmond?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay. Who is the vice-president of finance?

MR. ROBERTS: Yes, he is.

MS. BUTLER, Q.C.: And clearly, you've indicated among your many duties preparation and coordination of both the corporations operating and capital budget?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Can you just explain, perhaps, for us what the finance department's role is in relation to the preparation and coordination of the two budgets?

MR. ROBERTS: Finance's role is primarily a collector of all the various sources so that it all feeds through to one section for further reporting. As an example, in the area of the capital budgets, all the various capital budgets that are prepared in the production and TRO divisions, which is primarily most of the capital program. Individual capital budget proposals, once they have been reviewed and approved within the various divisions, are forwarded to my section within the controller's department, who provides a summary document of the various capital budget proposals that have been submitted. The summary is then further reviewed by the management committee, changes made, revised documents issued, and then eventually to the Hydro Board of Directors for approval, and then subsequent to that approval, we're involved in the preparation of the document that's relating to filing with the Public Utilities Board for approval of the capital budget. On the operating side ... I should back up for just one second. In the case of capital budget proposals, if there is requirement within the finance division itself this would also go through the same process. In the operating budget side of the system my staff provide guidelines to all areas of the corporation as to how things should be recorded, where they should be recorded. We provide a time table, key dates that have to be met, and provide assistance wherever possible in making sure that the budgets are completed. The information with the new system that we have now is actually entered by the originators of the budget directly into our general ledger system, and this information then is summarized within the controller's department, reports prepared for review both at a divisional level and at a management committee level. Once the management committee has approved the budget a budget document is prepared for furtherance to Hydro's Board of Directors for approval.

MS. BUTLER, Q.C.: Thank you, Mr. Roberts. Would you agree that your role does include monitoring the corporate progress against the budget or forecast?

MR. ROBERTS: I report, if you want to consider that as monitoring. I provide the tools and the reports that are available to individuals to take appropriate action if deemed necessary.

MS. BUTLER, Q.C.: And the actual preparation of forecasts from time to time, is that the department of finance's role?

MR. ROBERTS: Forecasts are responsible for ... are the responsibility of anybody that has budgetary responsibility, so for instance, I, as being a manager responsible for the controller's department, have responsibility for preparing of budgets for my own section as well as preparing forecasts or changes to one that would require approval, but in the case of the other areas it's the responsibility of the actual business unit owner to prepare a forecast.

MS. BUTLER, Q.C.: Okay. An example?

MR. ROBERTS: For instance, well, maybe I can use my own area as an example. I have three managers that report to me.

MS. BUTLER, Q.C.: Uh hum.

MR. ROBERTS: One manager looks after financial reporting and budgets, another individual manager that looks after, as we refer to it, as module support, and this is an area that does the coordination between our IS & T department and my staff because of the financial systems that we have, and these are the in between people who try and gather information from me as to what I mean by a problem in a system or what I want for a change in the future and that they will run with it with the IS & T people to try and reach a resolution. The other section that I have that the manager is responsible for would be in the area of accounts payable, and in the capital reporting side, so they would have a budget of their own, responsibility for staff, and as those circumstances warrant they will prepare forecasts and forward them to me for approval.

MS. BUTLER, Q.C.: Would your department, Mr. Roberts, also do cost benefit analysis?

MR. ROBERTS: No. We're primarily a service provider to other sections.

MS. BUTLER, Q.C.: So within Hydro then who, or what section does the cost benefit analysis?

MR. ROBERTS: The cost benefit analysis, if they are required, would be done by the originators of the request for, as an example, the capital budget proposal.

MS. BUTLER, Q.C.: I.e. TRO?

MR. ROBERTS: Could be in TRO or in production. I mean, as an example, Mr. Budgell had mentioned in the case of interconnections as to what would be done, but I think he was referring that they're cost effectiveness studies rather than a cost benefit analysis.

MS. BUTLER, Q.C.: And your role then in preparing the documentation that ultimately lead to this application, what was your role there?

MR. ROBERTS: Besides being a witness, my responsibility in this case was to pull together all the sections for the capital budget that's been presented at this hearing, i.e., all the various schedules and the backup sheet for the over 50,000 proposals that are attached, so my staff were actually the people that provided the clerical staff to do that, to summarize this into one document. In addition to that, the actual revenue requirement that's attached to my evidence and the other schedules would, of course, all be done through my department.

MS. BUTLER, Q.C.: Okay. I wonder if we could start then with **NP-179**, and this actually is, I think, a description of the processes followed in developing the operating budget. While we're doing this, Mr. Roberts, do you refer to the budgets as one budget or do you actually distinguish between operating budget, capital budget in terms of your involvement?

MR. ROBERTS: I actually refer to it individually as well as one.

MS. BUTLER, Q.C.: Okay. Let's look at the operating budget first, then. Can we go to page 4 of **NP-179**, please? Okay, and Line 12, or 11 and 12. Okay, so each business unit prepares their own individual budget?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: And we saw from Mr. Reeves, I believe, there was 150 business units, and the budget in each case is prepared on an account by account basis?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Where the process, you say here, is starting in March of every year with the budget instructions forwarded to directors and managers by the controller's department. That's your department?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay. Each area given four weeks to prepare, and then at line 20 you indicate that each division inputs their information into the JD Edwards system?

MR. ROBERTS: That's correct. Now, if the area doesn't want to enter the data themselves they can provide it to my department and we will enter it on their behalf, and we do do that in certain cases.

(11:30 a.m.)

MS. BUTLER, Q.C.: Once each of the 150 business units has either put their information into the system or had you do it for them, there are a number of levels of review of each of the operating unit budgets, correct?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: And I think the first of these ... let's look, if we might, at the Grant Thornton report 2001, page 4. Yeah, under methodology. There you go. Okay. Mr. Brushett, on behalf of Grant Thornton, has indicated here that the budgeting process followed by you is comprehensive and detailed commencing with the issue of instructions in March, not normally finalized and approved by the Board until October, so we have an eight month process involved with the operating budget?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: The comprehensive approach to the development of the operating budget and the period of time that we're talking about here, I realize, was not followed for the year 2002?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: And perhaps I'll come to that a little later in terms of his report, but in terms of this very detailed process and the different levels of review, Mr. Roberts, I wonder if you can tell us who ultimately ensures that the operating costs that are budgeted for are as low as they can be? Where does the bucket (phonetic) or the ball ultimately stop rolling?

MR. ROBERTS: To me, the final approval is by the Board of Directors. Going back from that, management committee has approved that document. Moving back from that, the individual divisional vice-presidents have reviewed their own areas of responsibility and have carried that information forward for additional review or final approval by the Board of Directors in the case of the operating. In the case of capital, the capital budget, once it's approved by Hydro's Board of Directors, and the same process is developed, the individual divisional vice-president is responsible for that budget and bringing that information forward. The management committee collectively agree that this is the corporate budget which is then presented to the Board of Directors. In the case of capital there's also an additional level of approval required, which is the Public Utilities Board.

MS. BUTLER, Q.C.: Okay. Well, let's just look at the operating budget, for the moment. Business units, then to the manager of each division for review?

MR. ROBERTS: To the manager, the individual departments within the division.

MS. BUTLER, Q.C.: Uh hum.

MR. ROBERTS: In the case of production and TRO, then could be to a regional manager and then to a vice-president, depending on the size of the division.

MS. BUTLER, Q.C.: And then to the management board or management ...

MR. ROBERTS: Then it goes to the management committee.

MS. BUTLER, Q.C.: Management committee, and I should ask you at this point, who is on the management committee?

MR. ROBERTS: Currently it's the vice-president of finance.

MS. BUTLER, Q.C.: Mr. Osmond?

MR. ROBERTS: Mr. Osmond. Vice-president of TRO, which is Mr. Reeves; Vice-President of Production, which is Mr. Tim Haynes, Vice-President of Human Resources, Legal Counsel and Corporate Secretary, Ms. Greene; and the President of Hydro, Mr. Wells.

MS. BUTLER, Q.C.: What happens and what process follows when an operating budget submitted by a particular department, say, to a regional manager or vice-president is too high, can you just explain to me what steps are followed?

MR. ROBERTS: If, during the discussion, as I understand it, if the divisional vice-presidents consider the budget to be too high, then he will request his managers to go back through their budgets and identify areas where changes would be made to bring the budget in line with the mandate that he particularly has for that area. Once they are identified, then a decision would be made as to what changes would take place within that particular budget.

MS. BUTLER, Q.C.: Okay, and while we're here in the Grant Thornton report we'll just take the opportunity now to look at page 5, and this is the reference to the fact that the 2002 operating budget was not performed under the usual time line. I think it's the first full paragraph here.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: It starts with "The process as described above." Can you just read that? I think it's just two sentences, really.

MR. ROBERTS: "The process as described above was used to generate the 2001 forecast revenue and expenses. For 2002 the full budgeting process, as described, with the long-term frames from start to finalization was not followed. For 2002 the business unit managers were requested to prepare their forecasts of operating expenses using the approved 2001 budget as a base and adjusting for any known or planned changes in operating activities.

MS. BUTLER, Q.C.: So there's a difference here in terms of the methodology that was followed for 2002 budget?

MR. ROBERTS: Yes. Because of the timeframes, what happened in the system is that the 2001 budget, operating budget, was basically approved in October.

MS. BUTLER, Q.C.: Right.

MR. ROBERTS: And the decision was, in order to develop a 2002 budget we would copy the 2001 budget within the computer system over into a field and label it 2002, and that information was provided back to all the various areas that had responsibility for budgets, and they were asked to review those 2002 costs and say what changes would be required, are you prepared to live with those amounts for 2002 the same as you did with 2001.

MS. BUTLER, Q.C.: Okay, and this abbreviated, I'll call it, process for the year 2002 was necessitated by the fact that we were involved in the application here?

MR. ROBERTS: It's a timing factor of how soon you can get the information done, and recognizing that you were in October of 2000, had just finalized your 2001 and you're trying to project out to 2002, the best information that you would have at that point, as a starting place, would be your 2001 budget, but I guess I want to elaborate just a small bit, if I may, is that that's what was done for the operating costs.

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: I.E.

MS. BUTLER, Q.C.: Operating budget.

MR. ROBERTS: Okay. It wasn't done for the fuels, or the power purchase, or the revenue, or the depreciation. It was just the operating costs themselves, this was the methodology and the method that we used to arrive at the numbers.

MS. BUTLER, Q.C.: Okay. Thank you. Now, can I just turn to the capital budget? And we have to go back to **NP-179**, and this time page 2 of 6, and I'll as you to read for us, if you could, Mr. Roberts, the paragraph that appears on lines 16 to 23?

MR. ROBERTS: "The capital budget process within Hydro is a very (unintelligible) and essential process that involves the input of supervisory personnel with budgetary responsibility all the way through each level of management until it is eventually approved by Hydro's Board of Directors before being forwarded to the Public Utilities Board for approval." Do you want me to continue?

MS. BUTLER, Q.C.: Yes, please, thank you.

MR. ROBERTS: "The process spans approximately nine months from start to finish and involves the review and evaluation of every capital budget proposal that is prepared to determine if it should move forward for approval to the next level of supervision."

MS. BUTLER, Q.C.: Okay, and again, of course, it goes on to describe the various steps, first of all, by supervisor personnel, etcetera. This process is, as described here, nine months. We saw a moment ago that the operating budget process usually is eight months, so are two things happening independent of each other, or in reality is this really one large process on the go at Hydro throughout that eight or nine month period?

MR. ROBERTS: Well, it's one process to develop an operating and a capital budget, but you have different people involved in the process. As an example, the capital budget process basically starts just before Christmas of every year with instructions being issued as to here is inflation factors that will be used in preparation of capital budget proposals, here is other things that should be watched for as to who should budget for, as an example, computer software or other things that are done, and then from the period, basically from January until about March or April your capital budget proposals are going through the review process in the various divisions until eventually reaching my area to a point where a document is prepared for further review by the management committee. At the same time then your operating budget is starting in roughly March and coming forward, as well so they both dovetail into a review by the management committee, a final review by the management committee ...

MS. BUTLER, Q.C.: In the fall?

