(9:30 a.m.)

MR. NOSEWORTHY, CHAIRMAN: Good morning everybody. A great morning out there and a great weekend, the weather, and hopefully the Farmer's Almanac is going to be wrong. *(laughter)* Who knows? We can hope. I'd like first of all to acknowledge once again and thank everybody who travelled on the road with us over the past couple of weeks. Certainly I recognize that it's not easy ... at the roof this morning ... I recognize that it's not easy travelling around like that location to location over an extended period of time and I wish to once again thank you for that and your tolerance along the way with the little episodes. I do think that public participation days are indeed worthwhile and necessary and certainly I think the information that we gathered and collected will be useful to us in making our decision ultimately.

We're here this morning to begin our cost of capital phase of the hearing. I do see some new faces out there this morning and perhaps I would ask the parties to introduce others who are at the table this morning with them before we begin. I notice nobody sitting next to Ms. Greene there.

MS. GREENE, Q.C.: Yes, I'm feeling quite alone here this morning.

MR. NOSEWORTHY, CHAIRMAN: There is, however, somebody new at Newfoundland Power's table so I'll ask ...

MS. BUTLER, Q.C.: Thank you, Mr. Chairman, and good morning. This morning we have Mr. John Brown (phonetic), who is the first of the two Newfoundland Power experts with us. Mr. Brown, although not truly a cost of capital expert, everybody has agreed will testify after Ms. McShane and Mr. Hall, so with your indulgence I'd ask that he sit with me for the cross-examination of Kathleen McShane this morning.

MR. NOSEWORTHY, CHAIRMAN: Welcome, Mr. Brown.

MR. BROWN: Thank you.

MR. NOSEWORTHY, CHAIRMAN: Industrial Customers?

MR. HUTCHINGS: Thank you, Mr. Chair. I'm pleased to introduce to the Board Dr. Michael Vilbert (phonetic) of the (unintelligible) Group from Cambridge, Massachusetts, whose evidence has been pre-filed and who is truly a rate of return expert, and we'll be hearing from Dr. Vilbert later on and he, it would be our intention to ask that he remain with us during the course of the evidence from the other experts in that regard.

MR. NOSEWORTHY, CHAIRMAN: Welcome, Dr. Vilbert. Consumer Advocate, please.

MR. FITZGERALD: Mr. Chairman, members of the Board, I'd like to introduce Dr. Basil Kaliman (phonetic), who's been retained by the Consumer Advocate to give expert evidence in the area of rate of return and the cost of capital and Dr. Kaliman is from the Ivy School of Business and his resume has been filed.

MR. NOSEWORTHY, CHAIRMAN: Welcome Dr. Kaliman.

DR. KALIMAN: Thank you.

MR. NOSEWORTHY, CHAIRMAN: Before we begin I'd like to ask Mr. Kennedy if there are any preliminary matters, please.

MR. KENNEDY: Yes, Chair, Commissioners, there are some additional letters of comment that have been received by the Board, and I won't read the actual letters in, some of them are lengthy, but just to indicate that they have been filed so that the parties can assure that they've received a copy of them. One is from the Health Boards Association. It's a letter signed by Mr. John Peddle, the Executive Director of the Newfoundland and Labrador Health Boards Association dated October the 26th, 2001. The second letter, dated October 24th, 2001, is a letter of comment received from Mayor Andy Wells, Mayor of the City of St. John's, and with it there's an attachment of a three-page document giving his comments concerning some points germane to the application. And there is a letter received by *(sic)* the Member Lawrence O'Brien, a Member of Parliament for Labrador, dated October the 26th, 2001. I also have some undertaking documents that have been filed by Hydro. I'm not sure if counsel for Hydro intended to raise them as preliminary matters or ...

MS. GREENE, Q.C.: I had planned to do it this afternoon. That's fine, we can do it now.

MR. KENNEDY: Well, we can do it this afternoon, if you want. That's fine. So at this time I'll just issue in the three letters of comment, Chair, and that's, as far as I'm aware, the only preliminary points.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Mr. Kennedy. We'll proceed directly into the cost of capital aspect. I'd ask Ms. Greene if she's prepared to proceed to introduce her cost of capital expert witness.

MS. GREENE, Q.C.: Thank you, Mr. Chair. Good morning. The first witness for cost of capital is Ms. Kathleen McShane and Ms. McShane is available to be called at this time.

MR. NOSEWORTHY, CHAIRMAN: Good morning, Ms. McShane ...

MS. McSHANE: Good morning.

MR. NOSEWORTHY, CHAIRMAN: ... and welcome.

MS. McSHANE: Thank you.

MR. NOSEWORTHY, CHAIRMAN: Give you a chance to get seated. Do you have everything there you need ...

MS. McSHANE: Thank you.

MR. NOSEWORTHY, CHAIRMAN: ... to get organized? I wonder could you take the Bible in your right hand, Ms. McShane? 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?

MS. McSHANE: I do.

MR. NOSEWORTHY, CHAIRMAN: Thank you. I'll ask you to proceed, Ms. Greene, please.

MS. GREENE, Q.C.: Ms. McShane, evidence was pre-filed in your name on May 31st, 2001. Do you adopt this pre-filed evidence as your own for the purposes of this hearing?

MS. McSHANE: Yes, I do.

MS. GREENE, Q.C.: Thank you, Ms. McShane. That concludes all of the questions we have for Ms. McShane at this time.

MR. NOSEWORTHY, CHAIRMAN: So that's all the direct examination, Ms. Greene?

MS. GREENE, Q.C.: Yes.

MR. NOSEWORTHY, CHAIRMAN: So you're in a position now to proceed with the cross, Newfoundland Power, please ...

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

MR. NOSEWORTHY, CHAIRMAN: ... Ms. Butler.

MS. BUTLER, Q.C.: Good morning, Ms. McShane.

MS. McSHANE: Good morning.

MS. BUTLER, Q.C.: In your pre-filed testimony, which will appear on the screen, on page one, lines 22 to 28, please, you indicate here that you will be addressing in your evidence three things. I wonder if you might just read for us the three issues that you will be addressing.

MS. McSHANE: I have been requested by Newfoundland and Labrador Hydro, Hydro, to (1) address the principles that should underpin the determination of the rate base, capital structure and return on rate base; (2) provide an expert opinion on the reasonableness of the proposals made by Hydro in this regard for the year 2002; and (3) recommend appropriate targets for capital structure and return on equity.

MS. BUTLER, Q.C.: Thank you. I wonder if we might first look at the capital structure? And here your testimony, I think at page 16, is relevant. Thank you. Lines four to seven. Actually, you can start with line three. I wonder if you might just read lines three to seven for us?

MS. McSHANE: "I analyzed Hydro's forecast capital structure from two perspectives. One, is the forecast capital structure compatible with the premise that Hydro should maintain financial parameters that are commercially sound and consistent with achieving an investment-grade debt rating on a stand-alone basis?"

MS. BUTLER, Q.C.: Thank you. I wonder, Ms. McShane, if you could tell the Board what are the financial parameters to which you refer at line five?

MS. McSHANE: The actual parameters would include primarily the capital structure ratios, the interest coverage ratios, and, secondarily, cash flow to debt ratios, and I guess those would be the primary ones.

MS. BUTLER, Q.C.: Okay. And when you were talking about appropriate capital structure, would I be correct in suggesting that that would refer primarily to the appropriate debt equity ratio?

MS. McSHANE: That's correct.

MS. BUTLER, Q.C.: And the capital structure for Hydro, as I understand your pre-filed evidence, page 19 ... sorry, Mr. O'Rielly, is that page 19? Thank you. Line ten. As I understand the evidence given there, concluding that Hydro would require a 60/40 debt common equity ratio as a relatively low risk utility to achieve a debt rating of Triple B on a stand-alone basis, suggesting that the capital structure should result in a Triple B rating for Hydro.

MS. McSHANE: If they were to achieve and maintain a 60/40 debt equity capital structure, that's correct.

MS. BUTLER, Q.C.: In the medium term your recommendation is a capital structure that is 70 to 75 percent debt and 25 to 30 or 30 to 25 percent equity, is that correct?

MS. McSHANE: Correct.

MS. BUTLER, Q.C.: And we see that at page 21 of your evidence. I don't think we need to actually put it on the screen. The medium term was defined for us in answer to a request for information, **IC-64**, line 13, and as I understand the answer that's given to that request for information from the industrial customer, Ms. McShane, the medium term is five to seven years.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And the long-term you define in the same answer as 10 to 12 years?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And it is in the long-term that you're recommending the appropriate ratio for Hydro is 60 percent debt and 40 percent equity.

MS. McSHANE: What I'm suggesting is that it's an appropriate target today but I think it's unreasonable to expect that the Company could achieve a 60/40 capital structure in the near term, given where its capital structure is today and given the fact that, unless there is an infusion of equity by the province, that the only source of equity is retained earnings, so the reason for the long-term target is because that's the only period over which it's reasonable to expect the Company to be able to achieve a 60/40 capital structure.

MS. BUTLER, Q.C.: Just so that I understand, because in terms of your pre-filed you did speak of medium term and long term and not near term, so the medium term, five to seven years, we're talking about 75 percent debt, 25 percent equity, the long term, you are recommending 60/40?

MS. McSHANE: That's correct, and the only distinction I was making was that the ... if the Company were able to achieve a 60/40 capital structure overnight without undue impact on the ratepayers, it would be an appropriate capital structure today, but because factors which make it impossible and unreasonable to expect that to happen, it is more appropriately viewed as a long-term target.

MS. BUTLER, Q.C.: And thus your recommendation based on the facts, the reality of the situation ...

MS. McSHANE: That's correct.

MS. BUTLER, Q.C.: ... is a long-term debt equity ratio of 60/40.

MS. McSHANE: Correct.

MS. BUTLER, Q.C.: Can we look at **IC-64**, please, the question first, which was posed on page one? "If the equity in Hydro were to be increased from its present level so as to meet the 60/40 debt equity ratio recommended by you as the long-term goal," and then it goes down, "what amount of additional revenue," I'm reading from line nine, "what amount of additional revenue would Hydro have to collect from its customers to produce these debt equity ratios?" The answer that was given, starting at line 17, refers to Hydro's five-year plan. Are you familiar with Hydro's five-year plan?

(9:45 a.m.)

MS. McSHANE: I have read it, yes.

MS. BUTLER, Q.C.: Okay. And the answer suggests that, "For the period 2001-2005, it has been filed. The requested information is beyond the time span of the five-year plan and is therefore not available for the medium term and long term as suggested by Ms. McShane." So at this particular time Hydro was unable to answer a question that was posed. Can I ask you, Ms. McShane, have you since provided Hydro with the information?

MS. McSHANE: No. This information would be up to Hydro to prepare in terms of their entire capital plan and outlook for earnings to determine whether, to what extent they would be able to achieve that over the long term. This wouldn't be information that I would provide to them.

MS. BUTLER, Q.C.: Have you since seen this information prepared by Hydro?

MS. McSHANE: No, I have not.

MS. BUTLER, Q.C.: Now, can we look at **CA-131**? This is a question from the Consumer Advocate, reading at line one, "Hydro was asked to prepare a table similar to what we had seen in Mr. Hamilton's evidence at page nine, based on the assumption of implementation of Hydro's proposed financial structure on January 1st, 2002." And the answer, I wonder if you could just read it for us, please, at lines four to eight?

MS. McSHANE: "The attached table has been prepared based on a debt equity ratio of 60/40 and 11 1/4 percent return on equity. These numbers do not include any additional funds from ratepayers to achieve 40 percent equity, nor do they incorporate changes to rural deficit area revenues or any cash flow impacts associated with interest and return on rate base from those filed in Exhibit JAB-1."

MS. BUTLER, Q.C.: Okay. And so have you seen this RFI prior to now?

MS. McSHANE: I believe I've looked at it but I don't recall the specifics of it.

MS. BUTLER, Q.C.: Let me just go then to page two of two, and this is the table that the RFI refers to. Just take a moment to refresh your memory on it, bearing in mind now that the question was to provide a calculation of the impact on customers if 11.25 percent return on equity and a 60/40 debt equity ratio, long-term, as you recommended, were put in place for the test year, what the impact would be. And as you quite rightly point out, this would be something done internally at Hydro. As I understand this table, and correct me if I'm wrong, the impact would be a requirement of an additional $41.3 million?

MS. McSHANE: That was my understanding of the meaning of the table.

MS. BUTLER, Q.C.: And a percentage change being a rate increase of 13.9 percent, that we see at the bottom of the last column?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And just so that we can compare the original table, which was in Mr. Hamilton's evidence, at page nine, Hydro's case, that is the application before the Board, seeks an increase of 18.159 million, shown at the bottom of column three.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: With a rate increase to consumers of 6.1 percent.

MS. McSHANE: Correct.

MS. BUTLER, Q.C.: So the 11.25 percent return on equity, 60/40 debt equity ratio, were that the case in this application, would have resulted in a far more significant impact on consumers, customers.

MS. McSHANE: It would have required the increase that you referred to previously, yes.

MS. BUTLER, Q.C.: I want to go back to your own evidence at page 15 and a table which you actually prepared at the top of the page, and the test year forecast utility capital structure. While we have that on the screen, Ms. McShane, perhaps this is the appropriate point to point out, through the course of the application I noticed several different references to common equity ratio for the test year sometimes referred to as mid-year and sometimes referred to as year end. So when we see on your table common equity ratio, with the equity component of the ratio at 15.3 percent, this is the mid-year equity ratio, correct?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And the end of the year ratio, there's several references too in the evidence, but it is lower, correct?

MS. McSHANE: That's my understanding, correct.

MS. BUTLER, Q.C.: Now, Mr. Wells as President of Hydro addressed the debt equity ratio for the test year in his evidence on September 24th and suggested that the debt equity ratio, at that time he was referring to 83/17, have not negatively impacted on the credit rating of the province. Do you concur with that assessment?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Alright. Can we leave your evidence for a moment and go to **IC-98**, which is Hydro's five-year financial plan that you indicated that you've seen, page four, Table 1? Now it's the last row of that table obviously which is of interest to me. And here we see that Hydro's debt component of its capital structure in 2002 is 84 percent, you were showing it a moment ago as 85, which would imply, of course, an equity component for 2002 of 16 percent.

MS. McSHANE: Approximately. I don't know exactly what is included in the non-debt component, whether this includes the future liability for post-retirement benefits.

MS. BUTLER, Q.C.: Okay. But we are talking approximately.

MS. McSHANE: Approximately, yes.

MS. BUTLER, Q.C.: It's the movement of the figures shown at the bottom line of the table though which is of interest to me, 2001 debt capital, 79 percent, 2002, 84 percent, 2003, 84 percent, 2004, 83 percent, and 2005, 82 percent. So Hydro is planning to move about a percentage point a year from 2003 to 2005 towards a long-term equity goal that you recommend, which was 40 percent.

MS. McSHANE: That's within this timeframe, that's correct, that's what the movement is.

MS. BUTLER, Q.C.: Now, Ms. McShane, what I want to ask you is to your knowledge has Hydro developed a plan to move towards the 60/40 debt equity ratio?

MS. McSHANE: I am not familiar with any specific plan that they have devised to move towards a 60/40.

MS. BUTLER, Q.C.: And ...

MS. McSHANE: Other than to retain earnings and to follow a rational dividend policy.

MS. BUTLER, Q.C.: And is that a plan that you can refer to in writing or is that just a general statement of your understanding?

MS. McSHANE: No, I've not seen a written plan in that regard.

MS. BUTLER, Q.C.: Can I ask you then, with this table in mind and realizing your area of expertise, how can a company move towards a long-term 60/40 debt equity ratio without a formal plan?

MS. McSHANE: Because it is very difficult to forecast beyond a five-year period, I'm not sure that you would need a formal plan beyond that five-year period. I believe that in this timeframe that what is required is to have that as an objective and each time that you revise your five-year plan that you take into account those long-term goals and arrange your financing to the extent possible and your dividend policy to the extent possible to attempt to meet those goals.

MS. BUTLER, Q.C.: So when you say within this timeframe, you're talking about within the five-year timeframe?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: So within the five-year timeframe it's important to bear in mind the long-term goal ...

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: ... of achieving the 60/40, but at this rate it's going to take Hydro a very long time to achieve 60/40.

MS. McSHANE: Yes, it would.

MS. BUTLER, Q.C.: Do you know how long?

MS. McSHANE: Not specifically, no. I have not done that calculation.

MS. BUTLER, Q.C.: Are you aware of any analysis developed by Hydro to show the impact of the 60/40 debt equity ratio on consumers?

MS. McSHANE: Other than the data request that you've just shown me?

MS. BUTLER, Q.C.: Yes.

MS. McSHANE: No.

MS. BUTLER, Q.C.: And do you maintain that the 40 percent equity component of the debt equity ratio you're recommending here today will in fact be the appropriate long-term target for Hydro in the future?

MS. McSHANE: I cannot guarantee that that is the fact because we do know that there is still to come a report by the Government regarding the future structure of the industry. My view is that generally speaking, given what's happened in other jurisdictions in this regard, that the 60/40 debt equity ratio on a stand-alone basis would be likely conservative.

MS. BUTLER, Q.C.: So, just so that we understand what you mean by likely conservative, the debt equity ratio that's less conservative would be what?

MS. McSHANE: More equity.

MS. BUTLER, Q.C.: Right. If Hydro has no formal plan to achieve the 60/40 debt equity ratio and if, as you say, at this rate it's going to take them a very long time to achieve that, I guess my question for you is, shouldn't this Board really be addressing the 80/20 short-term goal on this application?

MS. McSHANE: Clearly they need to address the 80/20, but I think that as a matter of principle that this Board should look to laying down the principles that it believes should govern the regulatory framework and the financial parameters of this corporation.

(10:00 a.m.)

MS. BUTLER, Q.C.: Okay. Ms. McShane, I'm going to move now specifically to the dividend, if I might, and you address this in your evidence at page 24. Try line 24. There you go. The question that was put at line 22 was what was meant by a supportive dividend policy, and I wonder whether you wouldn't just read the first paragraph of the answer there?

MS. McSHANE: "A supportive dividend policy is one which is predictable to both shareholders and management and thus permits reasonable planning on the part of both shareholders and management. It is also compatible with both the level of the Utility's capital budget and the objective of maintaining a reasonable and stable capital structure."

