(9:30 a.m.)

MR. NOSEWORTHY, CHAIRMAN: Good morning everybody and Happy Halloween. I'm sure it probably presented an interesting morning for those with small kids, trying to get them dressed and off to school, as I'm sure it will present an interesting evening. *(laughter)* We'll proceed. Are there any preliminary matters, Mr. Kennedy?

MR. KENNEDY: Not that I'm aware of, Chair, any preliminary matters this morning.

MR. NOSEWORTHY, CHAIRMAN: Are you completed with your cross-examination?

MR. KENNEDY: I have completed my cross-examination. Thank you, Ms. McShane.

MS. McSHANE: Thank you, Mr. Kennedy.

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

MS. McSHANE: Good morning.

MR. NOSEWORTHY, CHAIRMAN: We'll proceed with redirect, Ms. Greene.

MS. GREENE, Q.C.: Thank you, Mr. Chair. Good morning. The first question that I have for you, Ms. McShane, arises from your discussion with counsel for Newfoundland Power concerning the dividends, and I'd like first to turn to **page eight of the transcript of October 29th**, and in the hard copy of the transcript or the paper copy of the transcript the reference is to line 78 to 83, which is the same on the electronic version for once. *(laughter)* In the question there you'll see that you're talking about the payment of the dividends from '95 to, including forecast 2001, 2002. In line 78 to 80 you mention to some extent that there will be a catch-up of dividends that hadn't been paid up to the 75 percent in the past. Ms. Butler then said, "But it exceeds the catch-up." Your answer then on lines 82 to 83, "Yes, it does to some extent exceed the catch-up." Now my question is, in that exchange of question and answer, the period you were discussing was from '95 to 2002, is that correct?

MS. McSHANE: That's correct.

MS. GREENE, Q.C.: Have you had occasion to review from the period '75 to 2002 what the pay-out ratio would be if the entire period from '75 to 2002 including forecast for 2001, 2002 was included?

MS. McSHANE: Yes, I have looked at those numbers and in total over the period 1975 through the test year would be approximately a 40 percent pay-out ratio.

MS. GREENE, Q.C.: Of the dividends available ...

MS. McSHANE: 75 percent of operating income.

MS. GREENE, Q.C.: So the pay-out would have been approximately 40 percent of that entire period.

MS. McSHANE: That's correct.

MS. GREENE, Q.C.: The next question that I have also concerns the issue of dividends and the appropriateness of whether there should be a deemed capital structure, and here I'd like to refer to the **transcript of October 29th, page 8**, lines 33 to 35. The question there was from Ms. Butler in terms of whether you were recommending to the Board that the Board should deem a capital structure, and you'll see that there in line 73 to 35, and actually there's quite a bit of discussion on this, and the next reference that I would like to refer to is on page 9, and again you will see from lines 21 to 35 and from 51 to 70 you express your view why you are not recommending that the Board deem a capital structure for Hydro. In your answer to this question, particularly on lines 21 to 35, you took the Board through a mathematical type of example of how it would work with a deemed capital structure. My question is, have you prepared a schedule which would outline the calculation that you referred to in your evidence on October 29th?

MS. McSHANE: Yes, I have.

MS. GREENE, Q.C.: I have a copy of the schedule to distribute at this time. I'll just wait a moment for everyone to get a copy of the schedule.

MR. KENNEDY: I believe that would be **KM-3**, Chair.

MR. NOSEWORTHY, CHAIRMAN: Thank you.

EXHIBIT KM-3 ENTERED IN

MS. GREENE, Q.C.: Ms. McShane, I wonder if you could review the schedule with us in view of the fact that people have just received it for the first time?

MS. McSHANE: Certainly. What I've tried to illustrate on this schedule is essentially what would happen if the Board were to deem a capital structure but approve the same requested return, overall return on rate base that the Company has requested. At the top of the schedule what appears is a table which illustrates approximately the proportions of debt and equity that Hydro anticipates having in its capital structure during the test year and the proposed cost of debt and equity and the requested return on rate base which would result from those proportions of debt and equity and cost rates. The point that I would like to make from this table is that even if the Board were to decide that it was appropriate to deem a capital structure which has less debt and more equity in it than the Company anticipates having in its capital structure during the test year, the Company's actual cost of capital would still be well in excess of what it has requested in terms of return on rate base, thus there is no reason that even if the