MR. ROBERTS: In the fall, which is basically in September, but if I may, the operating budget is normally reviewed in June and the capital budget being initially reviewed by the management committee in April, early May, period process. Any changes then arising from either one of these documents then are recast again through the documents and a revised document then ready for presentation to the management committee in September.

MS. BUTLER, Q.C.: Okay. Now, the document that's on the screen, **NP-179**, page 2, we did indicate a moment ago the first step was for supervisory personnel to review their requirements with the regional managers and plant managers to identify potential projects that meet the criteria for capital expenditure, and then the requirements are indicated on the next page, and I gather what's indicated here is that once these requirements are identified the directors undertake a review of the individual proposals and assess the projects based on the criteria which are listed in lines 13 to 18?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Or 13 to 20. Yeah, 13 to 20, so do the directors, and while we're saying directors here we're not talking about Board of Directors, we're talking about the directors that are within management?

MR. ROBERTS: No. We're talking about directors within the various divisions.

MS. BUTLER, Q.C.: Yes. Satisfy themselves on each of the projects put forth by the supervisors?

MR. ROBERTS: Yes. As I understand it, each director will review all of the proposals that are prepared in his area of responsibility.

MS. BUTLER, Q.C.: Uh hum.

MR. ROBERTS: He will eventually, once he's satisfied with those, be reviewing those proposals with his vice-president.

MS. BUTLER, Q.C.: Okay. Now, given that you're a controller, where do you actually fit in here?

MR. ROBERTS: In my area I have some of my staff attend these meetings on occasion.

MS. BUTLER, Q.C.: Right.

MR. ROBERTS: To provide assistance or interpretation, and of course, all copies of all these documents eventually culminate in my department and from there we maintain a copy of the capital budget proposals and prepare a report outlining these various capital budget proposals for further review.

MS. BUTLER, Q.C.: But the review, of course, by the directors then goes to the vice-presidents of the divisions?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: And are you, as controller, involved in that?

MR. ROBERTS: Some of my staff may be at those reviews, as well.

MS. BUTLER, Q.C.: To provide assistance?

MR. ROBERTS: To provide assistance.

MS. BUTLER, Q.C.: And after the vice-president of a particular division like TRO has satisfied himself or herself of their portion of the capital budget, then it goes to the management committee?

MR. ROBERTS: Once the vice-president, as an example, of TRO is satisfied any changes that have taken place will be input to the reports that we produce so that we have the most current version of what proposals are to be brought forward to the management committee. We do the same thing for the other divisions so that we end up with a final document that we will present to the management committee for their review and approval. At that management committee meeting I will be in attendance, together with at least one if not two of my staff, to assist the management committee in the review and whatever further information that they may require that we can provide.

MS. BUTLER, Q.C.: Okay, and the role of the management committee is indicated on this page 3 of 6 at lines 27 and 28, I think. There you go. The management committee does its review and reassesses each proposal according to the criteria which were listed above? Is that right?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay, so before the capital budget goes to the Board of Directors each project within the capital budget has received the input of a supervisor, regional manager or plant manager, director, vice-president and the management committee?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Yeah, and this is the process, as we say, which takes about nine months. In general though Mr. Roberts, can you tell us how many capital projects would normally be reviewed and how many of them make it to the final cut?

MR. ROBERTS: I can't tell you at the low level out into the area because a lot of those things, proposals are prepared, and it's only when I get to the point of a summarization. All I can tell you is that the management committee level, at that point in time, most of the proposals that the divisional vice-president has decided, for whatever reason, that it doesn't want to bring forward to the management committee at this time, has been done. So at the management committee level, the report that's provided is very similar to what's filed in this application, this capital budget, so it actually is a one liner saying here's what their project is and here's the dollars that are associated, which is similar to what we're providing in the capital budget for here, so at the management committee level of the review they are dealing with, I would put it in the lines of proposals that a vice-president wants to bring forward to the management committee and discuss and gain additional input as to what's going to happen to this particular proposals. So the number of cuts that are happening at the management committee are not significant, but there are changes being made at the management committee level, and the reason being is that at that point most of the work and the review should have been completed.

MS. BUTLER, Q.C.: In one of those five lower levels?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: In which you are not directly involved, which I understand?

MR. ROBERTS: Some of my staff would attend some of these meetings, as I said, to provide assistance, but I, personally, am not.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: I'm at the management committee level.

(11:45 a.m.)

MS. BUTLER, Q.C.: Now, relevant to the capital budget process and how labour is dealt with in the capital budgeting process, I want to ask you a few questions. First of all, how is it that Hydro ensures that the labour which is allowed for on a capital budget, capital project basis is sufficient?

MR. ROBERTS: The responsibility is to the originator of the capital budget proposal to prepare that estimate, and that could be including internal or external labour, but it's the total capital budget proposal estimate that individual has responsibility to prepare.

MS. BUTLER, Q.C.: Give me an example so to make sure I understand who the originator would be?

MR. ROBERTS: Say, someone in TRO in replacement of a diesel engine in a particular community.

MS. BUTLER, Q.C.: Uh hum.

MR. ROBERTS: The need would be identified to replace a particular engine. Then in the engineering side of TRO they would develop the capital budget proposal which would reflect the cost of replacing the engine and what other costs would be incurred to do that replacement.

MS. BUTLER, Q.C.: Okay, and overtime on capital projects, can you explain to me how you budget, Hydro budgets for overtime on capital projects?

MR. ROBERTS: Hydro does not budget capital overtime. The project is ... as I mentioned, the capital estimate that's produced includes the costs to erase the project. In the case of the proposal going to a full fledged work order and being approved and the work started, in the event that overtime is incurred, the overtime trades dollar for dollar between the overtime expense account and the capitalized overtime for the capital.

MS. BUTLER, Q.C.: Okay, so I gather within accounting fields, Mr. Roberts, that there is another alternative? In other words, other corporations may budget for overtime on their capital projects?

MR. ROBERTS: I guess they could.

MS. BUTLER, Q.C.: Uh hum.

MR. ROBERTS: In the case of Hydro we don't because we don't know what overtime is going to be incurred, and when, on a particular capital budget proposal. The costs are developed to complete the project, as I understand them, and when the project requires overtime then the overtime would be worked and charged to the project, but it doesn't change the total cost of the project, as I understand it. In the case of the operating, because the individual happens to be within an operating business unit, then his labour cost has to hit that labour business unit first before it can get transferred to the particular work order, so I have an in and an out, so if I pay $10 there's $10 that comes back out and it gets charged off to the work order.

MS. BUTLER, Q.C.: Alright, so just so that we're clear on this. I guess what I was suggesting to you is in terms of an alternative, Hydro could accept that overtime is a fact of life on a capital project and plan for it in the capital budget for that project?

MR. ROBERTS: I don't think we're planning to incur overtime on capital work orders, but it will happen in some cases, but which ones, only the project manager knows once the job is started and he's involved in the construction. I don't think up front that they plan to incur overtime on capital work orders.

MS. BUTLER, Q.C.: Okay. Does the system which you follow make it more difficult to manage your capital projects?

MR. ROBERTS: In which respect?

MS. BUTLER, Q.C.: Well, if overtime were accepted as a fact of life on a capital project and planned for and included in a capital budget for the project, then you could compare your costs or forecast your costs against it as the project proceeded, but if you haven't planned for it and haven't allowed for it, then I'm curious as to how you're managing it.

MR. ROBERTS: Well, the project manager is managing the cost of the project and he has allowed in there costs for labour, costs for materials, both internal and external. So where he's controlling his costs on that particular project, if we were to turn around and budget them within the operating budget, it's added to one account and taken out of the other, and one will trade exactly with the other. It really serves no purpose in which to provide them in the operating budget.

MS. BUTLER, Q.C.: Alright, so for example, the one you gave me a moment ago, a replacement of a diesel engine in a community?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay. If the proposal for that capital budget item doesn't contain any reference to overtime and overtime is incurred, then how good is the budget sheet that we have for that particular project?

MR. ROBERTS: When the capital budget proposal is prepared and subsequently turned into an approved work order, various cost components of that work order were broken down between internal forces and external forces, but it was X amount of dollars that was required to do the work, so it may be in an actual basis when you look back, some of that actual dollars for completion of those projects could be straight time, some of them could be overtime, but there's a total amount of dollars that was required to complete that function.

MS. BUTLER, Q.C.: Okay. Let me ask you now about forecasting. Or actually, before I move into that, let me just take a quick peek, if I might, at the Grant Thornton report, 2001 again, because I think he dealt with this issue of the overtime on page 26. Okay. Thank you. It's the paragraph that starts with the overtime category. There were are. Can you scroll up a tiny bit? Thank you. Bear with me, Mr. Roberts, but perhaps you could just read in the sentence that ends with, about five lines down, capital projects? Start at the beginning of the paragraph. There you go. Okay.

MR. ROBERTS: Oh, start with the overtime?

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: Okay. "The overtime category of salary costs for 2001 is forecast to decrease in comparison to 2000 by $1.5 million or 37 percent. According to our analysis, from 1997 to 2000 Hydro has over budgeted, under budgeted overtime on an average of 59 percent or $1.4 million. While it is difficult to forecast the amount of overtime that is likely to incur in a year, these costs are generally linked to the maintenance requirements and to TRO and production divisions and requirements related to capital projects." Keep reading?

MS. BUTLER, Q.C.: Only if you feel that you need to to complete the thought that's contained in that paragraph.

MR. ROBERTS: "For 2001 the cost of assisting equipment maintenance in the TRO division has declined because of non-routine maintenance requirements on the gas turbine and a diesel plant in 2002. However, for the production division there is a forecast increase in the maintenance requirements at the thermal plant in Holyrood for 2001. In addition, the forecast does not include any amount for overtime on capital projects. In 2000 there was approximately $700,000 in overtime costs incurred on capital projects. Overall, the forecast decreases in overtime costs for 2001 and 2 appear reasonable, based on our review."

MS. BUTLER, Q.C.: Okay. Well, I guess when Mr. Brushett testifies he'll be able to tell us what may be customary in other corporations or utilities, but he certainly does confirm the point that your forecast does not include any amount for overtime on capital projects?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Alright. On the issue of forecasting, once the capital budget and the operating budget is complete and approved by the Board of Directors in October of each year then your job would, I gather, switch to monitoring performance against the budget?

MR. ROBERTS: Once the budget is approved in October, the case of Hydro still has to be presented to the minister responsible for Hydro.

MS. BUTLER, Q.C.: I wondered, actually, if it was required to get that approved?

MR. ROBERTS: It's not approved. It has to be submitted.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: As I understand it, to the minister responsible for Hydro by, I think by November the 30th, if the date serves me correctly.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: But it's not for approval.

MS. BUTLER, Q.C.: It's just for submission?

MR. ROBERTS: It's my understanding we're required to submit it to the minister.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: By November the 30th.

MS. BUTLER, Q.C.: And then does your job switch to monitoring?

MR. ROBERTS: If you can bear with me I'll try and lead you through what happens.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: Effective January 1st, in the case of the operating budget, it's created and then actually starts to get tracked against that operating budget. We can report on that at any point in time, and as well, so can any person with budget responsibility. They have access to the JD Edwards system and are able to go in on line and look at their own costs in relation to their budget and/or forecast at any point in time. In the case of the capital budget, once it's approved until such time as a project manager raises a capital work order and has it approved again internally, then that information is not available in the JD Edwards job costing system. Once my department receives approved capital work orders we will enter the required information into the job costing system, as I would refer to it, and set up the work order in accordance with the various packages or to breakdown the information that the project manager has for that particular work order. Costs are then actually tracked against those particular budgets in accordance with the accounts that have been set up for the project manager. The project managers also have access on line to those various accounts to compare budget against actual and against the forecast at any time that they so desire.

MS. BUTLER, Q.C.: Okay, so we get our language correct, the budget, of course, is the documents we've been referring to that are prepared over the eight or nine month period, submitted to the Board of Directors, approved and then given to the minister responsible?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Forecasts represent where you sit against that budget at any given point in time?

MR. ROBERTS: Just let me see if I can explain it this way to you. January 1 budget and forecasts are the same.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: Because we look at a year end. You're always trying to predict your year end results in relationship to where you are right now, as of any point in time, so as of January 1 in a particular year, in the case of an operating budget, your budget and your forecast are the same, and we maintain those two separate fields for reporting purposes. When a forecast change occurs then that's input into the forecast section and automatically you now have a new target that you've approved so you now have a new benchmark that you're now comparing your actuals against.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: But the budget stays intact forever, so you have always a moving forecast of where your year end results are.