MS. BUTLER, Q.C.: The next paragraph, which is actually quite long, perhaps you might just read the first sentence so we can understand the thrust of it, starting with, "The predictability."

MS. McSHANE: "The predictability of the dividend policy is also in the best interest of ratepayers who are then provided with assurance that the cost of capital they incur on rates will be equal to those incurred by Hydro."

MS. BUTLER, Q.C.: So essentially, as I understand it, the main features of the supportive dividend policy or the main feature is its predictability?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And ...

MS. McSHANE: Well, that's not fair. It's not just the predictability. It's also the compatibility with the overall financial plans of the Utility.

MS. BUTLER, Q.C.: But essentially for purposes of principles before this Board, as I understand your pre-filed evidence, you are suggesting that for regulatory purposes the Board should approve a supportive dividend policy as you define it.

MS. McSHANE: I don't think it's within the Board's purview to approve a dividend policy. It's certainly within the Board's purview to determine what an appropriate capital structure is, but if there is a distinction between what the capital structure is and as a result of the dividend policy and what is an appropriate dividend policy according to the Board, I think the Board has the ability to make judgements which appropriately determine the capital structure and costs that should be incurred by the customer.

MS. BUTLER, Q.C.: Okay, I accept that. You are, of course, familiar with Hydro's dividend policy or policies.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And these are presented ... Mr. O'Rielly, if we might go to **IC-276**. And you're aware that there were two policies, Ms. McShane?

MS. McSHANE: Yes, I looked at both the Board of Directors' statements in this regard. I believe one of them superseded the other one.

MS. BUTLER, Q.C.: Okay. I wonder if we might go to the attachment? There you go, thank you. The first policy is November '95, and perhaps you might just read that short one into the record, Ms. McShane.

MS. McSHANE: Starting with "That"?

MS. BUTLER, Q.C.: Yes.

MS. McSHANE: "That the Corporation shall pay each year to its sole shareholder, the Government of Newfoundland and Labrador, dividends of up to 75 percent of the Corporation's net operating income for that year, provided that such payment shall not cause a deterioration in the existing debt equity ratio of the Corporation, with such dividends to be paid on a quarterly basis."

MS. BUTLER, Q.C.: Before we leave that one then I'll just note that the caveat as stated in this policy is relative to a deterioration in existing debt equity ratio. And the second policy, which is also behind it, for 2000, and, yeah, May 12th, 2000, a little longer, Ms. McShane, but I wonder if you could just read that one as well?

MS. McSHANE: "That the Corporation shall pay each year to the sole shareholder, the Government of Newfoundland and Labrador, dividends of up to 75 percent of the Corporation's net operating income before net recall revenue for that year plus 100 percent of net recall revenues received, provided that such payment shall only be made after due consideration has been given by the Board of the impact of such payment on the debt equity ratio of the Corporation."

MS. BUTLER, Q.C.: I think we can stop there. I don't think the rest of this is necessarily appropriate. So the caveat on the subsequent dividend policy is just worded a little differently. Now it is provided that such payment shall only be made after due consideration has been given by the Board of the impact on the debt equity ratio.

MS. McSHANE: Correct.

MS. BUTLER, Q.C.: And was this the policy that you referred to in your evidence, the second of the two? You might look at page 25 of your pre-filed. Line 20, you refer to the 75 percent target pay-out ratio set by the Board, including their caveat.

MS. McSHANE: I would have had access too to the second one of those policies when I developed this evidence.

MS. BUTLER, Q.C.: Alright. Clearly in your pre-filed testimony you do address both the 75 percent target as the first component of the policy.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And a caveat as the second component of the policy. I wonder if we could look first at the 75 percent target pay-out ratio, and do you agree, Ms. McShane, that a dividend policy that resulted in a dividend pay-out not exceeding 75 percent per year would be considered predictable?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Now, Mr. O'Rielly, we will be coming back to that page a little later, but I wonder if I might look now at **NP-72**, page two? And through this request for information and the answer, Ms. McShane, we see the dividend history for '95 to '99, sorry, to 2000, proposed 2001, 2002, and it's the last column, of course, that I want to ask you about. We see the dividend pay-out as a percentage of net regulated operating income ranging from 10 percent to 730 percent as opposed to the dividend policy, which of course was up to 75 percent. Looking at the exhibit on the screen, I wonder if you could address for the Board whether this reflects a predictable dividend policy?

MS. McSHANE: No. I would say, generally speaking, I would not regard this as a predictable dividend policy in the sense that it has moved around a great deal, but to, you know, to some extent, through 1999, the dividends that were paid were considerably less than the 75 percent target.

MS. BUTLER, Q.C.: Thank you. If it's not predictable, then based on your own definition, it's not supportive.

MS. McSHANE: I would say that from my perspective if I were going to look at this as an investor, this would be somewhat less predictable than I would like as the investor in a public, an investor-owned public utility.

MS. BUTLER, Q.C.: But again bearing in mind the definition of a predictable dividend policy as contained in your pre-filed testimony, I'm sorry, definition of supportive dividend policy, if this is not predictable and that was one of the two components of a supportive dividend policy, then I'm suggesting to you that this is not reflective of a supportive dividend policy.

MS. McSHANE: And I would agree with you that it is not the type of dividend policy that one would normally see from an investor-owned utility, that it is much more volatile than typical.

MS. BUTLER, Q.C.: Thank you. Now, I reviewed this issue in part with Hydro's President and Chief Executive Officer, Mr. Wells, in September, and if I can paraphrase what he said to me on September 24th, I think he agreed that despite the dividend policy which we've seen, the amount of dividend paid is, of course, set by the Government based on its needs.

MS. McSHANE: I'm sorry ...

MS. BUTLER, Q.C.: The amount of the dividend actually paid out ...

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: ... was established by Government as shareholder based on its needs.

MS. McSHANE: That is my understanding of what he said, yes.

MS. BUTLER, Q.C.: Okay. And do you agree with that principle? Do you agree with that fact?

MS. McSHANE: Well, it's a fact. It's a different question whether I agree with the principle or not. As an outsider looking at it, I would prefer to see the dividends set by reference, not the needs of the Government, but primarily the needs of the Corporation.

MS. BUTLER, Q.C.: You prefer to see the dividend pay-out matching a dividend policy.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Okay. So even if Hydro has a predictable dividend policy, if a shareholder can ultimately ignore the policy and pay out what it likes, the application of the policy is not predictable.

MS. McSHANE: To date the application of the policy has not been predictable in the sense that I have put forth in my evidence as what I would view as a reasonable dividend policy.

MS. BUTLER, Q.C.: Okay, thank you. Now, back to page 25 of your evidence. The other salient feature of the dividend policy referred to was the caveat on the debt equity ratio. The debt equity ratio of 83/17, is that an acceptable level from your perspective?

MS. McSHANE: It depends on in what context. From the point of view of trying to achieve a commercially-sound stand-alone capital structure, no, it is not reasonable and it certainly would not be acceptable to the capital markets, but since the fact is that there is a debt guarantee which is provided by the Provincial Government, that capital structure will not cause the Provincial Government to incur higher debt costs than it otherwise would, so there is, from strictly the point of view of the province's finances, there is no negative impact of that capital structure.

MS. BUTLER, Q.C.: Okay. Well I guess I was asking the question specifically relevant to the policy, so let's just get **IC-276** back on the screen and look at the 2000 policy, which is the second of the two attachments. Okay. So the wording was, just after ... the line starting with 100 percent. "Provided that such payment shall only be made after due consideration has been given of the impact of such payment on the debt equity ratio of the Corporation." So when you answered my question in terms of it being reasonable and not acceptable to capital markets, how does it fit with a dividend policy, a debt equity ratio of 83/17?

MS. McSHANE: Well, the way the dividend policy is now stated, it's relatively vague in terms of what the extent of the impact can be. I would say that the payment of dividends in total that will have been made by the end of 2002 would be somewhat inconsistent with trying to maintain and improve the common equity ratio.

(10:15 a.m.)

MS. BUTLER, Q.C.: I accept that, and maybe we can look now at the **Grant Thornton 2001 Report**. Are you familiar with the report that was written by Grant Thornton on behalf of the Board?

MS. McSHANE: Yes, I am.

MS. BUTLER, Q.C.: Mr. O'Rielly, page 11, please. And this addresses, I believe, the very point that you just made in terms of it being inconsistent. Here we see at the table at the top the equity component of the ratio going from 20.7, 21, 20, 18.4 and now 15.3 percent for the years 1998 to 2002. That's correct?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And I wonder if you could read the paragraph that follows under Mr. Brushett's table, please?

MS. McSHANE: "As can be seen from the above table, the debt equity ratio has deteriorated from 1998 to 2000 and is forecast to decline further for the 2002 test year. While total average capital required to finance the rate base is forecast to increase approximately 13 percent from 2000 to 2002, the equity component of the capital structure is forecast to decrease by 22 percent over the same period. The primary reason for the decrease in equity is the forecast pay-out of dividends in 2002 of approximately $70 million."

MS. BUTLER, Q.C.: Mr. Brushett's suggestion of course that the primary reason for the decrease in equity being the proposed $70 million dividend, you accept that?

MS. McSHANE: Yes, but there are other reasons that there has been a decline in equity ratio. One would be that Hydro has chosen to write off, I've forgotten the exact amount, but 20 plus million of employee future benefits from equity.

MS. BUTLER, Q.C.: His reference was to the primary reason?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: So you accept that.

MS. McSHANE: Yes. That would be the major reason.

MS. BUTLER, Q.C.: And in fact I think in your own evidence at page 23 you referred to the payment of the dividend as the key factor in accounting for a test year common equity ratio of 15 percent.

MS. McSHANE: Correct.

MS. BUTLER, Q.C.: That page 30, I'm sorry, page 23, line 31.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Yeah, top of the next page, "a key factor accounting for the common equity ratio, 15 percent." And I think Mr. Wells actually said the same thing. Okay. So we know that you recommend a supportive dividend policy and we can see Hydro's history on the dividends, so we accept that Hydro's management is free to pay out whatever dividend it wishes, but with your experience in this field, Ms. McShane, do you accept that this Board should only approve a dividend for rate-making purposes that is reasonable to ratepayers, that is the deemed capital structure?

MS. McSHANE: I think those are two separate issues.

MS. BUTLER, Q.C.: Well, please address both.

MS. McSHANE: Okay. I don't believe that the Board has the ability to address the amount of the dividend. The Board does have the ability to address the appropriate capital structure.

MS. BUTLER, Q.C.: Can I stop you there and get you to tell me your position on that then as ...

MS. McSHANE: On the appropriate capital structure?

MS. BUTLER, Q.C.: No. In terms of whether your recommendation to this Board should be for a deemed capital structure.

MS. McSHANE: No, I don't think that the Board needs to approve a deemed capital structure. Typically the approval of deemed capital structures is under circumstances where the Board believes that a utility has too much equity underpinning its utility assets. There are, to my knowledge, or there has been in Canada, to my knowledge, over the past 20 years only one instance where a regulator has approved a capital structure which has more equity in it than the utility actually has. The reason for that is because equity is more expensive than debt and there is no benefit to the ratepayer for the regulator approving more equity than the company actually has. The role of the regulator in this regard, in my own personal view, is that the overall rate of return on rate base that the Board determines should not exceed that, that would be commensurate with a utility which has a reasonable capital structure, but it doesn't have to deem a capital structure to do that.

MS. BUTLER, Q.C.: They don't have to but they can.

MS. McSHANE: They certainly ... they can deem a capital structure but, as I said, it's almost unheard of for a regulator to deem more equity than a utility actually has, because then it's asking ratepayers to pay for more expensive equity that the utility doesn't have in place.

MS. BUTLER, Q.C.: We're talking about a capital structure that is as low as it is because of the payment of a $70 million dividend primarily.

MS. McSHANE: Correct.

MS. BUTLER, Q.C.: Right. In my question to you, you said, we were talking about two different things, and I know you've addressed one. Was there a second that you wanted to address?

MS. McSHANE: No. My point was that the Board doesn't have the ability, in my understanding, to determine what the dividend should be. The Board does have the ability to determine what the appropriate capital structure should be.

MS. BUTLER, Q.C.: Yes, I think you made that point earlier, okay. The level of dividends from everything we've seen so far this morning can have a significant impact on Hydro's capital structure and in the test year Hydro is forecasting payment of a dividend which is equal to 730 percent of its net operating income, correct?

MS. McSHANE: Correct. To some extent that that would be a catch-up of dividends that hadn't been paid up to the 75 percent in the past.

MS. BUTLER, Q.C.: But it exceeds the catch-up.

MS. McSHANE: Yes, it does to some extent exceed the catch-up.

MS. BUTLER, Q.C.: And the payment of the 730 percent net operating income, does that affect Hydro's commercial viability?

MS. McSHANE: It would affect Hydro's commercial viability on a stand-alone basis, yes, it would.

MS. BUTLER, Q.C.: And at page 25 of your evidence, lines 22 to 24, again we're talking about the dividend pay-outs should be structured so as to provide Hydro the opportunity to achieve a commercially-viable capital structure. So again is 83/17 commercially viable?

MS. McSHANE: No, it is not.

MS. BUTLER, Q.C.: Perhaps I'm a little confused then, because if 83/17 results from the payment of a $70 million dividend and if the 83/17 is not commercially viable, then what is your recommendation?

MS. McSHANE: As far as?

MS. BUTLER, Q.C.: The dividend and the dividend policy as it relates to the capital structure of the Company.

MS. McSHANE: My recommendation would be for the province as shareholder to implement and maintain its dividend policy as approved by the Board of Directors. As far as my recommendation for this Board, my recommendation is that the Board use the actual capital structure in place and to ensure that the overall cost of capital that is paid by the ratepayers is not in excess of what it would be if the Utility were appropriately capitalized.

MS. BUTLER, Q.C.: Alright. Now perhaps you could explain, Ms. McShane, specifically and on a practical basis that recommendation to the Board.

MS. McSHANE: If the Company were regulated or had a viable capital structure of 60/40, it would have a cost of debt, I'm going to embedded cost because the embedded cost is approximately the same as the current cost for a Triple B company, of 7.35 percent, and it would have or it should be allowed to achieve a return on equity of about 11 1/4 percent, so that would give you, if I can do these calculations quickly, an overall cost of capital of about 8.9 percent. So if you take into account the fact that we have an approximately 85/15 debt equity capital structure and if the Government is being paid a one percent debt guarantee fee on that 85 percent of the capital structure, and the Company is asking for a normal utility rate of return, which I have estimated at 11 1/4 percent, the totality of those percentages should not exceed 8.9 percent.

MS. BUTLER, Q.C.: But in this application the Company is not looking for 11.25 percent.

MS. McSHANE: No, not in this application, they are not. The Company determined that from the point of view of share, sorry, of ratepayer impact, that the increase in rates that ratepayers could be expected to accept was limited and therefore they based the return that they requested on their view of the cap, if you will, on the acceptable revenue requirement.

MS. BUTLER, Q.C.: Okay. Can we go back then and substitute that figure in the answer that you earlier gave when you suggested that Government is being paid a one percent debt guarantee fee on it and the Company is asking for a normal rate of return when in fact the Company is asking for three percent instead of 11.25 percent?

MS. McSHANE: I can go back and put those numbers into the calculation but I don't think that they tell the story correctly. The three percent return was only in the context of, as I suggested, the cap that was believed to be reasonable, acceptable, on the revenue requirement. If, on the other hand, you were to say, well, let's assume that the $70 million dividend hadn't been paid and then were to apply a three percent return to those dollars of equity rather than to the 15 percent of equity, it's not that the revenue requirement in a larger sense would be lower, it's not. You're just making an assumption that you would apply only a three percent return to 25 percent of the equity, and that's not getting you close to earning a normal return on capital. I don't think that if the Company had had 75/25 capital structure they would have come in and said I only want three percent on a 25 percent of equity. You can't, to me, just take the three percent on the capital structure they have, put it on a deemed equity and say that that's what they would be asking for, because they wouldn't.

MS. BUTLER, Q.C.: But again this relates to the payment of a dividend too, because the capital structure is based on payment of the $70 million dividend to Government.

MS. McSHANE: I agree, but if you had 75/25, 75/25 common equity or debt common equity structure, you would have still looked at what you believed the reasonable, acceptable increase in rates that could be borne by ratepayers without rate shock and you wouldn't have necessarily said that the three percent return applied to 25 percent equity is what you would have asked for. The revenue requirement that would have been acceptable to ratepayers would not have been different irrespective of, or different depending on the capital structure.

MS. BUTLER, Q.C.: Perhaps we're getting a little ahead of ourselves, because I will be addressing those issues a little later, but in terms of the dividend policy and its effect on the debt equity ratio, we ask in **NP-169** if Hydro could provide us with reports that supported the dividend policy, and in the answer which you'll see on the screen there was a letter provided from Scotia McLeod. Are you familiar with the letter?

(10:30 a.m.)

MS. McSHANE: I have read it.

MS. BUTLER, Q.C.: Okay. Let's have a look at the attached letter from Scotia McLeod in April of '95. Now, as I understand it, Ms. McShane, correct me if you know me to be wrong, Scotia McLeod were Hydro's financial advisors at this time.

MS. McSHANE: I believe that's true.

MS. BUTLER, Q.C.: Okay. And they were recommending a particular dividend policy and this pre-dates the dividend policy that we saw a moment ago, the first of the two dividend policies. The first dividend policy was May '95.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Okay. I wonder if we might look first at page 3 of 11, which is the last two paragraphs of the letter, and maybe you could read for me starting with "We suggest that."

MS. McSHANE: "We suggest that Hydro institute a dividend policy which will govern all future dividends. The policy should have a maximum debt to capital structure test and a target pay-out ratio with respect to earnings. We believe that the capital structure should be leveraged no greater than 80 percent debt to 20 percent equity, therefore, no dividend would be payable if the post-dividend ratio exceeds this level. By instituting this cap, Hydro will mitigate the negative effect that the payment of a large dividend might have with the rating agencies and the bond holders."

MS. BUTLER, Q.C.: And the next paragraph, sorry.