Board were to deem a different capital structure that the overall requested return on rate base need be changed. So what I tried to illustrate in the bottom half of this page is what would happen if you assume that the Company had, instead of 85 percent debt, 75 percent debt, and instead of 15 percent equity, 25 percent equity. What would happen is the Company could still, and would still, request the same return on rate base, but instead of applying the cost of debt plus the guarantee fee to 85 percent of the debt, it would now apply it to only 75 percent, which effectively then would result in a somewhat higher return on the deemed equity of 25 percent, and that number, if you look at the bottom line on the little indented section just before the last paragraph, would be approximately 4.8 percent instead of the 3 percent that's actually then proposed in this application. Just as a general comment, I would add that clearly the Board has the power to deem a capital structure different from what is actually in place, but as I noted Monday, I guess it was, that usually this is reserved for situations where the Company has more equity in place than the Board feels is reasonable for a utility of that risk, not to deem more equity than is actually in place, and in this particular case, since what the Company is asking for overall is a return on rate base that is lower than what would be required in the marketplace, I don't see any advantage in the Board deeming a capital structure.

MS. GREENE, Q.C.: I think on Monday as well, Ms. McShane, you said it was virtually unheard of, as you've mentioned again, for a Board to deem a higher equity than a company actually has.

MS. McSHANE: I know only one circumstance when that has occurred.

MS. GREENE, Q.C.: And could you please explain what that circumstance was?

MS. McSHANE: It was in the case of NOVA Gas Transmission where the Alberta Public Utilities Board, as it was known at that time, decided that the stand-alone capital structure for NOVA Gas Transmission would have more equity than its corporate parent actually had in place and deemed more equity to the capital structure than the corporate parent actually had, but that's the only case that I'm aware of.

MS. GREENE, Q.C.: Turning now to another subject matter which is, was raised by counsel for the Consumer Advocate, which is whether there should be a cap on earning, and I think in your answer to him you referred to this as the belt and suspenders approach in the context of this current application, and I just wanted to clarify for the record what your recommendation is to the Board should the Board consider that there be a cap on earnings for Hydro in this particular application, and I'd like to refer to the **transcript of October 30th at page 21 and lines 19 to 23**. It's page 19 *(sic)* of the October 30th transcript, and I just wanted to clarify, confirm for the record that your recommendation is found in that section of the transcript as opposed to the information request that had been discussed at that time as well. Is it correct that your recommendation would be that the cap should apply if the return on rate base exceeded 9 1/4 percent in the context of this current application?

(9:45 a.m.)

MS. McSHANE: In the context of this current application, that's correct.

MS. GREENE, Q.C.: The last question that I have for Ms. McShane arises from a question of counsel for Newfoundland Power and it is found in the **transcript of October 29th at page 15**, and what I'd like to do is really correct for the record the question of Ms. Butler on line 14 to 17, which is found on page 15 of the transcript of October 29th, and really it's not a correction with respect to Ms. McShane, but I'm using Ms. McShane in order to ensure that the record is accurate. I'm going to get her to read a section of a prior transcript, as she did so well yesterday in reading lines from various parts of transcripts and evidence. What I'm referring to is the question of Ms. Butler which was found, as I said, on lines 14 to 17 of page 15, and there's a reference there that Mr. Wells as President had testified that the increase in consumer rates over the five-year financial planning horizon would be a total of 26 percent, and I think that really just was a slip on behalf of counsel for Newfoundland Power. She was referring to the five-year plan. And here I'd like to refer to the **transcript of September 24th** which was the cross-examination of Mr. Wells by counsel for Newfoundland Power when Ms. Butler took Mr. Wells through the forecast included in the five-year financial plan, and here, if we could find the **transcript of September 24th, lines 28 to 32**, which is a question from Ms. Butler which is probably the easiest way to correct the reference.

MS. BUTLER, Q.C.: I think we need the page number, Maureen.

MS. GREENE, Q.C.: Oh, I'm sorry, **page 23**, sorry. So in the hard copy it's **page 23, lines 28 to 32**, and this is one where it's not ... okay. On the electronic version it is actually lines 35 to 39. This is one case where the electronic version and the hard copy doesn't match the line numbers. And I wonder, Ms. McShane, if you could read, please, lines 35 to 39.

MS. McSHANE: Which is Ms. Butler's question.

MS. GREENE, Q.C.: Ms. Butler's question. I think this is just the easiest way to correct the record without going to the five-year plan.