MS. BUTLER, Q.C.: Right, so the forecast at any given point in time, is the best indication of where Hydro expects to end up?

MR. ROBERTS: That's correct.

(12:00 noon)

MS. BUTLER, Q.C.: Okay. Now, how often do you, as controller, prepare forecasts?

MR. ROBERTS: I ...

MS. BUTLER, Q.C.: Or your division.

MR. ROBERTS: I'll probably, as a result of my background, my responsibility, look at it more than other people do. There are two mandatory periods that are required.

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: Which is during the preparation of the operating budget for the coming year, and an update required in October.

MS. BUTLER, Q.C.: So is there a date on your first one?

MR. ROBERTS: The first one is run with the March/April period when you're doing your initial operating budget.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: So that's a mandatory review period, and then there's another mandatory review period in October.

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: And other than that, throughout the year it's the responsibility of the various managers to look at their operating costs and see where they are in relationship to year end.

MS. BUTLER, Q.C.: Okay, and with what frequency then Mr. Roberts would you actually review variances?

MR. ROBERTS: In my case?

MS. BUTLER, Q.C.: Yeah.

MR. ROBERTS: I normally go in and look once a week, but in the case of preparation of a forecast, you'd be looking at maybe you would review at the end of the month and see what your results are, is it still deemed necessary or will you go for another month or two months, whatever the case may be. It's really no hard and fast rule as to what you're doing in that respect. You're monitoring your cost, you know what's happening.

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: Where it's a requirement, are you able to do something in another area that will offset a change.

MS. BUTLER, Q.C.: Alright. Well, what guidance, if any, do you give to the managers who, as you say, have the overall responsibility throughout the year to report to you on the variances?

MR. ROBERTS: The managers are responsible for managing that budget, and in the event that additional funds are required or there are reductions, then a forecast change should be prepared and provided for additional approval.

MS. BUTLER, Q.C.: I'm sorry, what I was looking for, I think, was more what guidance do you give them in terms of how routinely they have to report to you on those variances?

MR. ROBERTS: The responsibility rests with those people. From my area the direct responsibility is to ensure that the March and October ones are done. Other than that, it is their responsibility throughout the year to manage their budgets.

MS. BUTLER, Q.C.: Alright, so there's no guideline to a manager, for example, to report to you within seven days of a variance of a significant amount?

MR. ROBERTS: No. The responsibility is within that division to ensure that it's done through that particular division.

MS. BUTLER, Q.C.: Okay, and how is it, Mr. Roberts, that you are normally alerted to variances?

MR. ROBERTS: From an actual report of forecast versus actual?

MS. BUTLER, Q.C.: Yeah. A phone call, e-mail, meetings?

MR. ROBERTS: Receipt of an approved forecast. I'm not sure if I'm answering your question for you.

MS. BUTLER, Q.C.: I'm just wondering whether variances are things that are more routinely reported to you in bundles or individually?

MR. ROBERTS: From my perspective I would end up getting a forecast form from a particular area which would say here's the original budget, here's the forecast, here's the revised forecast and provide the numbers and the distribution over the 12 months, if there's still 12 months left in a particular year, and an explanation would be attached and we would check to make sure that we have the appropriate signatures and level of responsibility.

MS. BUTLER, Q.C.: Okay, and that could land on your desk at any time?

MR. ROBERTS: That could be anytime.

MS. BUTLER, Q.C.: Right. Without warning?

MR. ROBERTS: As a matter of fact, could be daily.

MS. BUTLER, Q.C.: Right, okay.

MR. ROBERTS: That it could come in. It's a function of what's happening within the various divisions and where they are and things.

MS. BUTLER, Q.C.: Well, let's say one division, one manager is forecasting to be seriously over budget on a particular item. Then what do you do, as controller, do you go looking to other divisions to see where reciprocal savings can be made?

MR. ROBERTS: The actual situation you're referring to refers within the division. It's that area responsibility that has that role to carry out first.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: So for instance, if I happen to find that I'm going to be over budget $5000 in a particular area and if I can't get that within my area of responsibility, then I will take that to my vice-president who then in turn will look at his additional areas of responsibility to see if something can or cannot be saved to offset it.

MS. BUTLER, Q.C.: Alright. Let's have a look at Schedule 1-A to your supplementary pre-filed evidence, October 31st, 2001. Okay. Mr. Roberts, I notice here now where we talk about revenue requirement we're talking about operating budget, capital budget, what?

MR. ROBERTS: Operating.

MS. BUTLER, Q.C.: Operating budget, okay, so the line 30 of Column C, which is called a revised, represents the revised operating budget for Hydro for the 2001 year?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay. Now, clearly, on the screen we can see that this has grown from $97.768 million, which is Column B filed in May to $101.6 million revised filed in October, so the $3.8 million variance, when this was brought to your attention, just tell us as an example perhaps, what steps were taken to address the increase that was being forecast?

MR. ROBERTS: Well, these forecasts and changes in costs were developed within the various divisions and were submitted forward to my department for entering within the financial reporting system, and this information was then provided to management committee for their review, together with explanations as to why the changes were taken place, as we've outlined in the attachment to Schedule 1-A.

MS. BUTLER, Q.C.: Yes. Okay, but beyond simply taking the new figures and inputting them into the system as a given, I guess what I'm looking at is what was the process in terms of conscious decisions to reduce the expenses that might otherwise simply have been taken as granted?

MR. ROBERTS: The expenses were looked at within the divisions and it was reviewed as to whether or not they could, in fact, reduce other costs, and if they couldn't, then this information came forward.

MS. BUTLER, Q.C.: I see, so that decision has already been made before it reaches you?

MR. ROBERTS: The decision within the division is made.

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: Of course, management committee still reserves the right to have the final say.

MS. BUTLER, Q.C.: Okay. Alright. I want to talk now about ... and we can leave this on the screen, because it may be related. Issues concerning the rural deficit which is incurred in the isolated regions. Now, you actually have in ... let's see. I think perhaps we might look at **Exhibit JAB-1**, which is Mr. Brickhill's **Exhibit JAB-1**. Page 3.

MR. ROBERTS: Ms. Butler, are you talking about in his original?

MS. BUTLER, Q.C.: Yes. I was only because I can go back to ... I can go to the other one in a moment, but I think we have to start with his original. Page 3 of 94, the cost of service deficit. Yeah, okay. Thank you, Mr. O'Rielly. It's on the screen. I don't ...

MR. ROBERTS: Yeah, I'll try and answer from the screen, if I can.

MS. BUTLER, Q.C.: Sure. I really don't think there's any need to pull the hard copy out. Okay, so at the time that this was originally filed with the application, the rural deficit, which is shown in Column 5, was anticipated to be $26.16 million?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay. Now, these are costs that are incurred, of course, as a portion of the operating budget?

MR. ROBERTS: That's correct, these are allocations of what these costs are in the operating budget or forecast.

MS. BUTLER, Q.C.: Alright. Then, this figure was later revised in Mr. Brickhill's second supplementary testimony. Maybe we could have a look at that. Mr. O'Rielly, that would be **JAB** revision 1, page 3 of 94.

MR. O'RIELLY: That's not available.

MS. BUTLER, Q.C.: Okay, so when it was revised the figure increased, I believe, Mr. Roberts, to $30.648 million?

MR. ROBERTS: That's the figure I just saw in the first revision, which fixed some reallocation of how costs are being allocated.

MS. BUTLER, Q.C.: Okay, and I know that then there was, what I call Mr. Brickhill's third supplementary, the figure got changed again.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: And this time it went up to $31.7 million?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay. Now, because these are discrepancies within an operating budget, in a sense, what I want to do is ask you some questions about how the deficit that Hydro runs or incurs in the rural systems managed to grow from $26.16 million as the original number to $31.7 million?

MR. ROBERTS: You can try me, but I would venture to say I'm not going to be able to answer it for you because the 26 to the 30 is not a change in cost, it's the change of allocation of certain costs within the cost of service.

MS. BUTLER, Q.C.: Okay, I accept that, and what about the change from the $30 to the $31.7?

MR. ROBERTS: The $30 to the $31.7 would certainly be impacted by the change that's shown on my Schedule 1-A of my revenue requirement, but once again, it's the cost of service taking these operating costs and allocating them through various factors within the cost of service.

MS. BUTLER, Q.C.: Just so that we're clear, the growth from $26.1 to the $30.6 million is merely a change in allocation?

MR. ROBERTS: As I understand what's been filed, and I think it may have been outlined in, I think, Mr. Reeves or Mr. Brickhill's evidence. It's a change in the allocation of the way that certain costs were done in the cost of service, not an increase in "cost" per se.

MS. BUTLER, Q.C.: Okay, I accept that, and then the change from $30.6 to $31.7?

MR. ROBERTS: Should be as a result of the revised revenue requirement.

MS. BUTLER, Q.C.: Okay. Now, would you agree, looking at what's on the screen here for the figures for the rural deficit, that one of Hydro's goals would be to work towards reducing the rural deficit?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: And through your department's role in preparing financial budgets forecasts and analysis, etcetera, can you tell the Board what you consider in terms of the impact of various expenses or projects that are coming forward and the effect that they may have on the rural deficit?

MR. ROBERTS: Well, if I can back up?

MS. BUTLER, Q.C.: Sure.

MR. ROBERTS: From my perspective, I can provide the corporate total costs. The calculation of the rural deficit is a function that can only be determined by preparing and doing a cost of service. Within that cost of service, for the little information that I know about it, will depend on load, allocation factors, all different areas for which I have very limited knowledge. So I guess if operating costs go up or down, then I think the rural deficit will also change but there may also be other factors within the cost of service that can change these costs without changing the revenue requirement.

MS. BUTLER, Q.C.: Yes, I accept that, so what I'm asking you, because, of course, you're not the author of the cost of service study ...

MR. ROBERTS: No, I'm not.

MS. BUTLER, Q.C.: ... is what impact or what consideration you were giving in your involvement through the capital budget process and the operating budget process to the impact that a particular expense, an operating expense, or capital project submission, may have on the rural deficit? Is it something that you're considering at all throughout this eight or nine month period?

MR. ROBERTS: It's always being considered to minimize cost, not just because of the rural deficit, but just to minimize cost as to what's required, and the same thing in the review of the capital budget proposals, that is the responsibility of the various divisions to bring forward the various capital proposals that they deem necessary for their respective divisions. In the case of the operating costs, the same philosophy is used. You bring forward those budgeted costs to perform your work plan and your requirements for a particular year. The actual determination of a rural deficit is a function of taking those costs and putting them through a cost of service methodology to arrive at that particular amount. It's not known at the time of budget preparation what the rural deficit would be. It can only be done when a full fledged cost of service study is done.

(12:15 p.m.)

MS. BUTLER, Q.C.: Okay, I accept that as well, Mr. Roberts, so knowing that ultimately the mandate is to keep your operating costs and your capital costs as low as possible, which I accept, can you tell me, or perhaps give me an example of an investment or a proposal that did not proceed because of Hydro's conclusion of its impact on the rural deficit?

MR. ROBERTS: I can't. I'm not deep enough within the capital budget process to provide it to you, and in the case of the operating costs, I am looking at them from a corporate perspective, not from an individual low level area, and the particular costs that are here for the rural deficit are allocations of those costs.

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: I only deal at the higher level, not down below. Physically we have no way of knowing how much of those particular costs until the cost of service is done, so if you are dealing with the control of the costs in total, then somewhere it has an impact on the rural deficit. It could go up and it could go down, but it's also affected by other factors which may not have an impact on operating costs.

MS. BUTLER, Q.C.: Alright. Let me apologize first. I don't mean to bring you down below a level where you're comfortable, but if you can tell me at what level that kind of consideration may be given, I'd appreciate the education?

MR. ROBERTS: I guess if you're asking is everybody looking at these things specifically for the rural deficit?

MS. BUTLER, Q.C.: Is anybody, yes.