MS. McSHANE: Oh, sorry. "The dividend policy should also include a target pay-out level of 75 percent of net income. It might be desirable to segregate the income of Hydro and CFL Co. for the purposes of this test in order to ensure that CFL Co. retains some cash for debt retirement."

MS. BUTLER, Q.C.: First of all, in the first of the two paragraphs that you read, do you agree with Scotia McLeod's recommendation, the policy should have a maximum debt to capital structure test, capital structure should be leveraged no greater than 80/20?

MS. McSHANE: I hadn't really thought about whether that should be part of the dividend policy to have a maximum ... certainly it should have a target pay-out ratio. I'm not sure that it's necessary that it have a maximum debt to capital structure test but oftentimes utilities have such tests within their bond indentures which preclude the necessity of having it as part of their dividend policy, because their bond holders are required in ... I think it's useful to have a statement as to policy with respect to capital structure to provide a basis to the capital markets that will allow them to conclude that you will conduct your business in such a fashion as to not negatively impact on, in this case, on the province's guaranteeing your debt.

MS. BUTLER, Q.C.: Okay. And specifically my question is whether you agreed with the recommendation that the capital structure should be leveraged no greater than 80 percent debt to 20 percent equity.

MS. McSHANE: Certainly as long as the guarantee is in place then I would agree that 80/20 would be an appropriate cap on the capital structure.

MS. BUTLER, Q.C.: And then the author goes on, "Therefore, no dividend would be payable if the post-dividend ratio exceeds this level." Would you agree with that as well?

MS. McSHANE: That would be the impact of having such a policy, but policy is simply a policy. There is ...

MS. BUTLER, Q.C.: No. Actually I think that would be the impact of the implementation of the policy.

MS. McSHANE: Sorry.

MS. BUTLER, Q.C.: Yeah.

MS. McSHANE: Could you ask me the question again? Maybe I misunderstood.

MS. BUTLER, Q.C.: Okay. Well all I'm asking you is whether in fact you agree that no dividend would be payable if the post-dividend ratio exceeds this level, not simply as a matter of the policy but in terms of the recommendation to the Company, because they can have a policy and the shareholders might still direct that the policy be ignored and money be paid out.

MS. McSHANE: Correct.

MS. BUTLER, Q.C.: Okay. What I'm asking you is whether you agree with the sentence, "No dividend would be payable if the post-dividend ratio exceeds this level."

MS. McSHANE: Well, that's what a policy means.

MS. BUTLER, Q.C.: Alright. Well you can speak of it in terms of the policy if you want. I was speaking of it in terms of the actual practical implementation of the policy.

MS. McSHANE: I can say to you that I would agree that that's what the policy would say would happen, but a policy is only that. I mean, it is not the same as when you have an indenture provision in your bond that says you can't do that, because if you do do that, if you do have debt in excess of 80 percent, then you are in technical default. As far as a dividend policy, the fact that it is strictly a policy does not prevent you from doing something other than what is in the policy. It's not a law.

MS. BUTLER, Q.C.: Right. I think what we've established, Ms. McShane, is that you have a recommendation for Hydro in terms of its capital structure. It's long-term target is 60/40, short-term or medium-term, 80/20. We've also established that the primary factor in the current debt equity ratio of 83/17 is the payment of the dividend.

MS. McSHANE: That's why it's as low as it is, yes.

MS. BUTLER, Q.C.: So looking at this, these two sentences read together, the payment of the dividend causes the capital structure to be leveraged greater than 80/20. So I guess what I'm getting at is what is your actual recommendation on the payment of a dividend in a test year and its effect on the capital structure, or do you have one?

MS. McSHANE: I don't have a recommendation as far as the payment of the dividend. The province has decided that it is going to have dividends paid. My recommendation is simply that whatever the rate of return on rate base that this Board determines is reasonable, is not higher than it otherwise would be had the dividend not been paid.

MS. BUTLER, Q.C.: Okay. I want to turn to an earlier section of the same letter, which is a different point, and it's on page one at the bottom, and here, Ms. McShane, the author, who is Theresa McLeod (phonetic), is saying, "Dividends were not the only form of monetary transfer to the provinces in terms of the study that they had done, or investigation. Several of the utilities like Hydro pay guarantee fees on their long-term debt and some also paid water rental fees, therefore, we believe that one of the most relevant figures is the total amount of transfers to the province as a percentage of book equity." Do you agree that one of the most relevant figures is the total amount of transfers to the province as a percentage of book equity?

MS. McSHANE: I clearly believe that the most relevant figures is the total amount on the transfers. As a percentage of book equity, my preference would be to look at it in terms of the total return on the assets of the Corporation.

MS. BUTLER, Q.C.: Okay, I accept that. Dealing then with the figure being the total amount of transfers to the province and applying it to the facts of this case, we have the proposed substantial dividend of $70 million as one element of a total transfer.

MS. McSHANE: No, I'm sorry, I don't agree with that, because those are earnings that, retained earnings that the Government has a right to. It's already earned those. What we need to be looking at is simply what the return in terms of guarantee fee and in terms of equity return will be going to the Government in the test year, not the dividend payment.

MS. BUTLER, Q.C.: Okay, so that's fine. You suggest that in reading this paragraph you would not include in terms of the total amount of transfer the amount of the dividend.

MS. McSHANE: Not ... no, I would look at the return on equity and the guarantee fee that are being requested. The dividends that are going are from money that's already been earned.

MS. BUTLER, Q.C.: Now, the debt guarantee fee would be a relevant figure.

MS. McSHANE: Absolutely.

MS. BUTLER, Q.C.: And that is approximately 12, $13 million?

MS. McSHANE: I don't know the exact amount but it's approximately one percent of the outstanding debt.

MS. BUTLER, Q.C.: And what about the subsidization of Government in rates, would that be a relevant figure as well?

MS. McSHANE: You mean the fact that the Government is not ...

MS. BUTLER, Q.C.: Paying the full cost of service.

MS. McSHANE: My understanding is that this is, in and of itself, is temporary, and that Government will be, Government's rates will be raised to cover their full cost of service, so, you know, as a matter of principle, no.

MS. BUTLER, Q.C.: Temporary or not though, just bearing in mind the wording of this author's letter, total amount of transfers to the province, is it, once we know the exact figure, is it a relevant figure in terms of considering the total amount of transfers to the province?

MS. McSHANE: I suppose that if the Corporation were looking to have Government pay less than their cost of service in the long term and were asking for a full rate of return, then again it would be (inaudible) relevant to look at.

MS. BUTLER, Q.C.: Thank you. Mr. Chairman, I'm about to start another section and if you'd like to break now I can or if you want me to keep going I can as well.

MR. NOSEWORTHY, CHAIRMAN: Will this section take long, do you have any idea?

MS. BUTLER, Q.C.: I can probably get through it in, like, 15 minutes, if you ...

MR. NOSEWORTHY, CHAIRMAN: Okay, that's fine. We'll continue on.

(10:45 a.m.)

MS. BUTLER, Q.C.: Ms. McShane, I want to address now issues of social policy, and these are alluded to at page 16 of your pre-filed, and I think lines 16 to 26. Okay. Looking at line 13, you were asked to describe the principles that should underpin the financing of Hydro's utility operations as a commercial entity, and perhaps you could just read your answer there for us, from 16 to 26?

MS. McSHANE: "I start with the proposition that a utility, Crown corporation or investor-owned should be financed in a manner which is compatible with commercial viability on a stand-alone basis, without subsidies as among shareholders, *(sic)* (inaudible) ratepayers versus investors and among classes of ratepayers."

MS. BUTLER, Q.C.: In that short paragraph you've addressed two points that I see in any event, commercial viability on a stand-alone basis and without subsidies among stakeholders, and the first I'd like to deal with is the commercial viability on a stand-alone basis. Does that mean without the Government guarantee?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And are you aware that when I was questioning Mr. Wells as Hydro's President, he suggested that he does not foresee the withdrawal of the debt guarantee in the foreseeable future?

MS. McSHANE: I heard that, yes. And there's no reason to withdraw the guarantee as long as the appropriate compensation for the risks that are being taken are represented in the return to debt and a return to equity.

MS. BUTLER, Q.C.: My point though is in your evidence, page 16, lines 16 to 26, you start with the proposition that they should be financed in a manner compatible with commercial viability on a stand-alone basis and that factually this company currently is not stand-alone because of the guarantee by the province and in the foreseeable future will have the guarantee of the province.

MS. McSHANE: When you say the reason that it's not stand-alone is it's not financed on a stand-alone basis is because it has a guarantee?

MS. BUTLER, Q.C.: No. Let's back up.

MS. McSHANE: Okay.

MS. BUTLER, Q.C.: I asked you when, in reference to your own language, commercial viability on a stand-alone basis, whether that means without a Government guarantee.

MS. McSHANE: Yes, and I agreed that, yes, that the capital structure should be such that it could survive on a stand-alone basis without the Government guarantee.

MS. BUTLER, Q.C.: Okay. And the facts of this situation are that the Company has a Government guarantee.

MS. McSHANE: Absolutely.

MS. BUTLER, Q.C.: And for the short-term foreseeable future the President says that's going to be a fact of life.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Okay. So the first of your two principles is not really applicable to the facts of this application.

MS. McSHANE: I don't see that. I mean, I'm starting with the proposition that that's the way it should look on a stand-alone basis, but when you take into account the fact that there is a guarantee, then certainly you have to make some adjustments to recognize the costs that, to the ratepayers that are involved with having the guarantee fee and having the guarantee in the guarantee fee.

MS. BUTLER, Q.C.: Okay. So in that sense you made an adjustment based on the fact that it currently is not stand-alone.

MS. McSHANE: Right. My objective was to ensure that when I looked at what the overall cost of capital should be, that that overall cost of capital would be consistent with, compatible with that, which would be achieved by a stand-alone utility with similar business risks, and those costs are perhaps divided differently as among the cost of debt, the guarantee fee and the return on equity, so in total the overall cost of capital should be the same.

MS. BUTLER, Q.C.: I'm satisfied that, as you say, you made the appropriate adjustment, but let me ask you, do the bond rating agencies view Hydro on a stand-alone basis or do they view Hydro with a Government guarantee?

MS. McSHANE: They view Hydro with a Government guarantee because those are the facts, but it seems to me that when, as an analyst or as a regulator, you are looking at what the overall appropriate return should be. You have to start with some principles and then you have to know or to recognize how the various costs of capital are distributed among the actual amounts of debt and equity that are outstanding so that you can determine whether or not the guarantee fee plus the return that you get to equity are in total appropriate numbers.

MS. BUTLER, Q.C.: But I'm dealing with the propositions and the first is commercial viability on a stand-alone basis, which you've addressed, and the second is without subsidies as amongst stakeholders. Now in the first you've told me that Hydro is, at the moment, not of course being treated as a commercial utility on a stand-alone basis because of the Government guarantee and that you've made adjustment, so I accept that. I want to move now to the second proposition, and that is without subsidies as among stakeholders. Are you aware that Hydro incurs a deficit in the rural operations?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And that Newfoundland Power and the Labrador interconnected customers pay for that deficit?

MS. McSHANE: My understanding is that the costs are reallocated to those customers, yes.

MS. BUTLER, Q.C.: Are you aware of the amount?

MS. McSHANE: The total amount?

MS. BUTLER, Q.C.: Yes.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: When we talk ... and that would be?

MS. McSHANE: About $26 million.

MS. BUTLER, Q.C.: I want to look specifically at **NP-214**, page one of two, where this is acknowledged as a social policy objective of Government, and you'll see there the first, the line 14, "Rural rates policy. Customers served on the island interconnected rural system will be charged the same rates as Newfoundland Power's customers," and this is what we're talking about in terms of this now being, down at number three, payment of the rural deficit by Newfoundland Power and Labrador rural interconnected customers. The exact calculation though, I'd like to look at **Mr. Brickhill's testimony**, if I could, and it's Brickhill, **Schedule 1.2, page one of six.** Schedule 1.2. And it's a revised one in the cost of service, Mr. O'Rielly, please.

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

MS. BUTLER, Q.C.: Ms. McShane ... okay, maybe we do have it. Ms. McShane, what we'll do, I think, is we'll get it copied during the break and make sure that everybody has a hard copy, but before we actually take a formal break I want to suggest to you that the cost of service will indicate $318 million and that the deficit is actually $30.6 million.

MS. McSHANE: And can you point me to where the deficit is?

MS. BUTLER, Q.C.: Column five, $30.648 million.

MS. McSHANE: Sorry, could you say that again?

MS. BUTLER, Q.C.: Column five at the bottom. Column five is labelled "Deficit," $30.648 million.

MS. McSHANE: I must be looking at the wrong page. This would be ...

MS. BUTLER, Q.C.: Alright. It is Schedule 1.2, page one of six of the cost of service revised.

MS. McSHANE: Aha, maybe that's because I don't have the revised one.

MS. BUTLER, Q.C.: Okay, that's fine. And we'll get it and ...

MS. McSHANE: Okay.

MS. BUTLER, Q.C.: ... hand it out after the break, but if you can bear with me for a moment just so I can finish this area.

MS. McSHANE: That's fine.

MS. BUTLER, Q.C.: Assuming that the deficit is 30.6 on a cost of service of $318 million ...

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: ... then we are talking about a significant subsidy amongst the stakeholders, that is that Newfoundland Power and the others are covering the deficit.

MS. McSHANE: They are covering costs that are attributable to other customers at this point.

MS. BUTLER, Q.C.: And I'm just wondering how that fits with the second component of your two principles where you, and perhaps we'll go back to that and get it on the screen, had indicated at page 16, lines 16 to 26, line 18 actually, "without subsidies as among stakeholders." You started with the proposition that the utility should be financed in a manner compatible with commercial viability and without subsidies as among stakeholders. Given that there is a substantial subsidy as among stakeholders, can you tell us what adjustment, if any, you made for that?

MS. McSHANE: I did not. I have looked at what typically happens in other utilities and clearly the existence of subsidies as among classes of customers exists as a matter of policy irrespective of who the shareholder is. For example, it has always been policy in this country to maintain residential single line telephone rates at below what it costs to serve those customers, particularly in the rural areas, and the approach that's been taken by the regulator is to have those subsidies borne by other customers, not by the shareholder, and so in, given that we see, you know, those types of subsidies throughout the investor-owned utility world, I did not make any adjustments to a shareholder return for that.

MS. BUTLER, Q.C.: Perhaps I'm a little confused because lines 16 to 19 suggest that you started with the proposition that has these two components, and the first component, financing in a manner compatible with commercial viability on a stand-alone basis, you did make an adjustment.

MS. McSHANE: No, I simply stated the premise. I didn't make an adjustment. I'm sorry, I misunderstood what you said. I apologize.

MS. BUTLER, Q.C.: Okay.

MS. McSHANE: I made an adjustment in the sense that I made sure that the total cost of capital did not exceed that which would be attributable to a stand-alone investor-owned utility without the taxes of course, and when I say I made an adjustment, I made sure that the costs were appropriately distributed among the actual categories of capital that exist. In that sense I made an adjustment. I didn't lower it or increase it. I just made sure that they were distributed in a manner that was compatible with the facts of the capitalization.

MS. BUTLER, Q.C.: But the second assumption or proposition, without subsidies as among stakeholders, is not factually correct.

MS. McSHANE: That's correct, it is not. There are ...

MS. BUTLER, Q.C.: And you made no adjustment for that.

MS. McSHANE: I did not.

MS. BUTLER, Q.C.: And that would be a good place to break, Mr. Chairman, and I will get that copied and handed out after the break. Thank you.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Butler. We'll break now till just shortly after 11:15.

(11:00 a.m.)

(break)

(11:20 a.m.)

MR. NOSEWORTHY, CHAIRMAN: Thank you.

MS. BUTLER, Q.C.: Ms. McShane, before the break you had indicated to me that you had understood the deficit to be approximately $26 million, and the documents being handed out currently is Schedule 1.2, page 1 of 6 of Mr. Brickhill's cost of service, revised.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Were you aware that through Mr. Reeves, the cost of service was revised such that the deficit has gone from $26 million to $30 million?

MS. McSHANE: I knew it had been revised but I didn't, hadn't looked at the new schedules.

MS. BUTLER, Q.C.: Okay, so this is the new schedule which was not entered electronically, and the deficit shown in column five is $30.6 million, cost of service revenue, 318, or revenue requirement, 318?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Now with this in front of us, and just to finish off this area, Ms. McShane, are you aware that this Board has referred to the deficit as particularly large?

MS. McSHANE: I know that they had referred to it as particularly large years ago, yes.

MS. BUTLER, Q.C.: In the '95 order.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And do you agree with that?

MS. McSHANE: I guess I probably don't have sufficient basis to judge whether it's particularly large. I looked at one answer to a data request, I don't remember the number of it, but it was a copy of, or a summary, I guess, of a survey that had been done by Manitoba Hydro of subsidies that were provided to remote customers, customers that aren't interconnected to the grid and various areas, and it really depends on how you look at it. If you look at it on a per capita basis, the total number of dollars per customer, per rural customer, I think it's about in the middle.

MS. BUTLER, Q.C.: Can we leave the area by suggesting that it is a significant subsidy amongst stakeholders in this province?

MS. McSHANE: There are subsidies to rural customers, as there are in other provinces.

MS. BUTLER, Q.C.: But a significant subsidy?

MS. McSHANE: It's a significant subsidy if you look at it in terms of the revenue to cost ratio, and it's of those customers, and it is, it's a fair amount of the revenue requirement, but as I said, on a per capita basis, it seems to be in about the middle of other provinces that provide equal rates to, try to provide approximately equal rates to rural customers as they do to customers in more densely populated areas.

MS. BUTLER, Q.C.: Okay, I'm going to move to the next area which is the return that you recommend, and your testimony again, pre-filed this time at page 52, and while we're waiting for that to come up, I note that, Ms. McShane, that the return on equity portion of your pre-filed testimony basically covers some 30 pages, close to 30 pages.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Okay, and at page 52, line 17 to 18 ...

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And following the lengthy discussion of the various tests, you conclude, based on these results, a fair return for Hydro would be 11 to 11.5 percent, and now we're talking about return on equity, right?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And is this conclusion for the test year, 2002?

MS. McSHANE: Yes, it would be a fair return for Hydro in the test year.