MS. McSHANE: "So perhaps this is the message, Mr. Wells, that the Newfoundland consumers need to hear first that the plan in this period, 2001 to 2005, is to increase those wholesale rates by 22 and 26 percent respectively in that four-year period."

MS. GREENE, Q.C.: Thank you, and I just wanted the record to demonstrate that the increases Ms. Butler was referring to from the five-year plan are in the wholesale rate, at the wholesale level, and not in the consumer rate, to ensure that the record was accurate. The other point with respect to this is Mr. Wells' view of the five-year plan and whether in fact that is what the Company is saying the forecast of wholesale rate changes will be, and here, Ms. McShane, for the second point, I'd like you to read for the record **line 43**, beginning there at line 43, please.

MS. McSHANE: "May I say this, that the financial plan that we maintain and that's required in the system, although I personally have a great deal of difficulty with five-year plans in this day and age, is done for financial planning purposes only. It's not to set rates and I would be very uncomfortable to take the projections in the financial plan and take them out to consumers as some sort of forecast that this is what you can expect."

MS. GREENE, Q.C.: Thank you. Thank you, Ms. McShane. That concludes the questions that I have on redirect.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Greene. We'll proceed on now with Board panel questions. I'd ask Commissioner Powell to begin, please.

COMMISSIONER POWELL: Thank you, Chair. Thank you, Ms. McShane. I've enjoyed your testimony.

MS. McSHANE: Thank you.

COMMISSIONER POWELL: I just have a few questions, more for clarification than anything else. I'm sure there's lots of things in your testimony where people here may have different slants on and I'm sure we'll get to that as we get into ... the first thing is the guarantee fee. There was some questions about that and I had some questions earlier when the, in the proceedings on the fee and there was some little confusion. So maybe if we can just take it the way I understand it and you can tell me if I understand it the same way you present it. The guarantee component of the fee itself ... excuse me, the halloween goblins are getting me ... the act of guaranteeing itself, would you characterize that as sort of a service that somebody would provide to somebody else?

MS. McSHANE: Yes, it is a service.

COMMISSIONER POWELL: And the fee component is the remuneration that somebody would expect to get for providing that service.

MS. McSHANE: That's correct.

COMMISSIONER POWELL: Okay. What would normally be included in the fee that somebody would charge, in general?

MS. McSHANE: What would be included in the fee? Certainly what would be included in the fee would be a determine, a determination of the risks that the guarantor anticipated that he was, he or she was being exposed to, and effectively it would be the price of taking on the risks involved in providing the guarantee in addition to whatever out-of-pocket costs that the guarantor would take on in place of the same services effectively being provided by the company itself.

COMMISSIONER POWELL: Okay. The cost associated with acquiring a debt, assuming that an entity such as Hydro was investing (inaudible) corporation and they were going to try to raise $100 million on the, in the market, what kind of cost would be incurred, assuming they didn't need a guarantee?

MS. McSHANE: For the actual raising of ...

COMMISSIONER POWELL: Yes.

MS. McSHANE: ... of the capital? Out-of-pocket costs ...

COMMISSIONER POWELL: Yes.

MS. McSHANE: ... would include commission fees, legal fees, filing fees, those types of things. If you want perhaps some more detail on that, Mr. Hall is probably the person who could provide you with a greater amount of detail ...

COMMISSIONER POWELL: Well, I just want ...

MS. McSHANE: ... on it but generally speaking those are the types of costs that are incurred.

COMMISSIONER POWELL: On **page 44 of your testimony**, well actually it starts on 43, on line six you talk about flotation costs and then on page 44, lines 1 to 13, you refer to out-of-pocket equity financing, and you basically come down saying that you should be allowed 50 bases points in arriving at a bare bones cost of equity. These are the type of costs that you're referring to there, the commission fees and filing fees and things like that?

MS. McSHANE: If I could perhaps back up a little bit and make a distinction between the debt and the equity, what you and I were discussing a moment ago were the costs of raising debt.

COMMISSIONER POWELL: Yes.

MS. McSHANE: There would be similar costs if a company had to go out into the public market and raise equity, but as I noted in this section of the testimony here to which you're referring, Hydro does not raise equity in public markets and therefore for equity there would be no out-of-pocket costs that would be associated with that equity, so the allowance that I'm recommending be added to the bare bones cost of equity is for the other factors that are referenced in the section of the testimony and excludes specifically any costs that would be quantifiable for out-of-pocket expenses.