MR. ROBERTS: I think the answer is we are always cognizant of the rural deficit, but to say we've got a tick list that here's the rural deficit is number one, the answer is no, but I can tell you from my involvement, and I do have the involvement at the management committee level of both the review of the operating and the capital budgets, that there is discussion saying we do have this rural deficit subsidy out there and we are cognisant of that deficit being there. Whether or not we can do much about it is a separate issue. What I'm saying is that we do have that in the back of our mind that we do have this rural deficit and the impact of it on our customers.

MS. BUTLER, Q.C.: And would it be fair to say, Mr. Roberts, that that would apply to one department more than another or is it right across or throughout the various departments or divisions of Hydro?

MR. ROBERTS: I think once you start reaching at the vice-president level there is no doubt that it's in their mind that we have a $30 million subsidy, or whatever it is, associated with the rural deficit, and within certain other areas, definitely in the case of TRO, because they do have and are working in those particular areas. And in the case of the plant manager down in Bay d'Espoir, undoubtedly he is aware that there is a subsidy, but the magnitude of it he may not be aware of.

MS. BUTLER, Q.C.: Yeah, I'm sure, but within the corporate hierarchy there is no particular division or section that is responsible for managing the rural deficit?

MR. ROBERTS: No, and the reason why is that deficit can only be determined from a cost of service.

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: And until that's done then you really don't know what the amount is. You know, it's, you know, it's $26 million, it's gone to 30, but it was an allocation of what derived those costs, not a change in cost, as an example.

MS. BUTLER, Q.C.: Okay. I'll start the next section, Mr. Chairman. I won't get through it but I don't mind keeping going.

MR. NOSEWORTHY, CHAIRMAN: Could we ... one of the panel has an engagement she'd like to get to if we could break now.

MS. BUTLER, Q.C.: Absolutely.

MR. NOSEWORTHY, CHAIRMAN: Eight minutes early. I'd appreciate it.

MS. BUTLER, Q.C.: Thank you, Mr. Chairman.

MR. NOSEWORTHY, CHAIRMAN: Thank you, very much. We'll reconvene at 2:00.

(break)

(2:00 p.m.)

MR. NOSEWORTHY, CHAIRMAN: Good afternoon. Before we get started, Mr. Kennedy, have you got any preliminary matters?

MR. KENNEDY: I believe Hydro, counsel for Hydro is going to report on some undertakings, Chair. Other than that, I don't believe there's anything.

MR. NOSEWORTHY, CHAIRMAN: Thank you. Ms. Greene, please.

MS. GREENE, Q.C.: Thank you, Mr. Chair. There were no undertakings provided by Hydro yesterday so I have no list of undertakings for Hydro to report on, but I do have two revised sheets from **NP-5A**, which was previously filed, which show the current organizational charts for Hydro, and these two pages are revised Page A-1 and a revised Page D-1, are in response to the request of Commissioner Powell on Friday, and they do reflect the fact that two directors in the Production Division, two positions at the director's level had been eliminated since the original filing, so these two charts, revised A-1 and revised D-1, would reflect those changes, and they are filed in response to the undertaking to Commissioner Powell. It was given on Friday past. Thank you.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Greene. Good afternoon, Mr. Roberts.

MR. ROBERTS: Good afternoon.

MR. HUTCHINGS: Mr. Chair, if I might ...

MR. NOSEWORTHY, CHAIRMAN: Sorry.

MR. HUTCHINGS: ... just while we're talking about undertakings, there was an undertaking given by Dr. Vilbert yesterday and I can advise that we have now received the information that we understand was requested and we'll get that copied and should have it available for distribution tomorrow.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Mr. Hutchings. Good afternoon, Ms. Butler. I wonder could I ask you to continue with your cross-examination?

MS. BUTLER, Q.C.: Thank you, Mr. Chairman. Mr. Roberts, I'm going to look now, if I might, at **NP-24**, where we have, I believe, the complete operating and capital budgets for Hydro submitted to the Board of Directors and ultimately to the Minister of Mines and Energy. Mr. Roberts, if you've located your copy can you go to page six, please?

MR. ROBERTS: Which year?

MS. BUTLER, Q.C.: 2001.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Mr. Roberts, thank you, page six, I believe, indicates that the 2001 budget for operating expenses had a total of $87,011,000.

MR. ROBERTS: Correct.

MS. BUTLER, Q.C.: Now, I wonder if we might compare that number to what you had originally reflected on your **JCR Schedule 1** for revenue requirement? And I realize this schedule was changed but I will go back or go forward, Schedule 1A in a moment. Mr. Roberts, in terms of comparing the net operating expenses from NP-24 to the revenue requirement in your Schedule 1, which is now on the screen, am I correct that we would look at line 39 for the comparable figure to the net operating expenses from NP-24?

MR. ROBERTS: For 2001?

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: Okay. You'd be comparing to 90 million 204, which is on line 39.

MS. BUTLER, Q.C.: Right. Now, this difference of approximately $3 million was apparent when Mr. Reeves, who is Vice-President TRO, had testified, and were you in the room when we asked him some questions about the discrepancy?

MR. ROBERTS: Yes, I was.

MS. BUTLER, Q.C.: Okay. And he provided in terms of an explanation of the discrepancy an exhibit that's known as **U-Hydro 3**, which I'm going to ask Mr. O'Rielly to put on the screen for us. Okay.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: So really what U-Hydro 3 does, it compares in the opening line the figure which we saw from Hydro's operating budget submitted to Minister of Mines and Energy in October, November of 2001, or 2000.

MR. ROBERTS: 2000.

MS. BUTLER, Q.C.: To what was filed here in May of 2001, which is the 90 million 204.

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay. And in terms of explaining the differences, the first is an addition at the top for loss on disposal of fixed assets. What I'm interested in you telling us, Mr. Roberts, is why that particular adjustment is shown separate from all the others below.

MR. ROBERTS: The reason being is because page six does not reflect loss on it. It reflects it back on the income statement which is on page one, so to be comparable to get to that 90.2 million that's in my revenue requirement, I've had to bring that forward from the first page of the budget.

MS. BUTLER, Q.C.: Would you ... would it be fair to say then that it's merely a presentation issue?

MR. ROBERTS: The first item is, yes.

MS. BUTLER, Q.C.: Yes, okay. Whereas the others that are shown towards the bottom of the page are not presentation issues. These are true variances in cost.

MR. ROBERTS: They are true changes in cost, yes.

MS. BUTLER, Q.C.: Okay. So what I want to go through with you are the true variances in cost which follow, and on U-Hydro 3, as of October 31st, 2000, in addition to the $88 million shown at the top, let's see, we're now trying to explain a $2 million discrepancy. I think what I'll do, if you don't mind, Mr. Roberts, at this point is I'll hand out, because otherwise it's impossible to follow along on the screen, a copy of your **JCR Schedule 1A** to show how that $90 million has now been changed again to the new figure. Clearly, while we have the document on the screen, Mr. Roberts, most of the additions are in the area of salaries or maintenance, roof repairs, reclassification Crown lease costs, right, the two large numbers towards the top.

MR. ROBERTS: Yes, they are.

MS. BUTLER, Q.C.: Now, in comparison then to the number at the bottom of the page, 90 million 204, which is the number as of May 31st, 2001, your Schedule 1A is now showing comparable figure of 91 million 050.

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay. So growth of another $1 million approximately.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay. Can we look first then to the increase in salary grouping due to additional salary increase of $1.103 million and the hand-out I've just given out, which is Schedule 1A. I believe there is also an increase in that same sort of a category, salaries and fringe benefits, at line 18, of $1.669 million.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay. So this is an additional $1.669 million over and above the $1.1 million shown on the screen.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: And can you just look at Note 7, please, and tell us how the increase in salaries and fringe benefits arose from May to October of 2001?

MR. ROBERTS: As highlighted in Item No. 7, the increase is due to higher temporary wages being related to backfilling permanent positions for $872,000, additional capital work of $200,000, partially offset by lower permanent salaries due to additional vacancies of 433, higher overtime mainly related to additional maintenance requirements, 415, rate hearing, 173, and more capital works, 72, revised employee future benefits of 190 and higher fringe benefits of $180,000.

MS. BUTLER, Q.C.: Okay. So a whole lot of different reasons for the increase of $1.669 million from May to October of 2001. What about the one million one that's on the screen, what was that related to, the change between October 2000 and May of 2001?

MR. ROBERTS: I think if memory serves me correctly, it's to accommodate for an additional increase in salary.

MS. BUTLER, Q.C.: Okay. So we've got combined growth between October 2000 and October 2001 in the area of salaries of $2.8 million, very substantial.

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Right. The next adjustment you have is $929,000 for increased maintenance costs at Holyrood, roof repairs, Hydro Place and reclassification of Crown lease costs. And again, this is an increase from October 2000 to May 2001, suggesting that these costs were not anticipated.

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Can you give us a breakdown between those three items?

MR. ROBERTS: Actually I think it was already filed. We did provide a breakdown because I remember it was 687 or $687,000 for Holyrood repairs and unfortunately I don't have ... but there was an undertaking to file, but maybe it was filed.

MS. BUTLER, Q.C.: 220 for the other two.

MR. ROBERTS: I'm just trying to go from memory but there was a response or a question ... oh, here we go, **U-Hydro No. 2**.

MS. BUTLER, Q.C.: And are the figures that you're reading from there correct, 687 for Holyrood ...

MR. ROBERTS: Additional maintenance to Holyrood air heater baskets of 688, roof repairs was 125, Crown lease, the Crown land lease costs net of reduced requirements, 131. That's the maintenance costs for Muskrat Falls to get us to 929.

MS. BUTLER, Q.C.: Okay. So in terms of how these items arose in order to explain the variance of almost $1 million between October 2000 and May 2001, what circumstances actually changed?

MR. ROBERTS: In the case of the roof repairs it's my understanding that in the fall of 2000 there was a report being prepared as to the condition of the roof in Hydro Place, and that report was not available at the time that our 2001 budget was completed, and that's why you have the extra provision for roof repairs to Hydro Place of $125,000. In the case of Holyrood, this was a item that arose as a result of completion of the maintenance in Holyrood in the fall, as I understand it, and as a result of completion of that maintenance there were problems identified with these air heater baskets as well as with the partnering agreements with the manufacturers with a cost increase.

MS. BUTLER, Q.C.: Do you normally see $1 million difference or anything in the range of $1 million difference in that category of maintenance-type costs from a budget submitted to your Board of Directors in the fall to May of 2000, or May of the year after?

MR. ROBERTS: It could quite conceivably happen in the case of when the budgets are prepared, which is basically in the spring of the following year, and looking forward in the meantime at that point your maintenance has not been completed for that current year and there's always a chance that there will be additional items that will arise from your maintenance during that coming season that will have an impact on the next year's budget that you didn't have in there at the time.

MS. BUTLER, Q.C.: Okay. Now is there a comparable figure for maintenance issues that drives the increase from $90 million to $91 million now shown on this Schedule 1A? Is any portion of the increase associated with a similar type issue on Schedule 1A?

MR. ROBERTS: If you look at the explanation for Item No. 8 on the system equipment maintenance, you'll find that there's additional maintenance required at Holyrood which may have arose as a result of doing the maintenance.

MS. BUTLER, Q.C.: $186,000?

MR. ROBERTS: That's correct. Additional maintenance in the TRO area which are things that have been identified as a result of the winter, may have been breakdowns or whatever that necessitates additional maintenance to be done this year.

MS. BUTLER, Q.C.: So looking back at the schedule itself, without looking at the notes, it's line 19, system equipment maintenance, $285,000 increase.

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: That would be similar to the explanation I just provided on the other maintenance.

(2:15 p.m.)

MS. BUTLER, Q.C.: So given the growth from October 2000 of $88 million to October 2001 forecast of $91 million, in terms of the revenue requirement, can I ask you, Mr. Roberts, as Controller, what has Hydro done to mitigate the impact of these two in particular significant increases in the salary and maintenance categories?

MR. ROBERTS: Hydro's management continues to monitor these costs and to ensure that the costs that are being incurred are what is properly to be incurred. It's based on approved maintenance that must be required and completed at the various facilities throughout the system and that maintenance program is what dictates the amount of system equipment maintenance that must be carried out in any particular year. In the case of salaries there is an approved complement of positions which is continuously under review, whenever a vacancy occurs. Same thing with temporary wages, overtime. All these costs are subject to review and approval by various levels of management and before they are being incurred.