MS. BUTLER, Q.C.: And in this application, what return does Hydro seek for the test year?

MS. McSHANE: Three percent.

MS. BUTLER, Q.C.: So can you tell me the purpose of having gone through the detail of these various tests and concluding with your recommendation on fair return when Hydro is seeking only three percent?

MS. McSHANE: Because I thought it was, it would be useful to the Board to know where a fair and reasonable return for a relatively low risk utility would fall, so that they had a basis upon which to, if not set a fair return in this hearing, to at least determine, you know, what the principles should be to underpin a fair and reasonable return on equity in the future.

MS. BUTLER, Q.C.: Are you aware that Hydro's five year financial plan indicates that they will move to the 11.25 percent in 2004?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Okay, and Mr. Wells, as President, testified that the increase in consumer rates over the five year financial planning horizon would be a total of 26 percent.

MS. McSHANE: I don't know what the increase would be.

MS. BUTLER, Q.C.: Okay, do you agree that an 11.25 return would be a significant contributor to the increase?

MS. McSHANE: It would likely be, yes.

MS. BUTLER, Q.C.: And do you also agree, Ms. McShane, that a fair estimate of an appropriate return for 2004 must be based on an assessment of economic factors in the year 2004?

MS. McSHANE: I agree.

MS. BUTLER, Q.C.: So you're not telling the Board that 11.25 percent is an appropriate return for 2004?

MS. McSHANE: No, it will have to be reassessed under the economic circumstances that prevail at that time. My purpose was to establish the principles and to look at, you know, what the tests that are typically used to determine a fair rate of return would show at this time.

MS. BUTLER, Q.C.: Thank you. In your evidence back on page 28, lines 16 to 21 please, and you're addressing here the question, since Hydro is a Crown corporation and its shareholder is the province, why are these standards relevant, and maybe you can just scroll up there, Mr. O'Rielly and we'll see what standards they're talking about, the concept of fair and reasonable return, and you have to go back one more page maybe. Thank you. Standards set the parameters for the return requirement necessary to induce investment in public utility assets, and then the factors are listed there with the bullets. And then back to the question. Since Hydro is a Crown corp., this is line 12, why are these standards relevant? Could you just read your answer for us please, like 16 to 21?

MS. McSHANE: The equity funds reinvested in Hydro by the province have an opportunity cost. The determination of a reasonable return on equity should be independent of the happenstance of the identity of the shareholder. The province and taxpayers as shareholders should expect to earn a return on the equity funds reinvested in Hydro equivalent to the return they could have earned on an alternative investment of comparable risk.

MS. BUTLER, Q.C.: Okay, then following that, and at line 23, you were asked whether there are publically owned utilities afforded the opportunity to earn a return commensurate with investor owned utilities, and you refer to some.

MS. McSHANE: Yes.

(11:30 a.m.)

MS. BUTLER, Q.C.: Can I ask you whether as an expert in this field, you would be aware that there are utilities that do not have the opportunity to earn a return commensurate with investor owned utilities?

MS. McSHANE: I'm sure there are several still.

MS. BUTLER, Q.C.: Can you think of any? And to assist you, can I ask you to ...

MS. McSHANE: Manitoba Hydro.

MS. BUTLER, Q.C.: Right.

MS. McSHANE: I'm coming across the country now.

MS. BUTLER, Q.C.: Go ahead.

MS. McSHANE: New Brunswick Power.

MS. BUTLER, Q.C.: Right.

MS. McSHANE: Those are the only two that come to mind.

MS. BUTLER, Q.C.: Okay, and those are the same two actually that were referred to by Mr. Hall in his evidence. Did you have an opportunity to read his evidence?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Okay, so it is fair to say that the rate of return on the equity component for rate setting purposes is not a market based equity return, but instead it's the rate of each utility's own embedded cost of debt, and in the case of Manitoba and New Brunswick.

MS. McSHANE: I'm not familiar with Manitoba Hydro specifically but I'm familiar with the decisions of the New Brunswick Board. They, to my recollection, they took the position that the return on the equity should represent the weighted cost, I guess, of debt that the province didn't have to raise, and they assigned the embedded cost of debt to the ...

MS. BUTLER, Q.C.: Okay, so not the market rate.

MS. McSHANE: No, that doesn't make it correct, economically correct, but that's what they did.

MS. BUTLER, Q.C.: No, I'm just suggesting for the Board though that there's an option.

MS. McSHANE: Well, there are always options but I mean I think that when you consider the options, that you ought to start with the proposition what is economically appropriate. I believe that Dr. Kaliman was in the New Brunswick Power cases in which that decision was made, and you know, he talked in his evidence at the time about a market rate of return on equity for New Brunswick Power.

MS. BUTLER, Q.C.: Well, I'm sure the Board is going to address what's economically appropriate not only on this issue, but on other issues that are currently before it, including the dividend. I'll leave that area now and turn for a moment to the bond ratings if I might. When we talk about a Triple B bond rating, we are talking about the rating that's afforded to Hydro by the Dominion Bond Rating Services, is that correct?

MS. McSHANE: Yes, and there must be one that's the provincial rating by Standard & Poor's as well, but yes, there is a bond rating by Dominion Bond Rating Service.

MS. BUTLER, Q.C.: Okay, now in Mr. Hall's evidence, and hopefully this is electronically stored, **Schedule 1**, page 3 of 3. Yeah, that's page 1, page 2, page 3. There you go. This is one page of what I understand to be a longer report from DBRS, the Dominion Bond Rating Service, on Newfoundland and Labrador Hydro, and this particular one is for the bond, long term debt and preferred share ratings. Is this what you would be familiar with when you speak about a Triple B bond rating for Hydro?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Okay, and what is an investment grade debt rating?

MS. McSHANE: Anything that's Triple B minus or higher, so Triple B, A, Double A, would all be, bonds within those debt rating categories would all be investment grade.

MS. BUTLER, Q.C.: Okay, so Triple B itself is the lowest?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Of the investment grade bond rating.

MS. McSHANE: Yes, and it can be one notch below the Triple B, Triple B minus.

MS. BUTLER, Q.C.: Triple B minus.

MS. McSHANE: And that would still be considered investment grade.

MS. BUTLER, Q.C.: Now during the course of this hearing, and not necessarily in your evidence, but other witnesses, we have spoken about the regulated versus the non-related operations of Hydro. Just so that the Board understands how the DBRS does its rating, can I ask you a few questions about this first page of the exhibit? What do they include in the Triple B rating consideration? Are they addressing Hydro's consolidated operations or only the non-consolidated regulated operations?

MS. McSHANE: They would include for debt rating purposes, the consolidated operations.

MS. BUTLER, Q.C.: So they would include for debt rating purposes, Hydro's interest in Churchill Falls Labrador Corporation?

MS. McSHANE: That's correct.

MS. BUTLER, Q.C.: And for the same purpose they would include Hydro's recall sales to Hydro Quebec?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Okay, and would you recommend, Ms. McShane, that the Board not consider allowing Hydro to drop below a Triple B?

MS. McSHANE: Well, let's make a distinction between what we're looking at here which is an actual debt rating for the consolidated operations, but which is in fact a flow through of the provincial government's rating.

MS. BUTLER, Q.C.: That's correct, and we see that referenced right underneath the title, Newfoundland & Labrador Hydro.

MS. McSHANE: So if the government's rating were to drop below Triple B, there's a good chance that Hydro's rating would drop below Triple B, and there wouldn't be much Hydro could do about it as long as it was attached to the province by means of the guarantee.

MS. BUTLER, Q.C.: Okay, well subject to that proviso though?

MS. McSHANE: I would say on a stand-alone basis that it would be prudent not to let Hydro drop below Triple B.

MS. BUTLER, Q.C.: Thank you. Okay, I'm going to leave that for the moment and look at the guarantee fee. We saw earlier in the Grant Thornton Report for 2001, page 11, that Hydro's equity component in the capital structure for 2000 was actually at 20 percent. We can have another look at it certainly. Back to page 11, there you go. You see in the year 2000 the equity ratio has actually reached 20 percent?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And Grant Thornton confirms that Hydro is predicting in 2002 to have an equity component of 15.3, which is in the 2002 column. Now Hydro recently obtained debt financing in the general market, am I correct?

MS. McSHANE: They may have. I'm not familiar with the specifics of a release of debt issue.

MS. BUTLER, Q.C.: Okay, if you're not familiar with it then you wouldn't be able to tell me whether or not they had faced any problems in marketing the bond issue?

MS. McSHANE: I'm not aware of any. I can't imagine that they would have had any.

MS. BUTLER, Q.C.: As I understand it, the government charges Hydro a guarantee fee of one percent of the outstanding long-term debt, promissory notes, and current portion of long-term debt, less long-term leases with the CF(L)Co. portion deducted for the guarantee fee?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Do you know how the rate of one percent was established?

MS. McSHANE: No, I do not.

MS. BUTLER, Q.C.: Can we look at **NP-77** and the schedule. I don't think we can enlarge that much. Okay, thank you. You see the guarantee fee for 2001, the last column over, the very last line, was $12.336 million.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Okay, and Newfoundland Power takes no issue with the size of the guarantee fee, while there's a debt equity ratio of 80 to 20, but your evidence clearly is that Hydro should strive to improve its debt equity ratio and over the long term go from 80/20 to 60/40?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: So what I want to ask you about is how the guarantee fee will be affected by that movement during the transition period?

MS. McSHANE: The guarantee fee would have to be reassessed periodically to determine what value is being provided and to what extent the guarantee fee was providing value for simply lowering the cost of debt to the ratepayer as opposed to some compensation for, to the guarantor for taking financial risk from the corporation.

MS. BUTLER, Q.C.: Because, I think clearly there's an acknowledgement and, in fact, through Mr. Wells as President, that Hydro could consider eliminating the guarantee and therefore the guarantee fee altogether if it got to 60/40.

MS. McSHANE: It could consider it and I think that the determination whether it would want to do so at that time obviously would come down to, you know, discussions between the province and the corporation. If there's no compensation that's deemed to be provided to the province, then there's no reason the province would maintain the guarantee, but I think the thing that one would have to look at is whether or not at the time there is still a differential between the cost of debt to a provincial government rated Triple B, and a corporation rated Triple B. At this point there is but that differential changes and would have to be reassessed.

MS. BUTLER, Q.C.: Okay, so while Hydro is 80/20, and has a guarantee fee of one percent or $12 million on the one hand, but while Hydro, or when Hydro gets to 60/40 there may not be a need for a guarantee and therefore there may not be a need for a guarantee fee on the other hand.

MS. McSHANE: That's correct.

MS. BUTLER, Q.C.: But in the transition period your evidence is that it should be assessed on a regular basis.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Can you help me with how regular, how many points in terms of the change in the ratio, or how many years?

MS. McSHANE: It would have to be assessed at least as often as the utility comes in to the Board. I would think probably no less than every three years would be appropriate to ensure that the overall cost of capital that was being borne by ratepayers was fair and reasonable.

MS. BUTLER, Q.C.: Okay, another area now, Ms. McShane, if I might. Hydro's application to the Board does not propose a cap on regulated earnings, correct?

MS. McSHANE: Not at this time because of the level of earnings that they've requested.

MS. BUTLER, Q.C.: Are you aware that in 1992 this Board established rates on a different basis, of course, but such that Hydro's margin could be $10.825 million without a cap?

MS. McSHANE: I am not sure what you mean by that.

MS. BUTLER, Q.C.: Okay, let's have a look at **JC Roberts, Schedule 1**. The last order that affected Hydro, Ms. McShane, was done on an interest coverage basis.

MS. McSHANE: Yes, that I'm familiar with.

MS. BUTLER, Q.C.: Okay, and the rate of the interest coverage, do you recall?

MS. McSHANE: Was, I believe, 1.08 times.

MS. BUTLER, Q.C.: Okay, and looking at this schedule now, 1992 final cost of service column, there you go, at the, towards the bottom, line 41, the margin, the return on equity set at 10.825.

MS. McSHANE: Okay, I see that.

MS. BUTLER, Q.C.: Okay, thanks. Just take a moment now and compare the actuals, if we might. The 1992 actual was 17.094. I'll just have a look at the 2000 for a moment and then I'll go back to a different exhibit that shows a spreadsheet for all the years in between. In 2000, actual, 5.829, and let's go if we can, to **NP-3**, and you'll see the full actuals for '92 to '97. Line 42, thank you. Alright, line 42, 1992 cost of service was 10.8, the actual was 17.094. The '93 actual was 13.841. The '94 was 12.682. '95 is 22.829. '96 is 20.693, and 1997 is 31.351. It's three times the margin in that particular year. Were you aware of this history for '92 to '97, Ms. McShane?

MS. McSHANE: I had not focused on this but you're talking about a period of time over which the company has had no rate changes, and we've had a shift in the capital structure, a shift in the cost of debt. We're talking about whether or not to set a band on earnings for a period which is very limited, and you basically know that the company will be coming back to this Board within a short timeframe to have rates set on the basis of a normal rate of return and it's at that point the Board feels it's important to set a range in the same fashion as it sets a range by Newfoundland Power, it can do so. It was simply, for this particular case, given what the company was asking for, that given the timeframe that these rates were expected to be in effect, that setting the range seemed to be rather a moot point.

MS. BUTLER, Q.C.: Okay, three things (inaudible). First of all, you're talking about the future in terms of Hydro's intention to come back.

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: In, as you say, 2003 or 2004, but this reflects this history.

MS. McSHANE: Yes, it does.

MS. BUTLER, Q.C.: Okay, and you also make the point, thank you for doing that, that Newfoundland Power's rates are based on a fixed return on rate base with an upper and a lower limit.

MS. McSHANE: That's correct.

MS. BUTLER, Q.C.: If, in fact, there were an upper and a lower limit then excess revenue is available for return to the consumer.

MS. McSHANE: That's what putting an upper limit on rate of return on rate base would mean, yes.

(11:45 a.m.)

MS. BUTLER, Q.C.: Okay, and what effect would it have had had there been such an order applicable to Hydro, for example, in the year 1997 when their margin was actually 31.3?

MS. McSHANE: I have no idea because you're talking about regulation on a totally different basis than regulation would be going forward, and so, I mean, you can look at these numbers in terms of what they mean as far as what the indicated return on rate base would have been, but, you know, I've not assessed them in that way.

MS. BUTLER, Q.C.: Okay, I accept that, but you do acknowledge the effect of having the upper and lower cap. Okay, those are my questions, Mr. Chairman, for Ms. McShane, and thank you very much, Ms. McShane.

MS. McSHANE: Thank you.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Butler. Thank you, Ms. McShane. I would ask the Industrial Customers to begin their cross now please?

MR. HUTCHINGS: Thank you, Mr. Chair. Good morning, Ms. McShane.

MS. McSHANE: Good morning.

MR. HUTCHINGS: It's still morning.

MS. McSHANE: Yes, it is.

MR. HUTCHINGS: For another few minutes. I think you and I have a lot less discussion to do about dividends that we might have had given that you and Ms. Butler went through that in some considerable detail. Just in general terms, however, in reference to your evidence at page two, line 26, you speak there of the Board's earlier recommendation of a slow movement toward the 80/20 debt equity target, and comment that the Board did not explicitly set a margin designed to allow Hydro to attain those ratios. I take it what you are referring to by those ratios is in fact the 80/20 debt equity target that is mentioned in the earlier part of the answer?

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay, and I presume that the movement toward that was intended to be done by increasing retained earnings?

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay, so you weren't contemplating any equity injection from any other source in your comments (inaudible) evidence.

MS. McSHANE: No.

MR. HUTCHINGS: Okay, alright, would you agree with me that the notion of meeting the debt equity target by increasing retained earnings is based on an assumption that not all of the earnings will be paid out by dividend.

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay, and would you agree with me that no amount of margin will increase retained earnings if all of the earnings are paid out by dividends?

MS. McSHANE: Correct.

MR. HUTCHINGS: Okay, so is it not implicit in the notion of a margin designed to allow Hydro to attain a certain debt equity ratio that there must also be a concomitant requirement to leave a certain portion of those earnings in the company?

MS. McSHANE: There is certainly an expectation. I don't know if you can say there's a requirement. There is an expectation that earnings be left in the business so as to build the common equity ratio up to the target.

MR. HUTCHINGS: Okay, and am I correctly reading this to say that it is based upon a margin or return equal to what you would call the required rate of return, and what I'm trying to get to is that you're not talking here about setting a rate of return for Hydro that's actually in excess of what the market would require with a view to increasing retained earnings thereby.

MS. McSHANE: Absolutely not.

MR. HUTCHINGS: Okay.

MS. McSHANE: I have no, there is nothing in my evidence that suggests that the return should be higher than is fair and reasonable to build up the equity.

MR. HUTCHINGS: Okay, but the equity will not be built up unless there is what perhaps you have called is support of dividend policy.

MS. McSHANE: That's correct. There have to be earnings left in the business in order for the equity to be built up.

MR. HUTCHINGS: Uh hum, okay, alright. And I think you've agreed with Ms. Butler effectively in the course of your earlier comments this morning that it would be very difficult to predict the future path of dividends out of Hydro to the Newfoundland Government on the basis of what has happened in the past five years?

MS. McSHANE: Correct.

MR. HUTCHINGS: If we could look for a moment to page 28 of your evidence, at line 8. I wasn't clear that I understood the impact of the sentence that begins there, a fair and reasonable rate of return falls within a range founded by the cost of attracting capital and the returns achievable by firms of similar risk to utilities. Comparable earnings standard ... do you intend by this to say that one of those two things is an upper range, and the other, or an upper limit and the other is a lower limit?

MS. McSHANE: Yes.

MR. HUTCHINGS: And which is which?

MS. McSHANE: The cost of attracting capital is the minimum and the comparable earnings standard is the upper end of the range.

MR. HUTCHINGS: Okay.

MS. McSHANE: Typically. There may be some periods of time when comparable earnings falls short of the cost of attracting capital but typically because earnings are measured on original cost equity, they tend to be higher than the bare bones minimum cost of attracting capital which is a market derived value, derived on the basis of the market value, not on the basis of book value.

MR. HUTCHINGS: Uh hum, okay, and that, that lower limit of the cost of attracting capital, how do you relate that to a company in the situation of Hydro which does not, in fact, go out to attract the capital?