COMMISSIONER POWELL: So this 50 bases points, you're talking about cost of equity, you're essentially saying this is cost, the equity that's still left in Hydro in the form of retained earnings that if they had to go raise it, this is what it would, type of costs you expect to incur?

MS. McSHANE: What I'm saying is that the market derived bare bones cost of equity does not include any cushion, if you will, for unanticipated market conditions and it also does not contain any adjustment for the fact that typically in the competitive markets that unregulated firms are able to trade at values in excess of book value, so the 50 bases points is in recognition of those factors and not to actually put into place any amounts that would be attributable to the actual waiving of equity in the future. If a time came where that were to be the case, then at that time the financing flexibility adjustment would recognize those but not as long as there's no intention to raise any equity in the public markets.

COMMISSIONER POWELL: Okay. So you're essentially saying then all the costs of raising the capital, the debt for Hydro, is included in the guarantee fee then.

MS. McSHANE: Some of them are. As far as the actual split between whether Hydro actually pays some of those costs itself, I'm not positive. I think Mr. Hall is probably the person who could tell you what is specifically included in the guarantee as far as the out-of-pocket costs and what specifically Hydro may pay from its own pocket.

COMMISSIONER POWELL: The reason why I brought it up, when the guarantee was first talked about, Mr. Wells and myself had a conversation back on the 27th, and I assume that the guarantee fee would be some sort of split, but he said there were no costs incurred, the Government didn't have to incur these type of costs in terms of commissions and things, and when I read your (unintelligible), but I can understand where you're coming from. Okay. I was a little concerned about a double dipping there in terms of you including some component for those costs and they were already in the guarantee fee.

MS. McSHANE: Oh, absolutely not, no.

(10:00 a.m.)

COMMISSIONER POWELL: Okay. Clarify that point for me. Bear with me now. I made notes as, when I read it, and some of it got clarified with questions and some that left me with not as much clarity as I would like. **Page 20,** yeah, on **page 20, line three and four**, in an answer to a question that started on page 19, "Doesn't the implementation of capital structure targets for a Crown corporation which are similar to those in investor-owned utilities negate the very purpose of the Crown corporation structure." And line three, you say, "The key cost benefit to customers are the exemption from income taxes." But unless I was missing something, I thought one of the factors that you took into setting the return on equity was to make, treat Hydro as if it was an investor-owned corporation and that would wash out. So how do you rationalize that statement with ...

MS. McSHANE: You're talking about the exemption from income taxes ...

COMMISSIONER POWELL: You say, "(inaudible) the key cost benefit to customers are the exemption from income taxes." I think it's on the (inaudible), but ...

MS. McSHANE: Okay. I guess the fact that it is treated like an investor-owned utility in some respects, which is to say that it's treated in a manner consistent with stand-alone commercial viability, is not going to in and of itself subject it to income tax provisions, so what I'm trying to accomplish through setting down what I believe to be the appropriate principles is to establish a framework that is consistent with economic principles and those economic principles essentially are drawn from the investor utility's experience but the fact is that the corporation will not be subject to income taxes and then that would still be a benefit. Now there are actually Crown corporations which pay fees in lieu of income taxes. For example, Hydro One in Ontario now pays fees in lieu of income taxes as a means of, one, paying down some of the stranded debt, but also as a matter of principle what the Ontario Government is trying to accomplish is to create a level playing field environment, recognizing that the electric utilities in Ontario are competing with the gas utilities, all of which are owned by investor-owned companies, so it has taken the position effectively that in order for that level playing field to truly be created, that even though Hydro One has maintained its Crown status and doesn't actually pay taxes to the Federal Government, it would pay fees to the Provincial Government.

COMMISSIONER POWELL: So you might even look at the 75 percent dividend policy as a provincial tax then.

MS. McSHANE: As a?

COMMISSIONER POWELL: As a provincial tax in a way simply because it's taking, the tax is taking a portion of your income, so the province using a 75 percent dividend in lieu of taxes ...

MS. McSHANE: No. I don't agree that the 75 percent dividend policy could be viewed as a tax. The retained earnings of the corporation are ...

COMMISSIONER POWELL: But if they took it each year ...

MS. McSHANE: ... the ... if they took it each year.

COMMISSIONER POWELL: Yeah.