MS. BUTLER, Q.C.: Can I turn now away from the operating budget and forecast to the capital budget and forecast, and here I think we need to look at Section F-1 revised of the capital budget. Mr. Roberts, I'm sorry, do you have that yet?

MR. ROBERTS: Yes, I do.

MS. BUTLER, Q.C.: Okay. Now, in comparison to the increases that we just saw in Hydro's operating budget, in the revised October 31st, 2001, evidence, and actually this is to the end of August 2001, Hydro has decreased its forecast capital budget by about $2.7 million, and we see that, I think, by comparing the line in column two, $55.897 million, which was the PUB-approved budget 2001 ... sorry, I lost my thought here ... to 53 million 164.

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay. A decrease of about five percent. And we saw some or heard from Mr. Budgell last week or maybe the week before that actual expenditures against that capital budget to the end of August are only $24.147 million. You'll see that in column three. Now, I gather from your early evidence, when we started this cross-examination today, that monitoring actual against forecast is part of your responsibility, so what I want to ask you is your position as Controller in relation to the fact that only $24 million of the $55 or $56 million budgeted has actually been spent in the first eight months of the year, which is 67 percent of the year.

MR. ROBERTS: That to me is not unusual when you look at the capital work that's being done. Most of the capital work will be starting in the spring and following through to the summer and into the fall, so I would expect a significant amount of capital expenditures to be incurred and paid within the last quarter of a year.

MS. BUTLER, Q.C.: Are you comfortable then that the revised forecast of $53.164 million will actually be spent by year end?

MR. ROBERTS: That amount could change daily. It goes back ... at the time that this document was completed, that was the best estimate of the project managers that are doing these particular projects.

MS. BUTLER, Q.C.: Well, I agree but of course you're testifying now in November and this was true for the period ending August 31st, and, you know, from my questions to you already I know that you watch these things weekly and, if not, get reports on them monthly. So I guess I'm asking you for your most current information.

MR. ROBERTS: I don't have that with me. All I can suggest to you is that the project managers have the responsibility. I provide a tool for them to manage and that information is provided. The onus is back with the project manager to either increase or decrease that particular forecast.

MS. BUTLER, Q.C.: And as you are with us now today and to be as helpful as we can to the Board, Mr. Roberts, do you believe that you, that Hydro will actually expend its full capital budget of $53 million?

MR. ROBERTS: To be honest, I don't think we will at this point, but you ask me tomorrow, it may change, and I'll give you a good example as to why, is that if you happen to look at the contingency fund ...

MS. BUTLER, Q.C.: I have some questions about that a little later but go ahead, yeah.

MR. ROBERTS: Up to this point in time I think there's approximately about $600,000 not expended.

MS. BUTLER, Q.C.: Yeah.

MR. ROBERTS: It is a contingency. It may or may not get spent between now and December 31st.

MS. BUTLER, Q.C.: Now we are of course looking at this document on the screen, speaking of your 2002 capital budget submission. I wonder if we might look at Page E-1, and this is a **revised Page E-1**, Mr. O'Rielly. Thank you. The actual shown here for 2000 came in at $38.563 million.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay. I'm going to ask to hand out what Hydro had actually submitted to the Public Utilities Board in its capital budget application for 2000. We'll just keep that one on the screen for a minute, if we can, Mr. O'Rielly. Mr. Roberts, if you accept that this is Page E-1 from Hydro's October 16th, 2000, submission on its capital budget to this Board, that's the hand-out, you'll see that the revised budget for 2000 as of that time was $43.750 million.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: And again, comparing it to the number that's on the screen, we know that the actual came in at $38.563 million.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: And of course the difference in dates here are only 75 days apart, because the hand-out was October 16th, 2000, and your actual would speak as of December 31st, 2000, right?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay. So we have a variance of 5 or $6 million, between, $5 million, between October 16th and December 31st.

MR. ROBERTS: Even though the document that you're looking at, the one that you just handed out that's dated 2000, that was compared, prepared as of October the 16th, that was probably as of the end of September.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: Not as of the exact date that's there.

MS. BUTLER, Q.C.: Okay. So maybe 90 days' difference.

MR. ROBERTS: So maybe 90 days, that's correct.

MS. BUTLER, Q.C.: I guess my point though is we've got a $5 million spread on what was the last, that is the revised budget submitted to the Board in October of 2000 and what came in as actual, and back to Page F-1 for the year 2001, I think we're headed in a similar way for 2001, subject of course to what you've told us about capital expenditures to a large degree being made in the fall, because you've only spent 45 percent of the capital budget to date, right?

MR. ROBERTS: Yes, and I'll go back to 2000 without actually looking at the details behind the 2000, to determine the reason. It's impossible for me to turn around and say that we won't spend 53. All I'm just saying is that's a snapshot at a point in time and as every day passes the number could physically change up or down.

MS. BUTLER, Q.C.: Let's talk a bit, while we have this document on the screen and the other hand-out with us, about the contingency fund. What exactly is Hydro's contingency fund as it relates to the capital budget?

MR. ROBERTS: It's a provision of approximately $1 million a year that's been allowed by the Board in its capital budget to cover unforeseen items.

MS. BUTLER, Q.C.: Can we look at Hydro's status report on the contingency funds used so far in 2001, which you referred to as **F-13**, and that's a revised page. Okay. So in assisting in an understanding of the contingency fund and what it is meant to cover, I note that the first line refers to preliminary engineering for, is that T1, 218, 236?

MR. ROBERTS: I think it's supposed to be TL 218, 236.

MS. BUTLER, Q.C.: Okay. So you're talking about preliminary engineering on those lines or line, some upgrade on distribution line and purchase of a gas detector monitor, etc. What is this reference to preliminary engineering as it relates to a contingency fund?

MR. ROBERTS: It's quite common in the construction side of things that preliminary engineering has to be done in advance of raising a work order for the full cost of the project. There is an element of pre-engineering, pre-studies, that have, pre-investigation that has to be done in advance of the work being done, and in order to meet the schedule for the work that's being requested in TL 218 and 236, the request was made to have these funds come out of the contingency.

MS. BUTLER, Q.C.: I'm still a little confused because under the reference to the first three items you've got, "This year, 2001," and then you've got a list of six projects, so ...

MR. ROBERTS: The first item ... the first three items, if I may, just to try and help you out, when these were incurred, incurred is the wrong word, these were items that arose in 2000.

MS. BUTLER, Q.C.: Right.

MR. ROBERTS: Okay. Late in 2000. I'm not sure of the exact date but they did occur in 2000, that were carried over into 2001.

MS. BUTLER, Q.C.: Well I guess that's my question, and that is how it is that a contingency fund can be used for projects that were, that arose the year before.

MR. ROBERTS: Well, what happened, if there was an amount of, say, $200,000 allocated in the contingency from the year before, and if we only had incurred 150 by the end of that particular year, we would carry over the extra 50.

MS. BUTLER, Q.C.: I see, okay. So for the six underneath the reference to, "This year, 2001," and if we look at, let's see, column two, "PUB-approved budget," and added those six amounts up, I make it $334,000. Just want to take a second to confirm that's approximately right.

MR. ROBERTS: It should be.

MS. BUTLER, Q.C.: Column three, "Expenditures to date, 2001," the same six projects only add up to $38,000.

MR. ROBERTS: Expenditures to the end of August, yes.

MS. BUTLER, Q.C.: So about one-tenth of the amount set aside in the contingency fund for 2001 have actually been spent to date.

MR. ROBERTS: Whatever the 38 is of the 300 and ...

MS. BUTLER, Q.C.: 34.

MR. ROBERTS: 34. That's correct, up to the end of August.

(2:30 p.m.)

MS. BUTLER, Q.C.: Right, okay. Now, I'd also like to review what happened last year relevant to the contingency fund because I think it did grow from the $1 million. Let's see. In Newfoundland and Labrador Hydro 2001 capital budget submission, which is also a hand-out ...

MS. GREENE, Q.C.: The previous hand-out on the budget wasn't marked.

MR. KENNEDY: The Section E one?

MS. GREENE, Q.C.: Yes.

MS. BUTLER, Q.C.: E-1, yeah.

MR. KENNEDY: With consent of all counsel, we call it a consent document if it was a previously filed document pursuant to the hearing, so it'd be Consent No. 11.

EXHIBIT CONSENT NO. 11 ENTERED IN EVIDENCE

MR. HUTCHINGS: I wonder, Mr. Chair, if someone could confirm for me the date that's supposed to be at the top of that because it's, I've lost most of it in the photocopy.

MS. BUTLER, Q.C.: I think all copies lost it. The date that was written on mine was October 16th, 2000.

MR. NOSEWORTHY, CHAIRMAN: Thank you.

MR. HUTCHINGS: Thank you.

MR. KENNEDY: Again we should call this Consent No. 12.

EXHIBIT CONSENT NO. 12 ENTERED IN EVIDENCE

MS. BUTLER, Q.C.: And, Mr. Chairman, the same date was at the top of that as well. Okay. So, Mr. Roberts, if you accept that Consent 12 is Page A-1 from Hydro's capital budget submission last year, you'll see that there's reference to a contingency fund for the year 2001 of $1 million which you confirmed a moment ago.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay. And if Mr. O'Rielly can be kind enough to put on the screen for us **Page F-1** of this year's capital budget submission. Thank you. You're showing a PUB-approved budget now, contingency fund of $1.120 million, am I right?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay. Perhaps, Mr. Roberts, you might just explain the missing link there between the original approval of $1 million and what's showing here is approved as one million one ...

MR. ROBERTS: The extra $120,000 represents carry-overs that were approved in a prior year.

MS. BUTLER, Q.C.: Does Hydro have to get approval for carry-overs, separate Board approval?

MR. ROBERTS: Grey area in my opinion.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: We have in the last couple of years been adding them on similar to what you're seeing here on the screen now so that we have been providing the information to the Board.

MS. BUTLER, Q.C.: Alright. Is there a specific Board order that approves the extra 120 in this case or is it simply just Hydro carrying it over?

MR. ROBERTS: I can't recall what the Board order would be for 2001, whether or not they approved the fifty-five eight ninety seven or if it was the fifty-four six eighty-one. I don't recall.

MS. BUTLER, Q.C.: Okay. Thank you, Mr. O'Rielly. I'm finished with that area. I want to ask a few questions, if I can, Mr. Roberts, about regulated versus non-regulated. Can you help us with that a bit?

MR. ROBERTS: I'll try.

MS. BUTLER, Q.C.: Well, we all know by now that Hydro has regulated and non-regulated operations and as well has affiliated companies that are non-regulated.

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: So how is it that Hydro identifies and distinguishes the non-regulated costs from its regulated costs in the books of account?

MR. ROBERTS: I believe the best place I can start is with the various entities. Churchill Falls, in the case, the relationship with Hydro, is that we maintain an administrative fee that we agree upon between Hydro and CF(L)Co. related to the services that are provided, and those services are outlined in, I think it's 11B, the most current agreement that we have dealing with the administrative fee between Hydro and CF(L)Co.

MS. BUTLER, Q.C.: That's **NP-11B**, okay.

MR. ROBERTS: NP-11B.

MS. BUTLER, Q.C.: Okay, uh hum.

MR. ROBERTS: And that outlines the services that Hydro provides to CF(L)Co. for that particular entity. Any services provided to Twin are charged to CF(L)Co.

MS. BUTLER, Q.C.: I'm sorry, any service provided?

MR. ROBERTS: To Twin Co.

MS. BUTLER, Q.C.: To Twin Co., yeah.

MR. ROBERTS: Twin Falls Power Corporation Limited, are paid for by Churchill Falls Labrador Corporation Limited. Gull Island Power Company Limited is an inactive company and at this point so is the Lower Churchill Development Corporation Limited. The other activity that we do have is our relationship of sales of re-call power to Hydro-Quebec. In the case of sales of re-call power to Hydro-Quebec, we are provided with meter readings from Churchill Falls and an invoice is prepared and sent to Hydro-Quebec and funds are received. To date the amount of time that's been involved in that particular transaction has not warranted separate recording of time.