MS. McSHANE: The same way that you would with any utility which does not go out and attract capital itself, of which there are ... most of them in this country these days, by reference to proxies, who do have market data, whose cost of capital you can use as a proxy for Hydro.

MR. HUTCHINGS: Okay, so the intention then is not so much on what it necessarily would cost Hydro to attract capital but what companies as similarly positioned as one can find actually have to pay to attract capital, is that fair?

MS. McSHANE: Well, yes, in principal you're measuring the cost that they would incur to attract equity.

MR. HUTCHINGS: On the assumption that that was something that they had to do and would do.

MS. McSHANE: Well they do attract, have to attract equity and keep equity.

MR. HUTCHINGS: Newfoundland Hydro does?

MS. McSHANE: Oh no, sorry, I thought you were talking about the proxy companies.

MR. HUTCHINGS: Okay, no, okay.

MS. McSHANE: Well, Hydro doesn't in the sense that there are alternative uses for those equity funds that are retained, and the return should recognize that there is, that those funds could be used in alternative investments of similar risk.

MR. HUTCHINGS: Okay, well let's talk about that and the notion of opportunity cost and I recognize this is somewhat, I guess, outside the envelope of issues that are generally addressed here, and in respect to public utilities generally, but what, do you see any difference between the opportunity cost of a government as shareholder, and the opportunity cost of a private investor?

MS. McSHANE: Not in principle, no. The opportunity cost in both cases should reflect the risk of the assets in which the investment is made, and it shouldn't matter whether I'm a government investor, or whether I'm a private investor. Just like if we ... if we look at, well let's take Newfoundland Power, for example. It has a single shareholder. We don't look to see whether the profile of Fortis is any different than that of any other utility to determine what the return on its equity should be. It should reflect the risk of the assets.

MR. HUTCHINGS: I guess I'm attempting to direct your attention more towards the nature of government as government as opposed to simply a single shareholder and if we can look at Fortis for a moment, I think it's fair to assume that the intent of Fortis and its shareholders is to make a profit?

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay, would you attribute that same intent to government?

MS. McSHANE: It should.

MR. HUTCHINGS: It should, government in all its operation or just in Hydro should make a profit?

MS. McSHANE: No, electricity was set up as a corporation. It wasn't set up as an agency or a division of the government. It was set up specifically as a Crown corporation which indeed has dual roles. One of those roles are to operate a commercial enterprise and to promote to the extent deemed required, public policy. But to the extent that it does operate as a commercial entity, there needs to be a recognition that the equity funds that are reinvested in that corporation have an opportunity cost associated with them, and to the extent that that opportunity cost is not recognized there will be in that instance a subsidy going from government to ratepayers. That has been well recognized by the Ontario Energy Board, in its regulation of Ontario Hydro before it was restructured, and I think that it needs to be recognized in this instance as well.

MR. HUTCHINGS: Okay, I understand what you're saying. The question I have, I guess, is the source of the notion that Hydro is to be operated as a commercial enterprise and do you say that simply because it is, in fact, created as a corporation?

MS. McSHANE: That's in part what it is, yes, but it's created as a corporation and there are, there is legislation surrounding the regulation of Hydro which suggests that it should be regulated in the same way as other utilities in this province, which to me is consistent with the notion that it should be operated and should be treated as a commercial entity.

MR. HUTCHINGS: Okay, we'll deal with the issue of the legislative intent, obviously, but your point would be that one of the factors that leads you to the conclusion that Hydro should be regarded as operating a commercial enterprise is the fact that it was, in fact, created as a corporation by the Legislature.

MS. McSHANE: Right, instead of actually deeming it to be a division of the province and, you know, not to have customer fees attached to usage. I mean the fact that it was set up as a corporation and determined to be, the services that it provided were being paid for by the ratepayers suggests to me that it's intended to operate as a commercial entity.

MR. HUTCHINGS: Okay, but the initial point was that it was, in fact, created as a corporation, so would you suggest, for instance, that the Newfoundland and Labrador Housing Corporation, one that the Chairman no doubt is familiar with, would also fall into the same category?

MS. McSHANE: Well, I don't believe that there is any equity investment in that.

MR. HUTCHINGS: Pardon me?

MS. McSHANE: Pardon me?

MR. HUTCHINGS: I didn't hear your answer.

MS. McSHANE: I said I don't believe there's any equity investment in that that ...

MR. HUTCHINGS: You don't believe there's an equity investment in Newfoundland and Labrador Housing Corporation?

MS. McSHANE: I don't think so. I think the only equity investments that the government has are in Hydro and in I think it's the Liquor Corporation.

MR. HUTCHINGS: Okay, so your answer then is not necessarily that it's simply because it was created as a corporation, but rather that it was created as a corporation and there is an equity investment in it.

MS. McSHANE: And there is an equity investment in it, and it is, it is a corporation which is ... sometimes I've got to use the word "funded", but that's not the right word, but whose business is carried on by payment of the cost of the services provided.

MR. HUTCHINGS: Okay, so that it has a source of revenue from the provision of services.

MS. McSHANE: Correct.

MR. HUTCHINGS: Okay, alright, and are there any other such corporations that you are aware of in Newfoundland aside from Hydro and potentially the Liquor Corporation that you would regard as being intended to be operated as commercial enterprises?

MS. McSHANE: I am not familiar with any other ones. That are owned by the government I assume you mean?

MR. HUTCHINGS: Yes.

MS. McSHANE: No, I am not familiar with any other ones.

MR. HUTCHINGS: Okay, alright, now your answer touches upon a point that also has significance and one that's referred to in a number of places in your evidence, and if we could go to page three initially at line 11, and here is where you state your basic premise on the rate base, rate of return model, is that the utility is entitled to the opportunity to earn a fair return on the investor supplied capital that finances the assets, and that phrase investor supplied capital reoccurs on any number of other occasions in your evidence. We see it again on line 23 on this page, and 22, in the determination of the amounts of investor supplied capital. If we go to page 6, line 8, we'll see the average amount of capital provided by investors is referred to, and there are a number of other references to the notion of investor supplied capital. If we can go to page 13 at line 2, you talk here about no cost capital and I think the example that we have most specifically here, the post-employment benefits and you've dealt with that in your evidence as well, that's appropriately dealt with as no-cost capital?

MS. McSHANE: That's correct.

MR. HUTCHINGS: Yes, okay, and in a number of places also throughout your evidence, you refer, and you can perhaps look at page 16, line 16, and you refer to different utilities and make a distinction as you do here, a utility, Crown corporation or investor owned, and those, you recognize those throughout your evidence as two categories of utilities, is that fair?

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay, so they are different.

MS. McSHANE: Yes, they have different owners and they have different tax statuses, I guess that's the plural of more than one status.

MR. HUTCHINGS: Yes, okay, alright, I'd like you to turn and I'm afraid we have to look at the hard copy of this because it's not actually on the system. It's the answer to **IC-211**, which you'll find in one of the books behind you there. I apologize for not having lined this up a little bit earlier but (inaudible). Attached to this answer in response to paragraph (e) of the questions, are copies of audited financial statements for Hydro and its predecessor for each of the years 1973, '74, I think it should say '74 and '75, and were you aware of the predecessor to Hydro which is referred to in these statements as the Newfoundland and Labrador Power Commission?

MS. McSHANE: Not specifically, no.

MR. HUTCHINGS: Okay, do you recognize Hydro as being a corporation as opposed to a government agency or a similar body? Are you at all familiar with the status of the Newfoundland and Labrador Power Commission?

MS. McSHANE: No.

MR. HUTCHINGS: Of being either a corporation or a body?

MS. McSHANE: No, I am not familiar with the pre-history of Hydro.

MR. HUTCHINGS: Alright, perhaps then we will look at the statement and there is a note, and the first statement that's there is Newfoundland and Labrador Hydro, Chartered Accountant's Report, Financial Statements, December 31, 1975, and if you go about six pages in you'll find the note to the financial statements.

MS. McSHANE: I'm looking at the, sorry, the financial statement dated December 31st, 1975, and you want me to find the note?

MR. HUTCHINGS: The notes, yes, they're about six pages in, I think.

MS. McSHANE: I have the notes.

MR. HUTCHINGS: Okay, and the initial note there, I think, refers to the name of the Power Commission being changed to Newfoundland and Labrador Power Corporation, by the Newfoundland and Labrador Power Corporation Act of 1974, and then the Hydro Act which we're familiar with changed the name again in 1975. Do you recognize that the Newfoundland and Labrador Hydro we're dealing with today is, in fact, the Newfoundland and Labrador Hydro that's referred to in the Act of 1975?

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay, if we can look then to the 1973 statement of the Newfoundland and Labrador Power Commission. The ...

MS. McSHANE: This is under the same tab?

MR. HUTCHINGS: Yes, yeah, it's just a couple of pages over from the note you were reading. It's the Newfoundland and Labrador Power Commission, Chartered Accountant's Report, Financial Statements, March 31, 1973.

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay, the third page in is the balance sheet as of March 31, 1973.

MS. McSHANE: I see that.

MR. HUTCHINGS: Okay, and on the lower right hand side of the page you'll find an accumulated revenue deficiency for accompanying statements of $2.465 million. Do you see that number?

MS. McSHANE: Yes, I see that.

MR. HUTCHINGS: Okay, if we can turn then to the previous statement again for Newfoundland and Labrador Hydro, and the statement of income and retained earnings, which is the fourth page in.

MS. McSHANE: Yes, I see that.

MR. HUTCHINGS: Okay, looking at the comparative figures for 1974 that are shown there, you'll see retained earnings at the beginning of the year at a negative $573,000.

MS. McSHANE: I'm sorry, I must be looking at the wrong one. What year are we looking at?

MR. HUTCHINGS: 1975, the statement is 1975, but it has comparative figures for 1974.

MS. McSHANE: And we're looking at the balance sheet?

MR. HUTCHINGS: No, the statement of income and retained earnings.

MS. McSHANE: Alright.

MR. HUTCHINGS: It's the next page over.

MS. McSHANE: I see that.

MR. HUTCHINGS: Okay, so we have, we had at the beginning of 1974, a deficit in retained earnings, correct?

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay, and that was turned around in the year 1974 as a result of net income of $1.481 million, and for the first time in, at the end of '74 then there were retained earnings of $908,000, correct?

MS. McSHANE: Apparently, that's what the statements say.

MR. HUTCHINGS: Okay, yes, and carrying on then and we can see in 1975 that there was a net income which increased the retained earnings at the end of the year to $6.8 million.

MS. McSHANE: I see that, yes.

MR. HUTCHINGS: Okay, in light of those statements and this represents the transition to the corporation, Newfoundland and Labrador Hydro, what evidence have you seen of investor supplied capital in Newfoundland and Labrador Hydro?

MS. McSHANE: Other than the retained earnings that have been left in the business, I mean the fact that there is a guarantee on all of the debt is a form of equity if you will, but it is not directly accounted for on the, on the balance sheet, but it is in a sense a form of equity to a certain extent because it means that the government has taken upon itself the financial risk of the corporation.

MR. HUTCHINGS: I'm not questioning that they've taken upon themselves the financial risk of the corporation, but I think you've already agreed with us, and Ms. Butler earlier this morning, that government is being paid now for it's debt guarantee fee.

MS. McSHANE: It's being paid something.

(12:15 p.m.)

MR. HUTCHINGS: Well are you suggesting that it's not being paid enough?

MS. McSHANE: I would suggest that it could be, that you could indeed justify, in the absence of a fair rate of return on equity, a higher guarantee fee, yes.

MR. HUTCHINGS: Well, you're assuming an inadequate rate of return on equity?

MS. McSHANE: Absolutely, yes, I would be assuming it. I mean these things play off against each other, right. I mean it's not that you can just say here's the cost of debt, here's the guarantee fee, and here's the return on equity and they don't necessarily change, they're dynamic, and if you look at the return that is allowed to equity, then that, a certain level of return may change what's appropriate in terms of the guarantee and vice versa.

MR. HUTCHINGS: Okay, I accept your point that there is an interplay between the various components of capital and that has to be taken into account, but I still have, I think, a problem with what I see is a contradiction in what I had understood you to say this morning earlier in that the debt guarantee fee should compensate government for its provision of the guarantee and I understand you now to be saying that as of this date you don't feel that that guarantee fee is high enough?

MS. McSHANE: I don't believe that the guarantee fee in conjunction with a rate of return of 11 percent, if you look at how those values break down, it does not equal the overall return that would be required of a company with a 60/40 capital structure and no guarantee. It would be slightly, the total return that Hydro would be seeking would be slightly less than that.

MR. HUTCHINGS: I'm sorry, I'm not following you now. The total return that Hydro would be seeking if it had a 60/40 percent debt equity ratio?

MS. McSHANE: If you start with the proposition that there is an overall cost of capital to accompany a 60/40 capital structure, and that is made up of the debt cost and the return on equity, and then you say that should be a proxy for Hydro's overall cost of capital, and then you look at what the government is getting in terms of a guarantee fee, which is one percent, and you will get what the debt cost to Hydro is and you look at the return on equity that they would be requesting if they were looking at, if they were asking for a full normal rate of return, and you compare that to the cost of capital for a 60/40 similar risk, 60/40 debt equity, similar risk utility, and the return to Hydro including a one percent guarantee fee, is less than the cost of capital to a company financed with a 60/40 debt equity, which means that in principal you could justify a somewhat higher debt guarantee fee at this point in time.

MR. HUTCHINGS: Should we not be evaluating the debt guarantee fee as if it were being provided to someone who was not a shareholder?

MS. McSHANE: Absolutely.

MR. HUTCHINGS: Okay.

MS. McSHANE: I would agree with that, so the total ...

MR. HUTCHINGS: How can the two things be related then?

MS. McSHANE: How can they be related? Because they are being provided to the same person, the same shareholder, the same ... so that, yes, I agree with you that you do have to look at how much of what is being provided to the guarantor is for lowering the cost of debt to Hydro and how much of it is being provided to, to take a certain amount of the financial risk from Hydro, but the fact is that, yes, the guarantor and the equity shareholder are the same entity, so the total dollars that go to these investors has to be, has to be evaluated. The fact is that they shouldn't be any different, if the guarantor was someone else than the province, and the investors were someone else than the province, but the total dollars for the various values that are being provided and the risks that are being accepted, the total return at the end of the day to whomever it is paid should not change.

MR. HUTCHINGS: Are you saying to us now that there is an element in the existing guarantee fee that represents a return to equity?

MS. McSHANE: Not in the current guarantee fee, no.

MR. HUTCHINGS: Okay, are you saying to us that the current guarantee fee is not set where it should be set if it were being provided by a party other than a shareholder?

MS. McSHANE: Yes, I think that if the return to the shareholder on the equity would be set at 11 percent ...

MR. HUTCHINGS: Excuse me, can we leave the shareholder out of it for a moment and talk about the guarantee fee and whether or not the amount of the guarantee fee is appropriate assuming that it was provided by someone who was not a shareholder?

MS. McSHANE: I think that if another entity were going to take all of the financial risk, then they would require a somewhat higher guarantee fee, and that's when you guarantee the debt that's what you're doing, you're taking the financial risk off of the ...

MR. HUTCHINGS: You're taking the financial risk of the debt.

MS. McSHANE: Yes.

MR. HUTCHINGS: The risk of default on the debt.

MS. McSHANE: Right.

MR. HUTCHINGS: Okay, and do you know how Hydro has calculated the guarantee fee?

MS. McSHANE: You mean the mechanics of it, or do you mean how, how the percentage was determined?

MR. HUTCHINGS: How the percentage was determined.

MS. McSHANE: I don't know.

MR. HUTCHINGS: Have you advised them that their percentage is not correct?

MS. McSHANE: It's not that far off, so it's within a reasonable range, but I think that you could justify a somewhat higher guarantee fee.

MR. HUTCHINGS: Okay, and have you quantified that?

MS. McSHANE: I looked at it. I think that what I determined was that ... this is the way I looked at it, and this sort of goes back to the same example that I was using earlier this morning, that there are various ways you can look at this, but this is what I determined that if a company, a utility were financed 60/40, and can I give you some numbers or maybe ...

MR. HUTCHINGS: Sure, go ahead.

MS. McSHANE: It may be too complicated and we may want to wait and I can do it after lunch, but tell me if it doesn't work. And the current cost of debt to a company, a Triple B rated company, for 60 percent debt was 7 1/4 percent, and the return on equity is 11, so if you multiply those numbers together you get an overall cost of capital.

MR. HUTCHINGS: Uh hum.

MS. McSHANE: Which would be 8.75 percent, and multiply the 60 times 7.25 percent, you get 435, and you multiply 40 times 11 and you get 4.4. So I asked myself the question then, if I am Hydro, and I'm getting an 11 percent return on 15 percent of equity, and on 85 percent of equity *(sic)* I'm getting the cost of debt, 7 1/4, plus ...

MR. HUTCHINGS: 85 percent of capital.

MS. McSHANE: Sorry, 85 percent of capital, right. Plus, on 85 percent of the capital I get the cost of debt plus the one percent guarantee fee.

MR. HUTCHINGS: Uh hum.

MS. McSHANE: And if you work out those numbers there, the overall return that I would get would be slightly less than 875. If I increased the debt guarantee fee to 1.1 percent, they would work out to be identical, so that's why I say it's marginal, it's slightly more but it's, you know, it's not worth, it's not something that's worthy fighting over because those numbers are within a range, they are subject to some judgement, and they're not things that you can determine precisely but clearly a one percent guarantee fee is not in any stretch of the imagination excessive and may be conservative.

MR. HUTCHINGS: Okay, I think given the time we should leave it there, and we'll continue to pursue it after lunch.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Mr. Hutchings, thank you, Ms. McShane, we'll reconvene at 2:00.

(12:30 p.m.)

(break)

(2:00)

MR. NOSEWORTHY, CHAIRMAN: Thank you and good afternoon. Before we get started on the cross-examination are there any preliminary matters, counsel, please?

MR. KENNEDY: Yes, Chair. I believe counsel for Hydro has some undertakings and updating on where we stand with those.

MR. NOSEWORTHY, CHAIRMAN: Fine, thank you. Ms. Greene?