MS. McSHANE: Is it a tax? No, I don't think it's a tax.

COMMISSIONER POWELL: I don't think so either but ...

MS. McSHANE: Well it's certainly ...

COMMISSIONER POWELL: ... in the sense of in lieu of no ...

MS. McSHANE: It's a return. Clearly it's a return to the shareholder but it's not a tax in the sense that it's going to ...

COMMISSIONER POWELL: It's going to the taxpayers. The problem I have with ... I have a problem with the statement, the key cost benefit to customers are the exemption from income taxes, and in lieu of the calculation we went through and I thought, unless I'm misunderstanding the whole calculation, was to negate that and treat everything as an investor, Hydro as an investor-owned, and your calculation was done based on that.

MS. McSHANE: Well, it's ...

COMMISSIONER POWELL: But it's really no advantage in terms of looking at the fact of exempt from income tax.

MS. McSHANE: It certainly is to some extent and there are, as I suggested, provinces who have gone further and imputed (phonetic) further fees to take the place of income taxes. B.C. has done that, Ontario has done that.

COMMISSIONER POWELL: And would you suggest that's what Hydro ...

MS. McSHANE: No, I am not suggesting that that be the case here.

COMMISSIONER POWELL: Okay. **Page 20, line 7**, you go on and talk about, "The Crown corporate structure, however, should not be construed as a means to shift to taxpayers the actual economic cost of providing electric utility service." What do you mean by economic costs?

MS. McSHANE: Well, specifically in this regard I was focusing on the cost that, the opportunity cost that is associated with the equity, however, you could view this as encompassing on any of the actual costs of providing the service that are not covered by the totality of the rates that are paid, so that if the total cost, including a just and reasonable return on the capital that's provided, are not covered in the revenues that are received by the corporation, then effectively the taxpayers are paying for those costs.

COMMISSIONER POWELL: So economic costs and least costs are two different things, okay. We've heard a lot of reference to utilities using least costs when they, setting rates. So how do you rationalize the economic costs?

MS. McSHANE: I'm not sure of the context in which the terminology "least cost" is being used. The least cost to me as a financial person may mean something different than it does to an engineer, so, I mean, I can only answer your question from my own perspective, which would be that it is good economics to try to provide service at the least cost consistent with safe and reliable service that is possible and the least cost in that regard would still include a just and reasonable return on the capital provided. It doesn't mean less than cost. It just means the least cost.

COMMISSIONER POWELL: Okay. **Page 20, line 8 to 14**, you have, you say, "Although there is clearly an overlap between taxpayers and utility ratepayers, they're not identical." I have no problem with that. You go on to say, "By ensuring that the true economic costs of providing utility service are borne by the ratepayers, appropriate market signals are being sent. If the taxpayer is subsidizing the ratepayer by virtue of setting rates which do not reflect the economic cost of service provided, ratepayers are encouraged to over-consume scarce resources." And that's sort of a motherhood (phonetic) statement, but you talk about the Hydro being a Crown corporation and you talked about social policy and you made an analogy, I think, somewhere about the telephone companies, telephone utilities having to provide telephone services to areas that, not necessarily economical for them. So I'm just wondering if you turn that statement around a bit and substituted where you say taxpayers, put in ratepayers, and you put ratepayers in where you have taxpayers, and rephrase it and said if the ratepayers continued to pick up the cost of the taxpayers' social policy, then the taxpayers are not getting the appropriate market signals and they, encouraged to over-consume scare resources. Would you agree with that? Doesn't that cut both ways?

MS. McSHANE: I have to think about this now. So the ratepayer is subsidizing the ...

COMMISSIONER POWELL: The taxpayer.

MS. McSHANE: Subsidizing ...

COMMISSIONER POWELL: Social policy. Therefore, the social policy planner is being encouraged to over-consume scare resources the same way? Doesn't it cut both ways?

MS. McSHANE: So can ... may I ...

COMMISSIONER POWELL: Sure.

MS. McSHANE: ... see if I ... so are you asking me if ...

COMMISSIONER POWELL: In your statement there, and I ...

MS. McSHANE: Okay. I just want to make sure I understand what your question is.

COMMISSIONER POWELL: Yeah.

MS. McSHANE: So if, for example, the rates of Hydro are set higher than they need to be so that there ...

COMMISSIONER POWELL: There has been some suggestion that there, and I'm not sure which one of the intervenors brought it up, but there's some suggestion that certain ratepayers within the Hydro customer base are not paying the true cost of service and the rest of the ratepayers are subsidizing it, okay.