MS. BUTLER, Q.C.: Okay. With that basic understanding of how the system works though, can you tell us perhaps in a little more detail what knowledge those individuals who are involved with the various companies or regulated versus non-regulated operations have of, or what understanding they are given of how the expenses have to be segregated? Is there a direction or policy?

MR. ROBERTS: There was a memo issued in early 2000 outlining out procedures that should be followed relative to the tracking of time to be charged to CF(L)Co., using our work order system and our Lotus Notes time sheet system that we have. In addition to that, any costs are directed wherever possible to be charged to the separate entity, not to Hydro and to be back charged to the entity, and in the case that the items do arise, then we will literally send it back to a supplier and ask them to re-invoice the company. In addition to that, any purchasing that would be done by Hydro's staff on behalf of CF(L)Co., the purchase order will be in the name of CF(L)Co. and handled appropriately.

MS. BUTLER, Q.C.: Okay. Well, where would I look to see a summary of the non-regulated expenses?

MR. ROBERTS: I guess what you would have to do is look at what the costs are in 11A, which is primarily CF(L)Co.

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: And the only other non-regulated costs that we have adjust my revenue requirement by are outlined in a PUB question. I think it's No. 57 or 58, and I think there's some donations and some costs associated with Muskrat Falls, I think approximately about 146, $147,000.

MS. BUTLER, Q.C.: Okay. Well I know we will be looking at PUB-57 in a moment because (inaudible) that reference in some of my questions. But let me ask you, Mr. Roberts, as Controller, how you satisfy yourself that all non-regulated costs are properly identified and removed from the regulated statements. For example, is there an internal audit process?

MR. ROBERTS: Specifically the CF(L)Co. admin fee, it may be on the audit plan but it's not every single year, if it is there. In the case of CF(L)Co., annually the CF(L)Co. administrative fee is prepared, it's reviewed and approved by the CF(L)Co. Board of Directors, and those costs would be built within that particular year. At the end of the year we will go back and recalculate that administrative fee based on the actual results incurred during that particular year, and any required adjustment, be it to recover or to refund, would be made within the first couple of months after the end of the year.

MS. BUTLER, Q.C.: Do you have a definition of non-regulated expenses?

MR. ROBERTS: There is a definition that's been outlined by us as to the non-regulated activities. That's been defined and I believe that's in **NP-259**.

MS. BUTLER, Q.C.: Okay. Let's have a peek at NP-259 then, if we can. Is there a particular page number, Mr. Roberts? Wrong reference?

MR. ROBERTS: It's the wrong reference.

MS. BUTLER, Q.C.: Yeah. I wonder if it's 269 actually.

MR. ROBERTS: I apologize. I'm not sure what the number is, what I had marked down, but it had basically defined that our investment in CF(L)Co., Twin, LCDC Chip (phonetic) Co. and sales for re-call power are all non-regulated items.

MS. BUTLER, Q.C.: Uh hum.

MR. ROBERTS: In addition to that we had some (inaudible) regulated costs as well.

MS. BUTLER, Q.C.: Okay. Well perhaps we can get that reference during the break and come back to the issue, but in terms of your own definition and if a staff member were to ask you is this particular expense a non-regulated expense, can you tell me how you would explain the difference?

MR. ROBERTS: I guess it's a function of what the expenditure is. Is it for Hydro or is it for one of the other entities. In our particular case, two of the other entities are inactive.

MS. BUTLER, Q.C.: Okay. Let's concentrate on it being within Hydro, because Hydro as a body has both regulated and non-regulated operation.

MR. ROBERTS: Uh hum.

MS. BUTLER, Q.C.: Quite aside from Hydro's related companies like Twin Co. and CF(L)Co. If a staff member had a question on whether a particular expense incurred by Hydro is regulated versus non-regulated, how do I make the distinction?

MR. ROBERTS: I don't think it's going to be that finite because of the service that's provided. The service that's provided to CF(L)Co. as outlined is NP-11B would take, as an example, my particular department, and whatever costs are included in my department, a portion of those would be reallocated to CF(L)Co. in the admin fee based on the time that's incurred and spent for that particular entity. If it was a cost specifically for CF(L)Co., it would be invoiced to CF(L)Co. and paid for by CF(L)Co..

MS. BUTLER, Q.C.: Again that's perhaps a slightly different example than what I was getting at. For example, I presume with any utility there are expenses incurred that are non-regulated.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Like charitable donations is ...

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: ... a good example, okay. So if a staff member has a question for you in terms of, you know, entering an expense into the JD Edward system for whatever program, is this a regulated expense or is it a non-regulated expense? What guidelines exist to assist them in determining what is and what isn't?

MR. ROBERTS: Well, in the case of non-regulated costs such as donations ...

MS. BUTLER, Q.C.: Yeah.

MR. ROBERTS: ... they are primarily controlled by one individual in each of the areas who have a small portion that they can allow and they have the account code for which they are to charge particular costs associated with that advertising, that donation, sorry. In the case of corporate donations, it requires the approval of the Management Committee to incur those costs, and the coding would then be done by a particular individual that would code it to a separate expense account called Donations and Contributions.

MS. BUTLER, Q.C.: So are there only two areas, donations and advertising?

MR. ROBERTS: There are only donations and Muskrat Falls' costs that are quote (inaudible) regulated costs that we have recorded.

MS. BUTLER, Q.C.: What about advertising?

MR. ROBERTS: Advertising, if you look at the response, the advertising that we've done historically has been for power outages and requesting hiring of personnel.

MS. BUTLER, Q.C.: Okay. So you consider it regulated.

MR. ROBERTS: I certainly do and the costs that we have incurred today.

MS. BUTLER, Q.C.: So in terms of coming forward to the Board with a definition for approval, has Hydro done that, brought an application to approve its internal definition of regulated versus non-regulated costs?

MR. ROBERTS: Nothing other than what's already filed within this hearing, either through evidence or through an RFI.

(2:45 p.m.)

MS. BUTLER, Q.C.: Okay. I wonder if we might look then to the **Grant Thornton Report 2001** as an example of the charitable donations? Mr. O'Rielly, are you waiting for me to give you a page number?

MR. O'RIELLY: Yes.

MS. BUTLER, Q.C.: Oh, sorry. 32. Okay. Here we have in Mr. Brushett's report on Hydro for 2001 a breakdown of items included in Miscellaneous category, and under the table, the second paragraph, he refers to the contribution amount. Can you just read that second paragraph in for us, please?

MR. ROBERTS: "The contribution amount indicated above includes $131,000 in 2001 and $133,000 in 2002 of non-regulated donations. These costs have been appropriately included in the Company's non-regulated expenses. The remaining $60,000 in this category relates to the street lighting in Bay D'Espoir, which is considered to be a regulated expense."

MS. BUTLER, Q.C.: Okay. And just give us an example, if you wouldn't mind, of what would constitute a donation that Hydro would make and which would fall under the category of Contribution.

MR. ROBERTS: For instance, the contribution to the Canadian Cancer Society.

MS. BUTLER, Q.C.: Directly a cheque to the Society?

MR. ROBERTS: Yes, yes.

MS. BUTLER, Q.C.: What about a table of ten at these dinners that every large firm gets invited to, is that ...

MR. ROBERTS: I honestly couldn't tell you where that cost is recorded.

MS. BUTLER, Q.C.: Okay. Can you tell me whether all donations are considered the same way?

MR. ROBERTS: All costs in that account with exception of street lights are considered to be non-regulated.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: So whatever gets charged to that particular account is adjusted for street lights and the balance is deleted.

MS. BUTLER, Q.C.: Alright. Would there have been similar expenses for charitable donations in the years prior to 2000?

MR. ROBERTS: I have no reason to believe that there wouldn't be.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: The amount would certainly change but ...

MS. BUTLER, Q.C.: Yeah, sure. But you'd expect there to be some.

MR. ROBERTS: There would certainly be some.

MS. BUTLER, Q.C.: Alright. Can we look then to **PUB-57**, which is the RFI you referred to a little earlier, page one of two? There's a table at the bottom of that page. Mr. O'Rielly, manage to get the whole thing on the page if we can. Okay. The question that was asked here, 57.1, the Public Utilities Board was interested in a calculation of forecast average common equity for 2001 and 2 based on one of your Schedules 11, details on how net earnings related to export sales to Hydro-Quebec and other non-regulated items were treated, and the answer is given in the format of a table at the bottom, which we'll just scroll down to. Now, the forecast closing non-regulated expense total is $295,000.

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay. If that number were higher, in other words, if there were more non-regulated expenses ...

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: ... more charitable donations, etc., what would be the impact on your regulated retained earnings in column one?

MR. ROBERTS: The retained earnings would be higher.

MS. BUTLER, Q.C.: And the non-regulated retained earnings would be lower.

MR. ROBERTS: Well, they would be (inaudible) because it's a debit.

MS. BUTLER, Q.C.: In the table, column four, non-regulated expense, as compared to the first three columns, you don't show an opening retained earnings balance.

MR. ROBERTS: For non-regulated expense, that's correct.

MS. BUTLER, Q.C.: Okay. So I took that to mean there's no carry forward figure in the non-regulated expenses.

MR. ROBERTS: The amounts have been treated the same as if a dividend had been paid and therefore the regulated earnings have been reduced. That's the way that it's been reflected on this particular schedule.

MS. BUTLER, Q.C.: Okay. Well, I don't understand that so I'm going to get you to do that a little slowly with me. If ... we're looking at the correct column now when Mr. O'Rielly has his signal. If there had been non-regulated expenses such as charitable donations incurred in the year before, I would have thought there'd have been an opening balance in that column.

MR. ROBERTS: Yes, and what I'm saying is the reason why there's not, it's been treated the same as if it was a dividend and reduced retained earnings. It has not been shown separately.

MS. BUTLER, Q.C.: Okay. So the figure that you reduced is in column one.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay. Now, Mr. Brown, John Brown, who's one of two experts and who has already testified on behalf of Newfoundland Power, suggested that it would be appropriate for Hydro to keep a separate sort of books for regulated operations versus non-regulated operations. Do you agree with that general principle?

MR. ROBERTS: I think records can be kept separately, yes.

MS. BUTLER, Q.C.: And would it be very difficult to do?

MR. ROBERTS: Depending on the level of details you want to get into. I don't think it's impossible to do but I think it certainly can be done all within the entity.

MS. BUTLER, Q.C.: But it's not being done now.

MR. ROBERTS: No, not completely.

MS. BUTLER, Q.C.: Not completely. Therefore there's no place that I can go to to find a full set of non-regulated books of account.

MR. ROBERTS: No, because historically the costs that have been incurred, as I mentioned to you, prior to January 1st, 2001, have been treated the same as a dividend and reduced retained earnings. I also want to point out too is that there's another issue within this as well, and that is that prior to, I guess it is January of 1996, only one portion of Hydro was even regulated, which makes it even more complicated, because at that point the only regulation was on the utility, not on the industrials. Now it's to be fully regulated, all customers with the exception of the re-call power and anything that's exempt.

MS. BUTLER, Q.C.: Okay. So you've certainly being dealing with a transition period. I accept that.

MR. ROBERTS: Yes. And there's no question there's going to be growing pains ...

MS. BUTLER, Q.C.: Yeah.

MR. ROBERTS: ... in trying to resolve things because there's absolutely no way you can ever predict ...

MS. BUTLER, Q.C.: No.

MR. ROBERTS: ... things that will arise. You try to but at the end of the day there's always going to be something that's going to come up that you never thought in your wildest dreams would surface.

MS. BUTLER, Q.C.: Yeah. But I guess in fairness and to make it as simpler or readable, user friendly as possible to all of us, maybe this is the right time to start separating the books.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay. I just want to ask you now, before we break for the afternoon, a couple of questions on interest coverage, so I'm finished with that exhibit. Thanks, Mr. O'Rielly. Now, again, the Board on this occasion will be addressing your application on the basis of a return on rate base model.

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: And interest coverage was of course the way you had looked at things in the past, but ...

MR. ROBERTS: Yes. That's the way that the Board had regulated up to 1992.

MS. BUTLER, Q.C.: Right.

MR. ROBERTS: Was on an interest coverage basis.