MS. GREENE, Q.C.: Thank you, Mr. Chair. I have copies of the undertakings for October 11th and 12th, which were the last two days before the public participation days. And I have a copy now to distribute to the Board at this time. I have circulated copies to the other counsel.

MR. NOSEWORTHY, CHAIRMAN: Thank you.

MS. GREENE, Q.C.: As indicated on what has just been circulated, and as we indicated verbally on October 12th, there were no undertakings recorded for Thursday, October 11th. There were two recorded for Thursday, October 12th. The first you will see related to a notice to be sent to town councils in the isolated communities on the Labrador coast where Hydro supplies electricity, and that was a request of the Consumer Advocate. A copy of that notice was circulated to all of the parties on the afternoon of the 12th of October. And I don't know if we would need to mark that at this time?

MR. KENNEDY: Hydro No. 11 for the documents under cover of October the 12th, 2001.

EXHIBIT HYDRO 11 ENTERED

MS. GREENE, Q.C.: I also wanted to do a little update on where we are with the other undertakings that are still outstanding. You will recall that on the 12th I mentioned that there were four outstanding undertakings at that time. Two of those have now been filed and I want to refer to them at this time. The first related to the 1997 cost of service done on the interim methodology end of the generic methodology. Both of those documents were filed on Monday, October 15th. And they complete the requirements of **IC-18** revised. The 1997 actual cost of service using the interim methodology was filed as **IC-18** revised No. E. Which the 1997 cost of service using the generic methodology was filed as **IC-18** revised F. I don't think it's necessary to mark those because they are the last requirements of **IC-18**. The second item which was filed during the public participation days that related to an undertaking was a description of the incentive plan, and that was filed in response to an undertaking given to the counsel for industrial customers. It was filed on Wednesday, October 17th and circulated to all the parties. And again, we would need to mark that at this time.

MR. KENNEDY: Hydro No. 12, Chair.

EXHIBIT HYDRO 12 ENTERED

MR. NOSEWORTHY, CHAIRMAN: Thank you.

MS. GREENE, Q.C.: That leaves two outstanding items. One is the one referred to on the list that I've just circulated related to the hydraulic average which is where Commissioner Whalen requested that Hydro file additional information, and that has not been filed yet, but will be in the near future. The second item outstanding from the previous days relates to a request of the Consumer Advocate to file a communication with the Department of Municipal Affairs relating to the status of the relocation of Harbour Deep. And that will be filed later in the hearing. So those are the only two outstanding items that would appear from Hydro's records. It is my understanding that there were no undertakings required during the public participation days, but we will confirm that once we've had the opportunity to review the transcript which has been circulated over the weekend. There are two other documents that I wanted to refer to, as well, that have been filed by Hydro during the last two weeks. The first is the response to **PUB-73** which was a request we received during the break to file the RSP reports for August and September. On October 26th Hydro filed a response and provided the July, August and September RSP reports. And the last document that was filed by Hydro that I wanted to refer to was a revised **NP-44** page 3 which was to correct an addition error which had been noted previously. Thank you, Mr. Chair, that concludes our preliminary comments on the documentation.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Greene. We'll proceed now with the cross-examination of the industrial customers, Ms. McShane, please?

MR. HUTCHINGS: Thank you, Mr. Chair. Ms. McShane, just before we broke for lunch we had been discussing the source of the investor supplied capital in Newfoundland and Labrador Hydro which lead us into a discussion about the debt guarantee fee and the level of that. And as I understand it, your suggestion was that there could be regarded as being an element of equity contribution by reason of the fact that the guarantee fee could be higher. Is that fair?

MS. MCSHANE: Well, simply by the fact that the guarantee is provided, and so, therefore, the risk of the financing has been taken on by somebody else. So in principal, the fact that there is a guarantee is, in a sense, a (inaudible) equity. In addition to that, we have the retained earnings that are equity.

MR. HUTCHINGS: All right. As I understood our discussion this morning, though, if there was adequate compensation by way of a monetary fee for the guarantee, then there would not be any contribution to equity by reason of the existence of that guarantee, is that fair?

MS. MCSHANE: Well, I guess what I meant to indicate was that to the extent that there is full compensation for the financial risk through the guarantee fee, then the return on the equity would reflect the risk that's left, the business risks that are left.

MR. HUTCHINGS: Um hm.

MS. MCSHANE: And so, there could be a lower rate of return on the equity to offset the higher guarantee fee.

MR. HUTCHINGS: I think it simplifies the discussion if we separate the equity from the guarantee for the initial purpose, in any event. Are we agreed that if the debt guarantee was coming from an unrelated third party there would be an appropriate fee that could be actuarially determined to represent the value of the debt guarantee and if that fee were paid then there would be no cross subsidization of any sort? Is that fair?

MS. MCSHANE: Could you repeat that?

MR. HUTCHINGS: Okay. Assuming the debt guarantee is provided by an unrelated third party, and an actuarial calculation produces an appropriate fee in terms of what that guarantee is worth in interest savings to Hydro, then if that fee were paid then there is no subsidization one way or the other, is that correct?

MS. MCSHANE: Well, I mean, I think you may have added something to the ... when you rephrased the question. It's just not a question of interest savings. It's also a question of the fact that the risk has been transferred to somebody else. So those are two separate elements for which you would effectively determine different components of the cost. So, for example, if ... this is just an illustration. If the cost of debt to a triple B rating company new debt was, say, seven and a quarter percent and by virtue of the guarantee fee ... a guarantee, sorry, you could raise debt at 6.75 percent. There is an interest savings there, but there is something in addition to that, and that is the fact that there is a value beyond that to someone taking the risk, the financial risk on the debt that's outstanding.

MR. HUTCHINGS: I guess the question is why the guaranteed party, in that instance, would pay any more if it could, in fact, get its debt simply by paying that amount of additional interest?

MS. MCSHANE: If I am a utility which could, on a stand alone basis, raise my debt at seven and a quarter and somebody is willing to provide a guarantee which allows me to raise my debt at 675 I would pay up to 50 basis points for the guarantee.

MR. HUTCHINGS: But no more?

MS. MCSHANE: But no more.

MR. HUTCHINGS: Okay. So, if we were to allow a maximum reasonable expense for a fee to obtain the guarantee we certainly wouldn't allow more than the 50 basis points, correct?

MS. MCSHANE: In that particular instance. But we're not talking about that ... I mean, the circumstances that we're facing are quite different than that. We're not talking about somebody who already had a 60/40 capital structure and all they're doing is saving 50 basis points by being able to raise debt at the provincial rate as opposed to the corporate rate. We're talking about a company that has 85 percent debt who wouldn't be able to raise debt at any kind of investment grade level at the current capital structure. So the value of that guarantee goes way beyond that 50 basis points of interest savings.

MR. HUTCHINGS: Okay. But, the situation that we are faced with here is that government has agreed to provide the guarantee fee for ... give a guarantee for one percent fee?

MS. MCSHANE: That's correct.

MR. HUTCHINGS: So, we certainly shouldn't allow any more than that, should we, in terms of an expense?

MS. MCSHANE: No, not unless they ask ... no. I mean, you wouldn't allow more than they asked for.

MR. HUTCHINGS: No.

MS. MCSHANE: Right.

MR. HUTCHINGS: Okay. So, to get back to the initial question which gave rise to our discussion about the guarantee fee, we were endeavouring to identify the source of investor supplied capital. You've stated a position relative to whether or not there is some contribution to investor supplied capital arising out of the guarantee fee. Is there ...

MS. MCSHANE: The guarantee, not the guarantee fee, the guarantee. Those are separate. I could have a guarantee without paying anybody for it.

MR. HUTCHINGS: Yeah. But if the guarantee fee was 40 times what it is now you wouldn't make the same point, would you?

MS. MCSHANE: I would certainly make the point that the fact that a guarantee has been provided means that the risk has been taken on by somebody else.

MR. HUTCHINGS: Yeah. And ...

MS. MCSHANE: So they may be overpaying for it, but the fact is that there is some risk that's borne by another party.

MR. HUTCHINGS: Yeah. But, I mean, that's what one of the purposes of this proceeding is, to determine how much one gets paid for taking a certain risk, correct?

MS. MCSHANE: Correct.

MR. HUTCHINGS: So if, in fact, the amount of the payment is equal to or greater than the risk being assumed then there is clearly no contribution to equity by reason of the fact that the guarantee exists?

MS. MCSHANE: Sorry, you'll have to say that again?

MR. HUTCHINGS: If the guarantee fee is equal to or greater than the amount which would adequately compensate the person who's giving the guarantee for the risk that they are assuming then there is no implicit contribution to equity by giving the guarantee?

MS. MCSHANE: I don't follow that, I'm sorry.

MR. HUTCHINGS: Okay. Your point, when I talked about investor provided capital initially, was that because you felt the guarantee fee was too low that there was an implicit contribution to capital, from government, by giving the guarantee, is that correct?

MS. MCSHANE: No. If I indicated that to you then I mis-spoke myself.

MR. HUTCHINGS: Okay.

MS. MCSHANE: What I said was, that the fact that the government provides the guarantee, period. I guess you can't get that period on the record, but ... that there is implicitly some equity that is unbooked but that backs up the corporation. The guarantee itself is a form of equity. They're taking the risk, the government is taking the risk.

MR. HUTCHINGS: Okay. And they deserve to have a return for taking that risk, correct?

MS. MCSHANE: They do.

MR. HUTCHINGS: Okay. There should be a return to that risk. If we properly calculate that and pay it as a guarantee fee, then that's the end of that issue, is it not?

MS. MCSHANE: Well, if you mean do I have to recognize some formal, a number of dollars, no, because there are no shares on the balance sheet. What we have to do, then, is to appropriately compensate the equity that is on the balance sheet which are the retained earnings.

MR. HUTCHINGS: Yes, okay. We'll get to that. But I just want to be clear that we reached a conclusion on this debt guarantee issue. Your position is that the giving of the guarantee provides a benefit to Hydro. And I think we're all agreed on that?

MS. MCSHANE: That's correct.

MR. HUTCHINGS: Okay. By giving the guarantee government is undertaking a risk?

MS. MCSHANE: Yes.

MR. HUTCHINGS: And deserves to be compensated for that?

MS. MCSHANE: Yes.

MR. HUTCHINGS: If, in fact, the guarantee fee is set at the appropriate level to compensate them for that risk do we need to make any other allowance to government in connection with the guarantee?

MS. MCSHANE: Not in connection with the guarantee.

MR. HUTCHINGS: Okay.

MS. MCSHANE: It's specifically in connection with the business risk that the ... of the assets that are held by the corporation.

MR. HUTCHINGS: So, in the simple case where the guarantee is not coming from a shareholder, then that's the end of the discussion once we pay an appropriate guarantee fee? Would you agree with that?

MS. MCSHANE: What do you mean it's the end of the discussion?

MR. HUTCHINGS: We don't need to make any other allowance for any return to the party giving the guarantee?

MS. MCSHANE: No.

MR. HUTCHINGS: If all they're doing is giving the guarantee?

MS. MCSHANE: No. Once you've determined what their return is in terms of the risk they're taking, that's correct. Then you have to determine what the return should be to the other parties to compensate them for the residual risk that they faced.

MR. HUTCHINGS: Yes, okay. So simply because it happens that the shareholder and the giver of the debt guarantee are the same person we can divide up the risk that they are undertaking as part of it is shareholder risk and part of it is debt guarantee risk?

MS. MCSHANE: Yes. But the fact is, they are the same party.

MR. HUTCHINGS: Yes, I understand that. But, for the purposes of these proceedings we identify the debt guarantee risk and pay them for that and then move on to decide what return they need on the rest of the risk? Is that not a fair approach?

MS. MCSHANE: No, I don't think that's ... well, that's certainly not my approach.

MR. HUTCHINGS: Okay.

MS. MCSHANE: My approach is to determine what the overall compensation should be for the ... all of the capital providers, irrespective of who they are. And the way I've done that is the way I explained to you before lunch, which was to determine what the overall cost of capital is if I were an appropriately capitalized utility where there are simply two types of capital, debt and equity. I figure out what the overall cost of capital there is. Now I have a utility which is, from my point-of-view, overly leveraged, okay. So because it's overly leveraged it needs a guarantee in order to raise debt. Its overall cost of capital, the capital borne by the ratepayers should be no higher or no different, really, it should be no different than the cost of capital to my hypothetical, if you will, 60/40 debt equity utility. I know how much the cost of debt is, I know how much the guarantee fee is. And I can then determine how much of the remainder needs to be paid so that all of the parts are appropriately compensated.

(2:15)

MS. MCSHANE: And in that way, I'd have to ... the debt guarantee fee is a given, we know that. We can determine whether or not it's excessive in terms of what would be required as the cost of debt to this company. We've determined that it is not, or I've determined that it is not. But at the end of the day, the overall dollars that should go to the various providers of capital should be no more than would go to the various providers of capital for an investor owned 60/40 financed utility.

MR. HUTCHINGS: Okay. So, if I understand what you're saying, then, one implication of that is that the overall risk associated with Hydro does not change when its debt equity ratio changes?

MS. MCSHANE: Yes, it does, its overall risk changes when its debt equity ratio changes.

MR. HUTCHINGS: Okay. Does that not run counter to what you just said about coming back to ...

MS. MCSHANE: I hope not.

MR. HUTCHINGS: ... 60/40 situation from the 85/15 situation? You said that the total requirement ...

MS. MCSHANE: No, because the ...

MR. HUTCHINGS: ... should not be any greater ...

MS. MCSHANE: That's right, because somebody is paying or being paid to take the financial risk. So, if I were ... I mean, I just want to insert here that it is the guarantee and the guarantee fee that sort of complicate this whole discussion. But, if I were a utility who was financed with 60/40 debt equity and I moved my capital structure ratios to 70/30 and that's all I did, I didn't do anything with a guarantee, a guarantee fee, I'm just one stand alone utility moving from 60/40 to 70/30, yes, my cost of capital would change. But, if I'm going from 85/15 to something else and I'm changing the distribution of the compensation to reflect the fact that perhaps I don't need as much protection if I'm at 70/30 than I do at 85/15 the overall cost of capital should be the same as they were before.

MR. HUTCHINGS: So, all other things being equal, a change from a 60/40 debt equity to a 70/30 debt equity, you say, will change the overall cost of capital?

MS. MCSHANE: It is likely to raise it, yes.

MR. HUTCHINGS: It's likely to raise the overall cost of capital?

MS. MCSHANE: Yes.

MR. HUTCHINGS: Okay. And if one ... I'm trying to understand the second example that you used, and I thought it was to say if you went from 85/15 to 70/30 but inserted a guarantee fee, then the overall cost of capital would not change?

MS. MCSHANE: It's not that the overall ... I mean, I probably mis-spoke myself. It's not that it doesn't change. It probably does change, it's probably higher. However, the point that I was trying to make was that we should not be compensating the investors for creating a capital structure which is inefficient. That by measuring the cost of capital against that that would be attributable to an appropriately capitalized utility, then we can use the values for the overall cost of capital as the bench mark against which the returns to the various providers of capital in Hydro can be compared, so to ensure that the cost of capital that is actually borne by the ratepayers does not exceed that which would be faced by an appropriately capitalized utility.

MR. HUTCHINGS: Okay.

MS. MCSHANE: Does that make sense?

MR. HUTCHINGS: I think I understand what you're saying. I'm not entirely sure that we'll be in agreement on that point, but we'll discuss that a little bit later. The point about the guarantee fee, though, that is still bothering me, to some extent, is that your initial comment was to the effect that the guarantee fee could, perhaps, be higher or should be higher. And that lead me to the conclusion that there was a way of determining what the guarantee fee should be, what the appropriate guarantee fee should be. Whereas, in your answer a few moments ago you were taking the guarantee fee as given, whatever that is, and then assigning the balance of the return to risk to the other categories of risk takers.

MS. MCSHANE: Well, I don't think that there's necessarily one answer.

MR. HUTCHINGS: Okay. Perhaps you could tell me, first of all, is there a way of calculating the appropriate debt guarantee fee?

MS. MCSHANE: As I said, I'm not sure there's a single answer. One way of looking at the guarantee fee would be to say, first of all, how much am I saving you in interest by allowing you to raise debt at a provincial level as opposed to a corporate level. So, if I were to start with the proposition that I have a utility, a Crown corporation that's financed 60/40 and with a provincial guarantee I can save 50 basis points on my interest that would be one element of what I'd be willing to pay for the guarantee. The second is to then determine what risk is the guarantor taking on. If the guarantor is effectively taking all of the financial risk from me, as the corporation, I would determine what the cost of capital would be at a 60/40 percent capital structure and then determine, from that, what the risk would be if I had 100 percent equity financed company because that would be a company that no longer had any financial risk. And I would be willing to pay the guarantor the difference ... I just have to think this through now. Effectively the ... and I haven't worked these numbers out, but in principal, it would be the difference between the cost of equity at a 60/40 capital structure and the cost of equity at 100 percent equity capital structure.

(2:30)

MR. HUTCHINGS: The guarantor is taking only, is he not, the default risk? The primary risk still remains with the utility?

MS. MCSHANE: The business risk remains with the utility, yes.

MR. HUTCHINGS: Um hm. So the only risk that the guarantor is being compensated for is the risk that the utility will default?

MS. MCSHANE: That's true.

MR. HUTCHINGS: Yes, okay. And if, at 60/40 our theoretical utility can only save 50 basis points by getting the guarantee I think we agreed earlier there'd be no reason for them to pay any more than the cost of those 50 basis points, correct?

MS. MCSHANE: That's correct.

MR. HUTCHINGS: Okay. So if the guarantor perceived that the risk was somehow greater than what they would be getting as compensation for those 50 basis points then there simply wouldn't be a guarantee. Isn't that correct?

MS. MCSHANE: Sorry, say that again? If the ...

MR. HUTCHINGS: If the guarantor perceived that the amount of money which was equal to the amount being saved by saving the 50 basis points that they were being ... the guarantor was being paid for the guarantee was not sufficient to compensate the guarantor for its risk the guarantor just wouldn't give the guarantee?

MS. MCSHANE: That's true.

MR. HUTCHINGS: Okay. So the maximum amount that the guarantee fee is going to be is the interest savings?