MS. McSHANE: Oh, I'm sorry. Then I ... okay.

COMMISSIONER POWELL: And so you have brought up the analogy, I think, saying, well, within the context of this being a Crown corporation, there's a certain amount of social policy initiative as well as the economics, and my words and not your words, the defence of that policy, you made the comparison, utilities having provided phone service in areas that they, not economical for them but it's part of the social policy, and so I'm saying, okay, but now there must be a point where you say here that the taxpayers should not have to pick up the cost providing the service and send a message to ratepayers, but there's got to be some point in time, I would think, that's what I'm asking you, would it not, that the ratepayers say to the taxpayers, we should not pick that up and send you a signal, if you want to have social policy you pay for it, not the ratepayer?

MS. McSHANE: I think in the aggregate that's true, that if in total the revenues that are coming out of Hydro would exceed the cost of providing the service and thereby providing excess funds to the province to give them funds to invest in services, that would be true, but I think here we're still dealing with a situation where, you know, within the confines of the Utility itself. We're certainly not dealing with an excess of revenues over cost.

COMMISSIONER POWELL: No, but we're dealing in a situation where we have greater costs than we do have revenue and that cost has been reallocated to other classes to pick up part of Government's social policy.

MS. McSHANE: Well, to the extent that Government policy is that there would be universal service at similar rates, similarly situated customers, there will be some customers that are going to pay less than the actual cost of providing those services to ...

COMMISSIONER POWELL: So what is the point when the signal should be sent the other way instead of ...

MS. McSHANE: That's the Government should then ...

COMMISSIONER POWELL: No, the ratepayer should send a signal to the taxpayer versus the taxpayer sending the signal to the ratepayer. From an economic point of view, you know, is it 2 percent, 22 percent, 5 percent?

MS. McSHANE: It's such a hard ...

COMMISSIONER POWELL: So would you agree that that statement could be turned around?

MS. McSHANE: I agree that it can be turned around.

(10:15 a.m.)

COMMISSIONER POWELL: Okay. Page 25, the note one on page 25, the note attached to the last, you say, line 20, 24, "To achieve a commercially viable capital structure," and you got a note one, and you talk about investors, how they raise money, but you made the statement, "Hydro's sole source of equity funding is through retained earnings." That's not 100 percent correct. Is there not an option for Government in this particular case of Hydro to borrow the funds in its own right and invest it in Hydro's equity rather than just guaranteeing their debt?

MS. McSHANE: Absolutely.

COMMISSIONER POWELL: So, yeah. So that statement, why ...

MS. McSHANE: Yes. I ...

COMMISSIONER POWELL: Probability is (inaudible), is it?

MS. McSHANE: Absolutely.

COMMISSIONER POWELL: Yes, okay. Just ... page 26, line 29, the sentence there partway across, you say, "At the forecast utility capital structure." I couldn't get my mind around that. What do you mean by that?

MS. McSHANE: That phrase, "At the forecast" ...

COMMISSIONER POWELL: Yes.

MS. McSHANE: ... "utility capital structure"?

COMMISSIONER POWELL: Yeah.

MS. McSHANE: The forecast utility capital structure is the proportion of debt and equity that Hydro expects to have in place during the test year, those being approximately 85 percent debt and 15 percent equity.

COMMISSIONER POWELL: So the utility in this case is Hydro.

MS. McSHANE: Oh, sorry, yes, it is, yes.

COMMISSIONER POWELL: Okay, okay. No, that's ... I didn't know if that was a generic term or not, okay.

MS. McSHANE: No, no. That was specific to ...

COMMISSIONER POWELL: Hydro.

MS. McSHANE: ... Hydro but also the utility only capital structure.

COMMISSIONER POWELL: Yes, okay. And you say in line 31, "Absent the provincial guarantee, there will be more than 100 bases points higher." Is that a professional opinion or is that ...

MS. McSHANE: That's a professional opinion based on what the likely credit rating would be of a corporation, a utility corporation which is financed 85/15.

COMMISSIONER POWELL: That's not something I look up in a book and tell me that.

MS. McSHANE: No.

COMMISSIONER POWELL: Okay.

MS. McSHANE: No, and it would differ from time to time too.