MS. BUTLER, Q.C.: Do you agree that interest coverage remains an important consideration in terms of Hydro's position in the marketplace generally and that this was basically what Mr. Hall was saying that the DBRS still relies upon?

MR. ROBERTS: It's one of the financial tools that's available to DBRS to use, but they also do another series of various other ratios in coming up with their opinion and their rating on Hydro.

MS. BUTLER, Q.C.: Yeah, but the interest ...

MR. ROBERTS: At the end of the day right now, as a result of this hearing, it would be on a return on rate base. We may still provide interest coverages and undoubtedly we will, it's been one of our financial measurements, but the key one is that return on rate base.

MS. BUTLER, Q.C.: Okay. I agree with all that but it's still a useful tool in terms of measuring Hydro's financial health and any other corporation's financial health.

MR. ROBERTS: Yes, (inaudible).

MS. BUTLER, Q.C.: Okay. Now in **NP-2**, I wonder if we might just look at the question first and then we'll look at the answer, there is a table, a schedule. Next page. Thank you. Can you enlarge it a bit? Mr. Roberts, you'd rather follow the hard copy?

MR. ROBERTS: Sometimes it's easier to see because it's almost like the screen, the numbers are moving.

MS. BUTLER, Q.C.: That's fine. You just take your time and let me know when you've got that available.

MR. ROBERTS: You go ahead. I'm familiar with the table.

MS. BUTLER, Q.C.: Okay. Here Hydro had been asked to provide the details of its interest coverage for the years '92 to 2000 and estimate, and of course it's the bottom line which tells us how well you've been doing in terms of interest coverage, right?

MR. ROBERTS: The bottom section is the pure regulated definition of the interest coverage.

MS. BUTLER, Q.C.: Okay. But in the answer that was given to the text to the question itself, it indicated, and this is apparent from the table, that the information on interest coverage was not available for '96, '97, '98 or 2000, and of course ...

MR. ROBERTS: That's correct, at that point in time on a regulated basis they were not available.

MS. BUTLER, Q.C.: Right. And the estimate for 2001 as well. Can you advise the Board why Hydro was not able to provide the financial figures at that time? Is that calculation a difficult calculation?

MR. ROBERTS: The reason being they weren't provided at that time is because they cannot be done unless a cost of service was done, and the cost of services for the years in question at that point in time were not completed, and if memory serves me correctly, I think it's '96 and '98 cannot be done.

MS. BUTLER, Q.C.: At all?

MR. ROBERTS: No. The reason being is '96 is the interconnection of the Great Northern Peninsula caused us problems and the cost of service works on annual items.

MS. BUTLER, Q.C.: Yeah.

MR. ROBERTS: And '98 there was a problem in the way that the switching over from the old system to the new JD Edwards system, so there's a compatibility problem in trying to develop cost of service for those two particular years.

MS. BUTLER, Q.C.: Okay. Well we now have your cost of service for the other years. They're filed in request to industrial customers' RFI, I think.

MR. ROBERTS: I believe they are.

MS. BUTLER, Q.C.: Okay. But has the cost of service gross interest coverage been provided?

MR. ROBERTS: It hasn't been filed to the best of my knowledge.

MS. BUTLER, Q.C.: No. Would it be ... would you be able to provide it now without any difficulty?

MR. ROBERTS: I don't see why we shouldn't. If the cost are services are done, we should be able to get the number.

MS. BUTLER, Q.C.: You don't see why you shouldn't be able to?

MR. ROBERTS: Don't see why we shouldn't be able to.

MS. BUTLER, Q.C.: Okay, thank you. If you don't mind giving me your undertaking for that, and I appreciate that those two years, '96 and '98, can't be provided for the reasons that you've indicated. Of the years that are available on the screen, Mr. Roberts, can you tell us, please, how we read the bottom line, that is the cost of service gross interest coverage line, vis-a-vis what the Board had recommended or ordered prior to '92?

MR. ROBERTS: What the Board had determined back in 1992 was that it should aim to achieve a 108 coverage.

MS. BUTLER, Q.C.: Yes. And you exceeded that in '92, in '93, '94, '95.

MR. ROBERTS: '99.

MS. BUTLER, Q.C.: '99. And you're forecasting spot on for '92, for 2002.

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Mr. Chairman, that would be a good place to break, if I can.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Butler. We'll break until 3:15.

(break)

(3:15 p.m.)

MR. NOSEWORTHY, CHAIRMAN: Thank you. Could I ask you to continue, Ms. Butler, please?

MS. BUTLER, Q.C.: Thank you, Mr. Chairman. Mr. Roberts, I want to talk a bit about capitalized expenses. Can you tell me what a capitalized expense is?

MR. ROBERTS: If an employee is working on a capital project we will take the time that he spends on that capital project and his hourly rate, based on the number of hours that he's working, and multiply it by a loading factor to cover fringe benefits, and then multiply it by a factor to cover overhead for the various departments.

MS. BUTLER, Q.C.: And then what do you do with it?

MR. ROBERTS: Well, the system actually goes through and puts the charge out into the work order and a credit back into the operating budget section.

MS. BUTLER, Q.C.: Okay, so an operating expense becomes a capital expense?

MR. ROBERTS: It's a credit in the operating expense. Maybe the best thing to illustrate for you would be you can go to Schedule 1 or Schedule 1-A of my ...

MS. BUTLER, Q.C.: Okay. **JCR**, Schedule 1-A was a handout.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: So why don't we just look at that?

MR. ROBERTS: You can look at ...

MS. BUTLER, Q.C.: Yeah, and I think you'll see the reference at line 34?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Hydro's capitalized expense.

MR. ROBERTS: So as I mentioned, if an employee works an hour that's the routine that will be done, and that's where the credit comes in to go against the operating cost, because the salary cost for that particular hour will be up in salary and fringe benefits, the credit is down here in the capitalized expense. If it happens to be overtime the same principle would happen, it will be up here in the salaries and it will come down here in the credit.

MS. BUTLER, Q.C.: Okay, so those portions or that portion of ... in this particular example that you're using, salaries and fringe benefits that would otherwise be at line 18, the $60 million?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: That you consider properly charged to a capital project, you capitalize using the formula you've just given me and then deduct at line 34?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay, so it reduces your operating expenses and increases your capitalized expenses?

MR. ROBERTS: It puts a charge out to the work order, which is in work in progress at that point until the job is completed.

MS. BUTLER, Q.C.: Now, does Hydro have a capital expense policy?

MR. ROBERTS: Yes. There was an RFI, I think, that was filed on that.

MS. BUTLER, Q.C.: And has Hydro's capital expense policy been the subject of a formal submission to the Board and approval by the Board?

MR. ROBERTS: Has the policy been submitted I do not believe so.

MS. BUTLER, Q.C.: And I gather that there are a couple of different methods for capitalizing or determining capital expenses, an incremental method and a full costing method?

MR. ROBERTS: In the capitalization of the cost?

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: There could be.

MS. BUTLER, Q.C.: Well, when you describe your particular procedure or formula, is there a particular name given to the method that you're following?

MR. ROBERTS: No.

MS. BUTLER, Q.C.: Now, does Hydro charge capitalized expenses to its non-regulated construction projects, for example, Granite Canal?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: So that a particular credit that we're referring to on line ...

MS. BUTLER, Q.C.: 34?

MR. ROBERTS: ... 34.

MS. BUTLER, Q.C.: Yeah.

MR. ROBERTS: If there was time charged by employees for Granite Canal that credit is coming out through there.

MS. BUTLER, Q.C.: But what we're looking at here is regulated revenue, right?

MR. ROBERTS: Yes, but I'm saying the quote, if we may, the regulated costs are being reduced by the time that's spent on non-regulated activities, i.e., Granite, and that reduction is in that $6.6 million.

MS. BUTLER, Q.C.: And the theory and principle behind capitalized expenses and their deduction here is what?

MR. ROBERTS: Is that these are times that are spent on capital projects, not an operating cost for a particular year ... i.e., the building of a Granite Canal is an asset that is being constructed, and the time of our engineers that are being assigned to the project should not be recorded in operating but should be added to that particular capital project, and eventually end up in fixed assets, and hopefully in the rate base.

MS. BUTLER, Q.C.: Now, all other things being equal, while we have this handout, Schedule 1-A, which is your revised schedule, if the Hydro capitalized expenses were greater at year end than what you had budgeted for, everything else being equal, what's the impact on revenue requirement?

MR. ROBERTS: It means more margin for Hydro.

MS. BUTLER, Q.C.: The revenue requirement decreases?

MR. ROBERTS: I'm not sure. I'm just trying to reverse around in my mind from an income statement to a revenue requirement basis. All I can say to you is that if you looked at it, if we, as an example, in 2001, instead of having $6.6 million capitalized we had $8.6 million ...

MS. BUTLER, Q.C.: I'm sorry, what line are you on?

MR. ROBERTS: If you just looked at line 34.

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: If that $6.6 turned out to be $8.6.

MS. BUTLER, Q.C.: Yes.

MR. ROBERTS: The change would be that the margin return on equity in line 40 would go to $13 million.

MS. BUTLER, Q.C.: Okay, and what would happen to line 41?

MR. ROBERTS: And if that's a function of sales it will remain unchanged.

MS. BUTLER, Q.C.: Alright. Now, we actually prepared a table summarizing Hydro's capitalized expenses as a percentage of Hydro's capital expenditures which needs to be handed out, and because this was taken from three different sources, Mr. Roberts, they are noted at the asterisks underneath. And if you wish to take the time now we can verify them from the various sources that are shown, or you might take a moment and just look them over. If you're familiar enough with them you might be able to tell me that they appear correct?

MR. ROBERTS: I'm assuming that they are correct based on just looking at 2001 and 2002. I have no reason to believe that it's incorrect.

MS. BUTLER, Q.C.: Okay. Now, if our calculations are correct, from `92 to 2000 Hydro's capitalized expense, as a percentage of capital expenditures, averaged 24.8 percent? And you'll see that just underneath the table there.

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay. Now, does that number surprise you or seem reasonable to you?

MR. ROBERTS: I guess I don't look at it in that vein, I look at it by the individual years, because the amount of capitalized expense is a function of the type of capital that's done in a particular year. To use an example, we would not charge capitalized expenses to the acquisition of vehicles as an example. Okay. I know one particular year we had approximately, say, $3 million worth of vehicle purchases because we couldn't get them physically in time for a particular year, so therefore, you may have a high capital program, but not necessarily entail higher capitalized expense, so it's a mix of what the capital programs are. It will also be a function of whether or not Hydro's staff were doing the capital programs or whether or not it's done by somebody outside.

MS. BUTLER, Q.C.: Alright. Well then for 2001/2002 we'll see that the percentage that we've calculated there is 12.9 percent?

MR. ROBERTS: For 2001?

MS. BUTLER, Q.C.: The average of 2001/2002?

MR. ROBERTS: Okay. 12.9?

MS. BUTLER, Q.C.: Yeah. In terms of the capitalized expense as a percentage of total capital expenditures?

MR. ROBERTS: Uh hum.

MS. BUTLER, Q.C.: And can you tell me why the decrease? It's almost half.

MR. ROBERTS: All I can suggest to you is that it has to be a mix of the capital programs as to what's in the 53 versus the 43.

MS. BUTLER, Q.C.: Can we have a peek, Mr. O'Rielly, please, at **NP-237**?

MS. GREENE, Q.C.: Excuse me. I wonder if we should mark that?

MR. KENNEDY: Yes. It's **NP No. 7**.

EXHIBIT NP NO. 7 ENTERED

MS. BUTLER, Q.C.: Thank you. Okay. There's a partial or maybe a complete, based on what you're going to tell me, explain here for this. "Explain why capitalized expenses for 2001 and 2 have decreased so significantly?" And perhaps you might just read for us the answer?

MR. ROBERTS: "Capitalized expenses for 2001 and 2002 have decreased from 2000 mainly due to the fact that in 2000 there were recoveries of approximately $650,000 related to the Labrador River project. In addition, there were recoveries of approximately $727,000 related to overtime for which there is no allowance made on the budget of forecast basis."

MS. BUTLER, Q.C.: Can you just explain that to me a bit?