MS. MCSHANE: No. Because the risk is different at a 60/40 capital structure and an 85/15 capital structure.

MR. HUTCHINGS: No, no, no. In our example here, assuming a 60/40.

MS. MCSHANE: Yes.

MR. HUTCHINGS: Debt equity ratio.

MS. MCSHANE: Yes.

MR. HUTCHINGS: The maximum amount that that utility would be prepared to pay for a guarantee fee which will reduce its borrowing costs by 50 basis points is the amount it would save by doing that?

MS. MCSHANE: Correct.

MR. HUTCHINGS: Okay. So, to come back to my question, the guarantee fee can be calculated, if you will, or the maximum that it should be, can be calculated by a process such as we've discussed?

MS. MCSHANE: It can be estimated. That's one way of estimating. And I think another way of estimating it would be to go out and actually ask somebody whether they would be willing to provide a guarantee and how much they would charge for it. I mean, that would be the way I would look at it in my role here, but there may be, you know, other considerations that the actual potential provider of a guarantee would look at that I haven't considered.

MR. HUTCHINGS: Sure. No, I understand. I think ... I guess the problem that I'm having now is there seems to be a reluctance on your part to suggest that it is possible to divide up the risk so as to evaluate the risk to guarantors versus the risk to debt holders versus the risk to equity holders. And are you telling me that there is, in fact, only one risk and we cannot divide it up between those three potential stakeholders?

MS. MCSHANE: No. I think you can divide it up, but I don't think it's an exact science.

MR. HUTCHINGS: No, okay. So if, in fact, we can identify the appropriate risk for a guarantee provider and assign a fee to that guarantee provider that pays them adequately and appropriately for that risk, then we can address the balance of the risk to be divided up among the balance of the stakeholders, correct?

MS. MCSHANE: Well, that's one way of doing it so that if ... but if the guarantee fee is what it is and it's not unreasonable, I mean, why would you seek to change it because, you know, you're providing the remainder of the compensation to the shareholder, to the equity shareholder.

MR. HUTCHINGS: Okay.

MS. MCSHANE: And the fact is that the provider of the guarantee and the shareholder are the same entity. And as long as the total compensation to the shareholder is not excessive do we actually have to sit there and say, well, you're going to get this much in guarantee fee and you're going to get this much in equity return?

MR. HUTCHINGS: Is it your suggestion, then, that what the Board should be doing is evaluating the total return to government rather than simply trying to come up with a return on equity?

MS. MCSHANE: No. I think it should come up with what the return on equity should be. But it does have to ... it can't avoid evaluating that in terms of how much the government is getting in the guarantee fee. I mean, how can you determine how much the government should get in total if you don't look at what the appropriate return on equity should be?

MR. HUTCHINGS: No, I quite accept that point. But what's puzzling me is that we managed to get to this point in the hearing without there being an issue as to the level of the guarantee fee, and there now appears to be an issue as to the level of the guarantee fee.

MS. MCSHANE: I don't see that there's an issue with respect to the level of the guarantee fee.

MR. HUTCHINGS: Okay. So ...

MS. MCSHANE: We determined that the cost of debt to a company with 85/15 capital structure would require a cost debt that exceeds the cost that's been incurred, plus a one percent guarantee fee. And the company certainly is not looking for a return, in total, that is anywhere close to the return that you'd expect on an appropriately capitalized utility.

MR. HUTCHINGS: Okay. The only point I'm trying to get to is to eliminate the issue of the guarantee fee by seeing if we are, in fact, in agreement that government is adequately compensated by the guarantee fee for providing the guarantee. Are we agreed on that or not?

MS. MCSHANE: Are we agreed that they are appropriately compensated?

MR. HUTCHINGS: Yes.

MS. MCSHANE: They are compensated to the extent that the return on equity after the guarantee fee has been paid should still be the same as the return on equity to a utility with 40 percent equity.

MR. HUTCHINGS: Okay.

MS. MCSHANE: They are not fully compensated in the sense that the only risks that are left to the utility are the business risks.

MR. HUTCHINGS: I'm not sure that the answer addresses, specifically, the question that I've asked.

MS. MCSHANE: Okay.

MR. HUTCHINGS: In the sense that my concern is whether we have an issue about the level of the guarantee fee. If your suggestion is that the guarantee fee is too low, and hence, there has to be an adjustment to the equity return to compensate for the guarantee fee being too low, then we have an issue about the level of guarantee. Is that your position?

MS. MCSHANE: I'm sorry if I'm being confusing. I do ... what I am trying to say is that the debt guarantee fee is appropriate in the sense that the utility, as it stands, with the capital structure that it has, would not be able to achieve a debt cost of less than what has been incurred, plus the one percent with the guarantee fee. So, in that narrow context the debt guarantee fee is reasonable.

MR. HUTCHINGS: Okay.

MS. MCSHANE: Another way of looking at it is to determine whether or not, if you give ... if the debt holder gets his cost of debt, the debt guarantor gets the fee that is asked for and the equity holder gets a return commensurate with the returns that are applicable to other utilities, if that total compensation is less, to some extent, then what the cost of capital would be to a 60/40 investor owned utility then one could argue that one of those values is slightly off. And that's ... I'm not saying that it is significantly different, but as I suggested this morning, one could argue that there is a small under compensation in the guarantee fee if the shareholder were to be allowed an 11 to an 11 and a quarter percent return. Not enough to make a big issue out of, but let's just say that it's not excessive.

MR. HUTCHINGS: Okay. Now, and I pursue the point simply because, getting back to where we did begin this morning, I was asking you to identify the investor supplied capital. And this issue which you now say is insignificant was, in fact, the first point that you raised in terms of identifying some investor supplied capital.

MS. MCSHANE: I'm sorry, but I don't believe I ever identified the debt guarantee fee as an investor supplied capital. I identified the debt guarantee as a form of equity that is not on the books. I think that's totally different.

MR. HUTCHINGS: But you would agree with me that that form of equity shows up only to the extent that the debt guarantee is not adequately compensated for by a debt guarantee fee?

MS. MCSHANE: No.

MR. HUTCHINGS: You don't agree with that?

MS. MCSHANE: No.

MR. HUTCHINGS: Okay. So no matter how much the debt guarantee fee was there would be a contribution to equity by reason of supplying a guarantee?

MS. MCSHANE: Yes.

MR. HUTCHINGS: Okay, if that's your position. Is there anything else that you can identify booked in Newfoundland and Labrador Hydro that constitutes investor supplied equity?

MS. MCSHANE: Retained earnings.

MR. HUTCHINGS: And what was the source of the retained earnings?

MS. MCSHANE: Retained earnings. I'm not trying to sound facetious, but they're earnings that are retained in the business.

MR. HUTCHINGS: Retained earnings are produced by the income of the company, are they not?

MS. MCSHANE: Yes, they are.

MR. HUTCHINGS: Okay. And the income of this company comes from its ratepayers, does it not?

MS. MCSHANE: As the income does to every utility.

MR. HUTCHINGS: Indeed. And generally speaking, the retained earnings are said to accrue to the shareholders equity? Is that correct?

MS. MCSHANE: They accrue to the shareholder.

MR. HUTCHINGS: Yes. As a return on the equity that the shareholder has contributed, correct?

MS. MCSHANE: It is the part of the return that is retained as opposed to being paid out in dividends.

(2:45)

MR. HUTCHINGS: Yes, exactly. But if you have a company in which there is no equity, there is zero equity, what will ... any agreed percentage of return on that equity will still be zero. Would you agree with that?

MS. MCSHANE: I mean, it's an arithmetic certainty.

MR. HUTCHINGS: Indeed. Okay.

MS. MCSHANE: And not a particularly meaningful one, but an arithmetic certainty, nevertheless.

MR. HUTCHINGS: Well, it may, in fact, turn out to be meaningful before we're finished. Would you agree with me that typically when a commercial enterprise is begun there is some injection of equity capital by the owners?

MS. MCSHANE: Normally there would be, yes. In this particular case we have the shareholder provided a debt guarantee.

MR. HUTCHINGS: And that's it?

MS. MCSHANE: The shareholder did not ... if you're asking did the shareholder inject, at the outset, any equity, no.

MR. HUTCHINGS: Okay. And I'm perhaps repeating the question, but I want to be sure that we're clear on this. Did the shareholder inject anything else other than the debt guarantee?

MS. MCSHANE: Not to my knowledge he didn't. I would say the debt guarantee was a major provision by the province.

MR. HUTCHINGS: Okay. And I think you've already identified that as what you call an unbooked equity?

MS. MCSHANE: That's the way I characterized it, yes.

MR. HUTCHINGS: Doesn't show up on the statements anywhere?

MS. MCSHANE: No.

MR. HUTCHINGS: No. Okay. Let's move on to the more general consideration, then, of returns. If we could look to your pre-filed evidence at page 1 and line 27? Ms. Butler referred you to this this morning. And one of the purposes of your testimony is identified to be recommending appropriate target for capital structure and return on equity. And I think you may, in fact, have spoken this morning about that capital structure, for all intents and purposes, being effectively a debt equity ratio. Is that a fair description?

MS. MCSHANE: Yes.

MR. HUTCHINGS: Okay. Why should there be a target for a capital structure for Hydro?

MS. MCSHANE: As opposed to anybody else or just as a general proposition?

MR. HUTCHINGS: Just as a general proposition.

MS. MCSHANE: So you could have asked me ... just so I understand what you're asking me. I'm not trying to be difficult. Are you asking me why for any utility there should be a target capital structure?

MR. HUTCHINGS: Yes.

MS. MCSHANE: Okay. Basically because there is, in the capital markets, an expectation that utilities will maintain certain financial parameters in order to achieve certain debt ratings. And the achievement of an investment grade debt rating is important for a utility to be able to attract capital on reasonable terms under most market conditions. And clearly, when the debt rating agencies look at utilities they are very focused on what the actual and approved capital structures are.

MR. HUTCHINGS: Okay. In the specific case of Newfoundland and Labrador Hydro, assuming the continued existence of the debt guarantee from the government, what is the effect of changing the capital structure to move toward what you call the appropriate targets?

MS. MCSHANE: The effect is ... the effect, I guess, is that the value of the guarantee changes, for one thing. The other effect is that the company moves towards being able to be self-supporting, to be a self-sufficient company which is consistent with the legislation that says that utility should be able to ... I've forgotten what the exact language is, but attract capital and maintain financial ratings in the capital markets of the world.

MR. HUTCHINGS: Okay. I think you're referring to Section 3A3 of the Electrical Power Control Act.

MS. MCSHANE: That's sounds right.

MR. HUTCHINGS: Which talks about a just and reasonable rate of return under the Public Utilities Act so that it is able to achieve and maintain a sound credit rating in the financial markets in the world?

MS. MCSHANE: Correct.

MR. HUTCHINGS: Okay.

MS. MCSHANE: That would be what I was referring to.

MR. HUTCHINGS: Okay. Does Hydro now have a sound credit rating in the financial markets of the world?

MS. MCSHANE: Only by virtue of that fact that it's got a guarantee, but not on a stand alone basis, no.

MR. HUTCHINGS: No, okay. And it has had such a sound credit rating since 1992 and earlier?

MS. MCSHANE: It's only had a credit rating by virtue of the flow through of the provincial credit rating. It does not have a credit rating of its own and it would not be able to stand on its own in the capital markets of the world.

MR. HUTCHINGS: No, I quite understand that. And there are a good number of Crown owned utilities in the same situation, are there not?

MS. MCSHANE: Yes, there are.

MR. HUTCHINGS: Um hm. And you've provided ... I don't think we need to look at it specifically, but in answer to **IC-53** you provided the copy of the DBRS report on the Canadian Electric Utility Industry, and there are a number of ratings included in the package that you provided which are said to be flow through ratings, just as Newfoundland and Labrador Hydro's is, correct?

MS. MCSHANE: Yes.

MR. HUTCHINGS: Okay. I don't want to take you into issues of statutory interpretation that may involve questions of law. But I would just ask you what your understanding is as to whether the section of the Electrical Power Control Act that I've quoted requires Hydro to achieve and maintain a sound credit rating on a stand alone basis or have you assumed that?

MS. MCSHANE: No, I've not assumed that it is required to under the legislation on a stand alone basis, but I have concluded that it is appropriate for it do so on a stand alone basis and stand on its own.

MR. HUTCHINGS: Okay. And how did you reach that conclusion?

MS. MCSHANE: Do you mean what analytical process did I go through?

MR. HUTCHINGS: Why do you feel that it's appropriate for Hydro to stand on its own?

MS. MCSHANE: Because I think that if an electric utility is forced to act, in all ways, as a commercial entity, that in the long run it will achieve lower costs and higher productivity than it would if it were able to go back to the government if it had a problem.

MR. HUTCHINGS: What's the source of the additional cost, in a universal sense, of reliance on the government guarantee?

MS. MCSHANE: The additional cost, I mean, it's not directly quantifiable, but the ability to act as a government division basically has an impact on the way you look at running your business. And I think that, generally speaking, that studies have shown that companies that are corporatized act with more efficiency and greater productivity than entities that are strictly part of government. And it seems to me important to, particularly in the environment that we're facing in North America today is to make sure that the ground rules are set such that the electric utilities are operating on a level playing field with other privately owned companies with which they effectively are competing for capital and for services.

MR. HUTCHINGS: Just one other question before we think about the break for the afternoon. If Hydro has maintained its sound credit rating since 1982 with a return based upon a 1.08 interest cover why does it become necessary to increase that return into the 1.6 or 1.8 range in order, from this point on, to maintain a sound credit rating?

MS. MCSHANE: Well, first of all, as I said before, it has ... it's only maintained a sound credit rating because of the flow through.

MR. HUTCHINGS: Yeah. Which is predicted to continue?

MS. MCSHANE: Correct. But also, I think that you have to look at not just whether or not the guarantee is there, but that in economic terms you do need to look at what the opportunity costs associated with the equity is. And when we were looking at a model that was based on a margin over the interest we were not focusing on what the economic cost associated with the equity was. And when we move to ... not that we were prevented from doing so, mind you, but that that's simply not the way the focus was undertaken. With the move to rate of return regulation we have the opportunity, now, to address, in an economic sense, the principals that should govern how the equity is compensated. And there are several principals that we should be looking at, only one of which is whether or not the company has the credit rating by virtue of the flow through or not, but we also need to be looking at whether or not the equity is ... or the return on equity is consistent with the principals underlying a fair and reasonable return.

MR. HUTCHINGS: Okay. We can carry on, I think, with that, after the break, Mr. Chair.

MR. NOSEWORTHY, CHAIRMAN: Thank you, very much, Ms McShane. We'll break until 3:15, please.

(break)

(3:15 p.m.)

MR. NOSEWORTHY, CHAIRMAN: Are we ready to continue to Mr. McShane?

MR. HUTCHINGS: Thank you Mr. Chair. Mr. McShane at the time of the break were discussing the notion of Newfoundland and Labrador Hydro as a stand alone entity, and you did make reference to the current legislative provisions that provide for a just and reasonable rate of return on rate base and so on. Having agreed that with the government guarantee hydro has been able to maintain its debt rating to this point, is there any compelling economic reason as opposed to a legislative reason to change what return hydro needs to get to maintain its current situation?

MS. McSHANE: Is there a compelling economic reasons?

MR. HUTCHINGS: Yes.

MS. McSHANE: Yes, there is.

MR. HUTCHINGS: And what is that?

MS. McSHANE: The compelling economic reason is that that the equity funds have a cost, an opportunity cost, and that cost should be recognized by allowing a return that is commensurate with the risk attached to those funds.

MR. HUTCHINGS: Okay, so that if there is, in fact, investor supplied equity in Hydro it should attract an appropriate return on the basis of economic principles.

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay. Now returning to the issue with respect to the capital structure of Hydro, is it your view that there is an optimal capital structure for Newfoundland and Labrador Hydro?

MS. McSHANE: It is my view that for most utilities that there is an optimal capital structure for utilities in general, there is an optimal capital structure on a stand alone basis that falls within a relatively narrow range.

MR. HUTCHINGS: Okay, and what are the characteristics of that optimal structure?

MS. McSHANE: I don't understand what you mean by what are the characteristics of it.

MR. HUTCHINGS: How do we know when we've achieved it?

MS. McSHANE: Typically for a utility of sufficient size it would be when the company is able to achieve a debt rating in the investment grade category, most large utilities, average risk utilities are able to achieve debt ratings of A, I don't believe it would be as easy for Newfoundland and Labrador Hydro on a stand alone basis because of its risk statistics to achieve an A rating, so I have recommended a capital structure that I believe is consistent with an investment grade debt rating, that being Triple B. So I think that the main characteristic is that its, the capital structure and the financial parameters, including the return are such that it is able to achieve an investment grade debt rating.

MR. HUTCHINGS: There are obviously any number of investment grade debt ratings, are you saying that as long as it has the, any investment grade debt rating, the lowest available investment grade debt rating, it's okay?

MS. McSHANE: No, I don't believe that generally speaking it's okay. If it is possible to achieve an A rating without incurring additional costs (inaudible), and I believe that it is most appropriate for a utility to achieve a debt rating in the A category because with an A debt rating there is greater assurance that the utility will be able to attract capital under most capital market conditions. Triple B utilities typically face situations where they are not able to attract capital as easily, that they have to enter into quite sophisticated arrangements in order to attract capital. However, if it takes a common equity ratio of say 50 to 55 percent for a utility to get to an A rating then there are obviously greater costs associated with that additional equity that don't justify setting the capital structure parameters that would permit it to achieve an A rating and I think that's the case with Hydro, that it would take a significantly higher equity ratio in order for it to be able to achieve a debt rating of A.

MR. HUTCHINGS: Is it fair to say then that the least cost capital structure which produces an investment grade rating is the optimum rating, is the optimum structure?

MS. McSHANE: That in general principles, that's correct.

MR. HUTCHINGS: And is there any reason in your mind why that general principle would not apply to Hydro?

MS. McSHANE: No.

MR. HUTCHINGS: Okay. In your evidence at page 54, and this may turn out to be an unrelated question, but it's an item that I need to have clarified. The table in below line 9 there, is dealing with an answer which relates to interest cover and the cost of equity that's shown in the table there is 9.75 percent, can you explain for me where the 9.75 percent comes from.