COMMISSIONER POWELL: Yeah, sure, I appreciate that. Page 27, okay, page 27, line 10 to 13, I'll see if ... "*The Public Utilities Act* which Hydro too is subject states, 'A public utility entitled to earn annually a just and reasonable return as defined by the Board on their rate base as fixed and determined by the Board for each type or kind of service supplied by the public utility," and I got a note here. I say what is your opinion on this statement when read in conjunction with Note 1 on page 54? Let's go to 54 and see what I got. Note 1 says, "The effective return on rate base requested is 7.35 percent because Hydro is not seeking to earn an equity (phonetic) return on the rural portion of the rate base which accounts for approximately 10 percent of forecast total rate base." Is that reasonable?

MS. McSHANE: The part where it's not asking to earn any return?

COMMISSIONER POWELL: Yes. Uh hum, yes.

MS. McSHANE: Well, that's my understanding of what policy has been and it's also my understanding that that is in some part to offset the fact that the rural customers are not paying rates which fully recover their costs, so that ...

COMMISSIONER POWELL: Would you consider that a reasonable ...

MS. McSHANE: Under the circumstances, I don't think it's unreasonable to have some of this deficit picked up in that fashion.

COMMISSIONER POWELL: And not put it into the rate base for ...

MS. McSHANE: At a full return on equity?

COMMISSIONER POWELL: Yeah.

MS. McSHANE: I think that this is, as I said, I don't think it's an unreasonable way to reflect the fact that the customers are not being asked to fully cover the cost of providing service.

COMMISSIONER POWELL: Legal counsel yesterday were talking and you referred to investor-owned utilities having economic rates, some question about whether rates always covered full cost, and I think you gave some reference to, I think the term you used was economic rates. Would you recommend to the Board that a taxpayer-owned utility that should go down this road in terms of same rates, in terms of ... we heard representation in the last couple of weeks from various people on various issues and everybody had their own, put their own personal spin on things, and so the issue of maybe having different rates for different economic conditions.

MS. McSHANE: I think that every case is an individual case. The specific reference that you made was to a discussion I was having about economic development rate.

COMMISSIONER POWELL: Yes.

MS. McSHANE: Which, generally speaking, are set to at least cover the incremental costs of providing the service, that it's not the fully-embedded cost, with the intention that in the future those entities which received the economic development rates will be in a position to allow the overall unit costs of providing service to be lower, because they, these entities and whatever secondary businesses that they bring in around them will be there to help spread the fixed costs around and effectively lower unit costs. So, you know, I think that you have to consider what the circumstances are and what the potential outlook for the area that you're looking at. I don't know that there is one specific answer to that question, but, generally speaking, if it is viewed that a customer who pays his incremental costs of providing service will contribute to the system as a whole, I mean, that's considered to be better than not having the customer on the system.

COMMISSIONER POWELL: My last question. Page 56, line 14 to 16, you're talking about setting the rates and whether we should set a range. At line 14 you said, "Nevertheless, that range would be essentially (inaudible) since the probability of Hydro's 2002 return would approach the bottom end of the range is minimal." What do you make of that statement ...

MS. McSHANE: This morning and yesterday we had a discussion about what the reasonable upper end of the range would be, and I guess we really haven't talked about what the reasonable lower end of the range would be, and I think you can go through the same type of analysis and calculation to determine what the lower end of the range would be, and what I had done to determine what I thought was a reasonable upper end of the range being 9 1/4 percent was to say that with a capital structure of 85 percent debt and 15 percent equity and the recognition that most of the cost of debt is fixed, that there would be not as much room for the overall cost of debt to move as there would be for the return on equity to move. So, I mean, you could look at saying, well, the, let's say that the return on the debt might be as low as 8.1 percent, that would be sort of a 25 bases point differential from what the expected cost is, and let's say lower end of the range of return on equity was 2 percentage points from the return that I determined was reasonable, which was 11 1/4, so that would give you a bottom end of the range of about 8 1/4 percent, so the range then would be, in that regard, 8 1/4 to 9 1/4 if you were actually setting rates for the Company in the expectation that they were going to have rates set on the full cost of capital.

COMMISSIONER POWELL: Okay, thank you very much. That's all, Mr. Chairman.

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

COMMISSIONER SAUNDERS: Thank you, Mr. Chair. Good morning, Ms. McShane.

MS. McSHANE: Good morning, sir.

(10:30 a.m.)