MR. ROBERTS: Well, the Labrador Hydro project, the costs incurred on that, it has been set up the same as a capital work order and all costs are being charged to work in progress and do not form part of the operating costs.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: And in the case of the overtime, this was overtime that was incurred that ended up being in an operating cost and came back out in the capitalized expense line, this line 34 that we were talking about over here, so that the effect on the operating cost should be zero. What went in up here as salaries came out down here in capitalized expenses, and the other side of that entry is sitting in the work orders in work in progress.

MS. BUTLER, Q.C.: Alright. The Labrador River project, is that an unregulated project?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay. Can we look at **NP-16**, please, page 2 of 2? And here we have Hydro's capitalized expenses as a percentage of capital expenditures, but I think the figures are taken from a couple of different sources. When we look at the capital expenses there, Mr. Roberts, are these regulated capital expenses or consolidated capital expenses?

MR. ROBERTS: They are all capital expenditures. They are not regulated.

MS. BUTLER, Q.C.: Okay. Consolidated?

MR. ROBERTS: They are all consolidated ... no, consolidated is probably not the right word. They were all corporate.

MS. BUTLER, Q.C.: Okay, that's fine, and for the capital expenditures, same thing?

MR. ROBERTS: Oh, let me back up. Yes, I'll back up for a second.

MS. BUTLER, Q.C.: Okay.

MR. ROBERTS: The capitalized expenses would be for any time incurred by a Hydro employee on any capital project, irrespective of whether or not it was regulated or non-regulated. The intent of that number is to remove these costs from operating costs. The capital expenditures column includes all capital expenditures for Newfoundland and Labrador Hydro, and that's part of the reason why you'll find, when you look at the 2001 and 2002 amounts for capital expenditures, these represent costs being incurred on the Granite Canal project.

MS. BUTLER, Q.C.: Okay. I'll make sure that we're clear now. For the capitalized expenses column, which is Column 2?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: It is both regulated and non-regulated?

MR. ROBERTS: It is time spent by any employee on a capital project irrespective of if it's regulated or non-regulated. From a capitalized expense perspective everything is treated equally.

MS. BUTLER, Q.C.: Okay, and for Column 3, capital expenditures represent ...

MR. ROBERTS: That is ...

MS. BUTLER, Q.C.: ... regulated and non-regulated?

MR. ROBERTS: Yes, that's the total capital expenditures for Newfoundland and Labrador Hydro.

(3:30 p.m.)

MS. BUTLER, Q.C.: Okay. Now, these numbers, I don't know if it's possible, Mr. O'Rielly, to do this, but I need to look at **NP-3**, line 77. **NP-3**, page 3 of 3, yeah, line 77. Hydro's capitalized expenses here ... no, we have to get the year on there if it's possible. Yeah, okay, so for `98 you've got $8,667 which matches what you had on **NO-16**. For 1999 can you read me the figure and I'll just compare it to what we had for **NP-16**?

MR. ROBERTS: 1999 is $8,537.

MS. BUTLER, Q.C.: Okay, and that matches, as well, and 2000?

MR. ROBERTS: It says $7,219 there but it says $7,852 over here.

MS. BUTLER, Q.C.: Okay, so why don't the figures match for the year 2000?

MR. ROBERTS: I don't have that answer right now.

MS. BUTLER, Q.C.: Okay. Can I just see the heading ...

MR. ROBERTS: Oh, correct me, I do.

MS. BUTLER, Q.C.: Yeah. Is it the Labrador River thing?

MR. ROBERTS: No.

MS. BUTLER, Q.C.: No?

MR. ROBERTS: If you went to **NP-8(b)**.

MS. BUTLER, Q.C.: Okay, we'll have a look at that. Thank you.

MR. ROBERTS: You will find there, see the line capitalized fleet?

MS. BUTLER, Q.C.: I'm sorry, capitalized what, fleet? Yes, okay.

MR. ROBERTS: Go to page 8(b). Okay. It's gone off to (inaudible), but anyway. You see 2000, see the capitalized expense, travel, district work orders 131 and the capitalized fleet, 502?

MS. BUTLER, Q.C.: Uh hum, yeah.

MR. ROBERTS: Two of those items, okay, are condensing, I think it is, in the year 2000, are actually back against the expenditure account, not as being part of the capitalized expense, so if you take, in the case of 2000, if you reduced it by the 633 it should give you that.

MS. BUTLER, Q.C.: So if we took the figure that was on **NP-16**, page 2 of 2?

MR. ROBERTS: You'll see **NP-16** shows you the $7,852.

MS. BUTLER, Q.C.: $7,852,000, yes, and if you took off $633,000?

MR. ROBERTS: It should, hopefully, put you back to the revenue requirement on **NP-3** as $7,219.

MS. BUTLER, Q.C.: Okay. Well, it would be close, anyway, if not exact. Thank you, Mr. Roberts. Allocation, can you explain to me what is meant when you use the term "allocation"?

MR. ROBERTS: Allocations in the particular sense that it's being used here in my revenue requirement schedule is these are costs that are to be "allocated" or assigned or recovered from another entity. As an example, the Hydro capitalized expenses, as we just discussed, are costs that are removed from the operating expenditures and added to fixed assets and form part of that. The case of CF(L)Co., these are costs that are incurred in the other operating costs that are to be recovered from that particular entity, so the allocations are designed to represent cost recoveries i.e., from either a fixed asset or from another entity.

MS. BUTLER, Q.C.: Alright. Now, the capitalized expenses that we just dealt with where an employee works on a capital project and his salary and benefits gets moved from an operating expense to capital budget, fixed assets, I appreciate. I wonder if we might just go back, Mr. O'Rielly, to **NP-16** where Hydro was asked about the methodology or the policy used to allocate expenditures from non-construction department? You see that right at the top there, the question at line 1, Mr. Roberts?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: "What methodology does Hydro use to allocate expenditures from non-construction departments to Hydro capitalized expense?"

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: And would you be kind enough to read the full answer there for me, please?

MR. ROBERTS: "Each non-construction department estimates the amount of effort that is expended on capital versus operating activities. Those proportions of each department's budget are totalled and compared to the total capital budget to develop a percentage or standard rate to use to allocate these costs to work orders. These allocations are intended to ensure that capital projects are adequately charged with the cost of support functions such as accounting and finance, operations and planning engineering and other such expenses which cannot be directly charged to specific capital projects."

MS. BUTLER, Q.C.: Okay, so with that explanation, should the allocations for these non-construction department estimates from non-construction departments bear some fairly consistent percentage basis to total capitalized expenditures on an annual basis?

MR. ROBERTS: I can't answer that question. I can only tell you that the amount of capital involvement can vary by the non-construction departments. Certain departments will be fairly routine, i.e., as an example, in my own case, in my department, the people that are providing the service to the people that are managing the projects I wouldn't anticipate changing from year to year.

MS. BUTLER, Q.C.: Uh hum.

MR. ROBERTS: But in other departments, and I'll just pick a hypothetical case, in materials management, in the case of using purchase orders, the amounts can certainly fluctuate from year to year, depending on the capital program.

MS. BUTLER, Q.C.: Alright. Well, you had a moment ago referred to **NP-8**. Perhaps we can get that back on the screen. **NP-8**, page 5 of 5. Okay. Then you've got a capitalized percentage allocation?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: And for `98 it was 1 million 4 ... for `99, 2 million 1 ... 2000 it's 2,032,000?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: And in comparison, the capital expenditures, let's just take the two years `98 and `99. **NP-97**, page 8. Total capital expenditures there are what? Oh, I'm sorry, it's ... page 8 of 10, yeah. Which figure here would represent the total capitalized expenditures? Total expenditures 31.7?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: Okay, so the allocation in that year was 1.4 of 31.761, and for `99, which is page 9 of 10, 36.65, and the figure that we were talking about that year for allocations was 2.1, I believe?

MR. ROBERTS: Yes.

MS. BUTLER, Q.C.: So should the percentage be consistent or ...

MR. ROBERTS: It will fluctuate based on the capital program that's there and the involvement of the people in that particular program.

MS. BUTLER, Q.C.: So the capital expenditures themselves increased from 31 to 36, about $5 million, is that right?

MR. ROBERTS: Yes, approximately.

MS. BUTLER, Q.C.: Okay, and the allocations between the two different years increased by?

MR. ROBERTS: Approximately about $700,000.

MS. BUTLER, Q.C.: $700,000?

MR. ROBERTS: Yeah.

MS. BUTLER, Q.C.: No surprise?

MR. ROBERTS: As I keep saying, it's not a function of just dollars, it's a mix of the capital program and the time that's incurred on those particular projects by the non-construction departments, so it's difficult to turn around and say that on a year by year basis you're going to have 15 percent or 10 percent or something like that. It's whatever that capital program happens to represent is what will dictate that involvement by the non-construction departments.

MS. BUTLER, Q.C.: Okay. Well, let's just have a look then, I'll leave that, at your Schedule **JCR-1(a)**, which was the handout, and line 34, which was the Hydro capitalized expense again. Now ... I'm sorry. Have you got that there? Okay. At line 34 you're showing that the revised capitalized expense is now $6,619,000 for a difference of $961,000?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: And if everything else on this schedule remained equal, Mr. Roberts, that increase would result in a net decrease in overall operating expenditures?

MR. ROBERTS: That's correct.

MS. BUTLER, Q.C.: Okay. Now, can we look at footnote 16 to see the explanation for the increase between what was forecast in May and what's now being forecast? You just indicate increased involvement of internal forces in the capital program, but what I'm interested in is what projects would have caused a $1 million increase since May?

MR. ROBERTS: I can't give you the specific projects. I have a couple of notes here of my own as an example in that particular category. There is an extra $150,000 worth of time that's been expected to be incurred on the Labrador Hydro project or Labrador River project. In addition to that of that 961, back when we were discussing the increases in the salaries and hourly wages grouping or salaries infringement of its grouping we had highlighted that there was additional capital work in overtime and there is additional time spent in temporary assigned to capital, as well.

MS. BUTLER, Q.C.: Well, I guess, again, I want to know from you, as controller, is whether, in fact, it is routine for you or comes as a surprise to you to have an increase of $1 million in capitalized expenses arising between May when you first filed this schedule and October when you filed your revised schedule?

MR. ROBERTS: Is it a surprise, no. I would expect that things may get better, and the reason why I say that is that there is certainly a very concerted effort to ensure that the capital program for 2001 is completed, and that is entailing additional time spent by employees that are responsible for these capital projects to ensure that they are completed within this year. In addition to that, as I mentioned to you, I know in the case of the Labrador Hydro project there has been additional internal forces working on that particular project in the last few months and that is part of the reason that's driving this increase in capitalized expenses.

MS. BUTLER, Q.C.: Mr. Roberts, do you expect similar pressure in 2002?

MR. ROBERTS: To maintain the capital program? I certainly believe that all efforts will be made to ensure that if this project is there that it will reasonably be completed as planned. Part of the shifting within Hydro, so Hydro historically has managed by project and looked at the project as the total. Now the emphasis is changing and placed towards a cash flow within a particular year, in addition to maintaining what the end result of that project is, so it's becoming more and more cognizant of the people that are involved in the capital projects. Not only do you have to bring the project in on time and on budget, but it's also crucial as to the years that the project is completed now and that costs are incurred because of the approval process that's now involved with the capital budget with the Public Utilities Board. Historically, as I mentioned, we used to approve a project and the project would be managed looking towards that end day to bringing it in on time and on budget. Now there's more of an emphasis also being shifted towards what is the cash flow within a particular year for completing that project, as well.

MS. BUTLER, Q.C.: Mr. Chairman, if you don't mind, I'm going to move into another section that I probably wouldn't finish anyway within the next ten minutes, and for the benefit of my colleagues and the Board, I would expect I'll be still some considerable time with Mr. Roberts in the morning, at least an hour, for sure.

MR. NOSEWORTHY, CHAIRMAN: Okay. Would you prefer to go to that section now for ...

MS. BUTLER, Q.C.: No, I'd rather not. Actually, we moved a little faster than I had hoped.

MR. NOSEWORTHY, CHAIRMAN: Okay. We'll break now. Thank you, Ms. Butler. Thank you, Mr. Roberts. Until 9:30 tomorrow morning.

(hearing adjourned to November 15, 2001)