MS. McSHANE: Yes, I believe it's indicated in, in the question. It was simply an illustrative coverage ratio based on what the allowed returns of other utilities are and in that sense it's not really the cost of equity per se, but it's an allowed return and it was used to simply provide an illustration of what the interest coverage might look like if the allowed return were equivalent to say Newfoundland Power's allowed return at 60/40.

MR. HUTCHINGS: The question as it appears there is "what approximate level of utility interest coverage ratio is indicated at your recommended stand alone target capital structure and the allowed return on equity for Hydro commensurate with that recently allowed other Canadian utilities?

MS. McSHANE: Correct. That's what the 9.75 is then. So it's the allowed return on equity for Hydro commensurate with that recently allowed other Canadian utilities. That was what the 9.75 is.

MR. HUTCHINGS: Okay. And the 9.75, I take it, is some sort of composite number which relates to any number of different utilities that may have different ratings, and so on.

MS. McSHANE: Yes, but most of the utilities in this Country have been allowed returns in a relatively narrow range and they've been allowed capital structures in relatively narrow range.

MR. HUTCHINGS: The investor owned utilities.

MS. McSHANE: Yes.

MR. HUTCHINGS: Yes. And the 9.75 in its reference to other Canadian utilities, did you take that to mean other investor owned utilities or other utilities generally?

MS. McSHANE: Utilities generally. Well all Canadian utilities generally, would include utilities such Epcor *(phonetic)* Utilities, which is not an investor owned but is allowed returns equivalent to other investor owned utilities in Alberta. It would include Hydro One, which is the, I'm sure you know, the electric utility in, the distribution and transmission utility in Ontario which falls within that range, so it's sort of a composite of the allowed returns for both investor owned and publicly owned companies whose returns are determined on the similar basis. As I said it was just, it's not supposed to be a precise value. It was simply supposed to be an illustration to give some sense of where the interest coverage might come out if it were, if the company were to finance 60/40 and were allowed a return similar to other utilities.

MR. HUTCHINGS: Okay, I take it this doesn't affect your position that even at 40 percent equity, the appropriate rate of return for Hydro is in the range of 11 to 11.5 percent.

MS. McSHANE: At 60/40?

MR. HUTCHINGS: Uh hum.

MS. McSHANE: No. My view is the appropriate return for Hydro at 60/40 is 11 to 11 1/2, at least under the economic circumstances at which, upon which the evidence was originally prepared.

MR. HUTCHINGS: Okay, given that the equity proportion is, would rise, if your recommendation to move toward a 60/40 was, was implemented, what would be the effect on the revenue requirement of increasing the proportion of equity?

MS. McSHANE: Principal, nothing, because you would be, in this particular case because we are dealing with a guarantee fee, then you would look at the components that make up the overall cost of capital and you would redistribute the returns to the various stakeholders and the overall cost of capital that ratepayers should bear should stay about the same.

MR. HUTCHINGS: So your consideration of Hydro when it reaches its 60/40 target, would that include a guarantee from government or not, or does it make any difference?

MS. McSHANE: It might, and whether it does depends on whether there's any value to it at that time. Today, as I indicated earlier, because there remains a spread in the interest cost to government and to a Triple B rated utility on a stand alone basis there still would be a value and therefore it would be worth maintaining and it would be worth paying the difference between the cost of debt to the utility and the cost of debt to the Province, to the provider of the guarantee.

MR. HUTCHINGS: So your position in terms of an 11.25, shall we say, rate of return on equity doesn't change no matter whether the equity is at 15 percent or 40, or whether or not there is a debt guarantee fee. Is that correct?

MS. McSHANE: Yes, it does. It does matter and you have, you do have to look at what the various parts of the compensation are that are being provided ... with the debt guarantee fee at the level that its at, the 11 1/4 percent return is appropriate as it would be appropriate at 60/40 with no debt guarantee, or no debt guarantee fee.

MR. HUTCHINGS: Okay. So you're saying that the increase in equity effectively transfers the risk which was previously taken by the debt guarantee provider to equity and the two things set one another off.

MS. McSHANE: Yes. They should, yes, except for the difference in the cost because the provinces generally today are able to raise debt at lower rates than corporations.

MR. HUTCHINGS: Okay, and have you done the calculations to illustrate that?

MS. McSHANE: You mean like actually presented them here?

MR. HUTCHINGS: Uh hum, yes.

MS. McSHANE: I'm not sure that I have actually. No, probably not. I can do one and present it to you. I was trying to do that earlier today but I think we got sort of confused about it, but that's that's exactly what I was trying to do was to illustrate how that would work.

MR. HUTCHINGS: And what would be the effect then if, for instance, instead of going simply to 60/40, Hydro carried on and got to 50/50. Would the overall cost of capital stay the same or change?

MS. McSHANE: It probably would stay pretty much the same. It might be a little lower but it might be a little higher because, because of the cost associated with the equity. Chances are the regulator wouldn't permit the company to be regulated on the basis of a 50 percent common equity ratio because it would view that as being too much equity to be consistent with the business risk of the corporation.

MR. HUTCHINGS: Too much equity in the sense that it would impose an additional burden of cost on the ratepayers?

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay. So if that additional equity means more cost to the ratepayer, who would be saving if the cost of capital overall were to stay the same?

MS. McSHANE: I don't understand your question. Can you rephrase it?

MR. HUTCHINGS: I understood you to say that you could go from 60/40 to 50/50 without an overall increase in the cost of capital. You said it could go up, could go down, could stay the same.

MS. McSHANE: It depends on where you end up in terms of your debt cost, I think, and that's sort of an unknown, until you actually go out and try to raise debt at that given capital structure.

MR. HUTCHINGS: Okay. Generally speaking as equity increases, what's the effect on the risk to debt?

MS. McSHANE: If equity increases it does down.

MR. HUTCHINGS: Risk debt does down and hence debt should be cheaper.

MS. McSHANE: Yes. The question is does the decrease in the cost of debt offset the increase in the equity ratio.

MR. HUTCHINGS: Okay, and if I'm understanding your earlier comments correctly that effect from where Hydro is now to 60/40 is seen by the gradual elimination of the debt guarantee fee. Debt is becoming cheaper by reason of the elimination of the debt guarantee fee as equity increases.

MS. McSHANE: Yes. Yes, as the equity increases then the cost of debt to Hydro on a stand alone basis would go down.

MR. HUTCHINGS: Under what scenario would an increase in equity result in an increase in overall cost of capital?

MS. McSHANE: Under the circumstances where the decrease in the debt cost as you add more equity is not sufficient to offset the decrease in the equity cost.

MR. HUTCHINGS: And is that what gives rise to the notion of an optimal capital structure?

MS. McSHANE: Yes.

MR. HUTCHINGS: Now I want to deal with the particular situation of Newfoundland and Labrador Hydro here as a Crown owned utility and the tax implications that arise from that. At page 20 of your pre-filed evidence, at line 5, line 3 to 5 actually ... you say the key cost benefits to customers, and this is the notion of Crown corporations, are the exemptions from income taxes and with the backing of the provincial shareholder are relatively low cost of debt. When you say "relatively low cost of debt", relative to what?

MS. McSHANE: To corporations.

MR. HUTCHINGS: Such as investor owned utilities.

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay.

MS. McSHANE: With the backing of the provincial shareholder.

MR. HUTCHINGS: Yes, uh hum.

MS. McSHANE: So I mean if your Ontario Hydro who doesn't have the backing of the provincial shareholder anymore, no longer has a debt guarantee, its cost of debt would be approximately equal to that, that would, would be incurred by investor owned utility with the same risk and capital structure.

MR. HUTCHINGS: Is there a difference in the after tax and before tax cost of debt to an investor owned utility?

MS. McSHANE: Yes, one of them is lower than the other because it's after tax.

MR. HUTCHINGS: After tax means a lower cost obviously.

MS. McSHANE: If it's after tax, but the cost is paid by the ratepayer who pays the before tax cost of debt.

MR. HUTCHINGS: In terms of the effect on the utility itself, an investor owned utility must recover an amount to pay its debt but it will, in fact, get a tax benefit on the interest that it pays on its debt, would it not?

MS. McSHANE: Yes, and that's the reason typically that utilities are financed with more debt in addition to the fact that they are relatively low business risks.

MR. HUTCHINGS: Would you agree with me that affect is not felt in Hydro, simply because Hydro doesn't pay any tax.

MS. McSHANE: No, Hydro doesn't pay any tax.

MR. HUTCHINGS: And the effect is therefore not felt.

MS. McSHANE: Which effect? I'm not sure what you mean by effect.

MR. HUTCHINGS: The effect of an advantage to debt in that one gets a tax benefit.

MS. McSHANE: No, it doesn't have the same tax benefit, then it doesn't pay tax.

MR. HUTCHINGS: Looking at the before and after tax cost of equity to both Crown and investor owned utilities, how would you compare those?

MS. McSHANE: In what perspective? From the perspective of the ratepayer?

MR. HUTCHINGS: From the perspective of the utility and what it has to collect from the ratepayer.

MS. McSHANE: That would be from the perspective of the ratepayer ... that the investor owned utility has to collect a tax allowance in order for it to achieve on an after tax basis, the rate of return on equity which it is allowed.

MR. HUTCHINGS: So in order to put X number of dollars into retained earnings it must collect X plus the tax rate, in order to get the net effect that it wants.

MS. McSHANE: Yes.

MR. HUTCHINGS: And relative to a Crown corporation, what's the difference?

MS. McSHANE: Dollars? You mean per dollar ... we could do it in terms of a dollar, so if I had, for example, see, I was told not to bring my calculator up here, its very dangerous, but basically if you've got a 50 percent tax rate and you add, for every dollar you add another dollar.

MR. HUTCHINGS: You add another 50 cents.

MS. McSHANE: At a 50 percent tax rate.

MR. HUTCHINGS: At a 50 percent tax rate, okay, okay you add your other dollar, but my question was in respect to the Crown owned utility which doesn't have to pay...

MS. McSHANE: Then you add nothing.

MR. HUTCHINGS: Then you add nothing.

MS. McSHANE: Correct. So as a Crown owned utility your cost of capital will always be less by the amount of tax that you don't have to pay.

MR. HUTCHINGS: Uh hum. Okay. I'm going to suggest to you though that the effect really is one which ends up preferring equity to debt in the case of a Crown owned utility, in fact equity turns out to be cheaper for a Crown owned utility than debt.

MS. McSHANE: Yeah, if you mean equity turns out to be cheaper because there's not a tax allowance attached to it, that's true. There is a pre, the pre-tax cost of equity is lower for an, sorry, for a Crown corporation, than it is for an investor owned company but it's not cheaper than debt.

MR. HUTCHINGS: Well, take the case of Hydro. Its debt with the guarantee fee in is 8.35 percent, something to that effect.

MS. McSHANE: Yes.

MR. HENDERSON: Okay. And it has to collect that entire amount from the ratepayers and it doesn't get any tax advantage, any saving from having paid interest, correct? From having paid taxes, I'm sorry, because it doesn't pay taxes.

MS. McSHANE: It doesn't pay taxes, but the ratepayers would pay the taxes, so I'm not quite sure why you say there's this, that they're avoiding a benefit or they don't have a benefit.

MR. HUTCHINGS: The tax that the utility has to pay is reduced by the fact that it's paying interest and interest is a deductible expense.

MS. McSHANE: Yes, it is. So a utility that pays taxes would be incented to use, the regulator would be incented to have the utility use more debt.

MR. HUTCHINGS: Yes. Okay. And if we look at the case of Hydro as regards its equity, in fact it gets to, the shareholder gets to keep essentially either its retained earnings or its dividends all of the return to equity, correct? Doesn't have to pay any tax on it.

MS. McSHANE: Right, but it also doesn't get an allowance for the tax, so it's, I guess I'm not following ....

MR. HUTCHINGS: What you you mean by an allowance for the tax?

MS. McSHANE: Well, if you're in a competitive market you set your price based on what the market will bear, okay, and you determine your capital structure in such a way that you'd maximize the return to your shareholder and presumably if you're working in, operating in a competitive environment, you may decide to have a very high amount of leverage because you can take advantage of the tax deductibility of debt, but that's not what happens in the regulated world. You go into the regulator and you say I need X dollars to cover my cost of debt, I need X dollars to cover my cost of equity, I need X dollars to cover my tax allowance, you go in there and you ask them for specific dollars related to the tax so it's not the same thing as operating in a competitive environment where your prices are determined by the market place, here they're determined by your cost of service which includes the tax, so I don't quite, I don't see the situation with this after tax cost of capital being quite the same with utilities as it is with competitive firms.

MR. HUTCHINGS: No, and I'm speaking only of utilities on the one side and Crown owned utilities on the other side, okay.

MS. McSHANE: Yes.

MR. HUTCHINGS: So if a utility in the position of Newfoundlnad Power which is taxable, wants to have its shareholders get the benefit of a return of 11 percent, then they have to collect from the ratepayers enough to pay the tax.

MS. McSHANE: That's right, and they're ...

MR. HUTCHINGS: Before you get to that 11 percent.

MS. McSHANE: Correct, and they would come to the regulator and say I want, or my cost of equity is 11 percent and the tax I require to earn 11 percent is, you know, 35 or 40, whatever the marginal tax rate is, times that, and then I would set my prices on that basis.

MR. HUTCHINGS: Yes.

MS. McSHANE: And Hydro would not ask for a tax allowance because it doesn't pay income taxes.

MR. HUTCHINGS: Exactly, and in the case of debt, Newfoundland Power would, if it could get 8 percent debt, which it probably can, would come and say I have to pay eight percent for my debt, but I'm giong to save four percent by reason of reduction in taxes, so effectively my after tax cost of debt is going to be 4.1 percent.

MS. McSHANE: No, they're going to, their ratepayers are going to pay eight percent. The ratepayers are not paying an after tax cost of debt.

MR. HUTCHINGS: Well, take it the second step then as you talked earlier, and how do you calculate the tax allowance? You're going to deduct the interest cost in calculation the tax allowance, are you now?

MS. McSHANE: Yeah, but the ratepayers still have to pay the full cost of debt.

MR. HUTCHINGS: Which is effectively after tax, half of what it would be before tax, correct?

MS. McSHANE: I guess I don't see that, no. It's not half of what it would be because you would be paying ... if you looked at the after tax cost of debt, and you were financed with 60 percent debt, at an eight percent tax rate, and 40 percent equity, sorry, 60 percent debt at 8 percent cost. The after tax cost of that is ...

MR. HUTCHINGS: Oh you did bring your calculator?

MS. McSHANE: I did, yeah. The weighted component of that would be about 2.88 percent, so I take 60 times 8 times one minus the tax rate gives me 2.88.

MR. HUTCHINGS: Okay.

MS. McSHANE: And let's just say for, just to make it a simple calculation, the equity return is 10 percent times 40 percent equity, so that would be four. So the after tax cost of capital on that basis would be 6.88 percent, right? In order for me to fully recover my debt cost plus my pre-tax cost of debt, I have to take that entire number and divide it by one minus the tax rate, so that I ended up collecting my pre-tax cost of debt, my tax allowance on the equity that I have and my after tax return on equity, so I'm not paying, the ratepayers are not paying the after tax cost of debt. They're paying the pre-tax cost of debt.

MR. HUTCHINGS: If, in fact, they're paying a tax allowance which is calculated by deducting the interest as a taxable expense, how are they paying the pre-tax cost of debt?

MS. McSHANE: Because they're not paying eight percent times one minus the tax rate, they are paying eight percent.

MR. HUTCHINGS: Uh hum.

MS. McSHANE: So ...

MR. HUTCHINGS: And if the tax allowance, if interest wasn't a deductible expense, then they would pay the full tax allowance without reference to the fact that there had been interest paid with is a deductible expense, but because there is a deduction for interest in calculating your tax, your tax is lower.

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay, so the effect of the two things, the before tax interest cost, and the calculation of the tax allowance is that the ratepayers end up paying the after tax cost of debt. Is that not correct?

MS. McSHANE: I disagree that they're paying an after tax cost of debt, they're paying a pre-tax cost of debt. They're paying eight percent.

MR. HUTCHINGS: Okay.

MS. McSHANE: And they're paying a pre-tax cost of equity.

MR. HUTCHINGS: Okay, perhaps you may get the opportunity to do the calculation that we spoke of and we may ...

MS. McSHANE: Sorry, which calculation is that, so I make sure that ...

MR. HUTCHINGS: I think there are probably two now.

MS. McSHANE: Okay.

MR. HUTCHINGS: The one that you just did in respect of the post, or pre- and after tax costs.

MS. McSHANE: Okay, and what was the other one that you wanted me to do?

MR. HUTCHINGS: And the earlier one was the one that you were attempting to explain to me before lunch in terms of the, the calculation of the overall cost of capital based upon the cost of debt. You had given me some numbers based on, I think, 7.25 percent and an ROE of 11 percent at a 60/40 debt equity ratio.

MS. McSHANE: Sorry, which ones were they? I've gone through several examples, so I'm not sure which one it is exactly you want.

MR. HUTCHINGS: Okay, we had been discussing the issue of the debt guarantee fee.

MS. McSHANE: Yes.

MR. HUTCHINGS: And you gave me some numbers based upon a 60/40 debt equity ratio.

MS. McSHANE: Uh hum.

MR. HUTCHINGS: And a cost of debt at 7.25 percent.

MS. McSHANE: Okay.

MR. HUTCHINGS: And a rate of return at 11 percent?

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay.

MS. McSHANE: And how that would shift if ...

MR. HUTCHINGS: How that shifts from the 85/15.

MS. McSHANE: Okay, I got it.

MR. HUTCHINGS: Okay. That's just about 4:00, Mr. Chair.

MR. NOSEWORTHY, CHAIRMAN: Will you be continuing tomorrow?

MR. HUTCHINGS: Yes.

MR. NOSEWORTHY, CHAIRMAN: Okay.

MR. HUTCHINGS: I'll continue for some short space of time in the morning.

MR. NOSEWORTHY, CHAIRMAN: Okay, we'll conclude and reconvene at 9:30 in the morning. Thanks very much.

(4:00)

(hearing adjourned to October 30, 2001)