COMMISSIONER SAUNDERS: I just have two questions basically. One is in respect of the application before the Board which was filed in May of this year. Have you given any thought or have you developed any numbers, I guess, in respect of what kind of a request in respect of the ROE, for example, that the Company is looking for, might have ensued if this application had been made back in 19-, say, '97, shortly after the Company became fully regulated by the Board?

MS. McSHANE: What return might have been requested in ...

COMMISSIONER SAUNDERS: Well, I'm wondering if, how much catch-up are we playing in terms of the application being made at this point in time. It seems to me that we are playing some catch-up, because the Company is requesting a three percent ROE and at the same time putting forward evidence through you and others that really we need 11 1/4 or some number in that range, in that area. So what degree of catch-up are we playing today and what would have been the case had the application or had an application been made in '97? Would we have avoided the catch-up?

MS. McSHANE: I'm not really sure that I'm understanding your question. From my perspective, I don't see that anything that's being proposed here reflects a catch-up. The Company may not have come in, you know, as soon as the new legislation was passed, but I don't see anything that's being proposed in this application that says, well, we sort of have an entitlement to this type of treatment as early as 1995. We didn't ask for it. Now we have to seek something that picks up what we were, by legislative orders, entitled to. There's none of that in any of the numbers that I've put together. I mean, this is simply a recommendation which would have been the same had the legislation been in '95, '97 or last year.

COMMISSIONER SAUNDERS: Let's take then the example, if I might, of the application, and I'll find the reference now in a moment ... bear with me. Too many pieces of paper. Oh, here. It's **the application, page 8**, where in paragraph 10, and I'll read it to you, "approving pursuant to Section 70 of the Act the continuation of the existing policy for setting the rates charged isolated rural system customers with the exception of government departments and agencies." Now, if the application had been made, and I think if you go back through Board orders, Board reports to the Minister under the old system of regulation, the question of the subsidies was, I think, raised and intended to be phased out in five years. Now the matter of that subsidy to government departments and agencies is still in place and here we are in 2002 test year with a request from the Company that we now do something with this. I'm saying that it probably should have been done in '97 or commenced in '97, and if so, and this is an example because there are others, what then would be the Company's request today in respect of an ROE? Would it have influenced the 3 percent or the 11 1/2 or the 11 1/4 percent one way or the other if this subsidy had been taken out in '97?

MS. McSHANE: All I can respond to is with respect to my recommendation, because I'm not privy to what the, any relationship there might be as between, you know, what the Company is asking for in terms of these rate changes and its request, specific request for the return for this test year, but from my own perspective as far as what the Company is suggesting and as per my evidence should be the long-term targets, those values are not at all dependent on the history of the Company's request for changes in rates. They are simply made with regard to what is appropriate for a Crown corporation but have no particular ... wouldn't change in any way because of these other circumstances.

COMMISSIONER SAUNDERS: So there wouldn't be any impact in your opinion.

MS. McSHANE: No.

COMMISSIONER SAUNDERS: Let's get away from that and talk about the impact, if you like, of the events in the United States on September the 11th on the, on any of your financial recommendations or projections, and I would like to hear your comment on that in terms of what this Board should take into account in respect of short or long-term impact, if anything.

MS. McSHANE: With specific reference to the evidence that I presented.

COMMISSIONER SAUNDERS: Yes.

MS. McSHANE: Well first of all, I guess, I would say that generally speaking the events of September 11th have resulted, as we all know, in potentially severe economic consequences in both the US and Canada. I think, however, that there is still an expectation that by the end of next year that both countries will have been able to pull themselves out of those circumstances and be back on the road to economic health. Now clearly there's a lot of uncertainty surrounding that, I can't deny that, because so much of it is dependent on both consumer and business confidence, and it's very difficult to assess what that confidence level is going to be because these are circumstances that we haven't faced before. Generally speaking, with regard to where this would, what this would do to the recommendations that were put into this testimony in light of the circumstances that were prevailing when it was prepared, I would say that the cost of capital at this time, the cost of equity in particular is somewhat lower than it was before, that if I were preparing this testimony today that I would likely recommend a return on, full return on equity of 11 percent instead of 11 to 11 1/2 percent. I have not gone through and done a full update of the testimony for the very practical reason that for the test year Hydro has not requested that a full normal rate of return be approved, and as a result it seemed to me that it was not a reasonable analysis to go through, particularly because there are a lot of uncertain circumstances that do factor into where these numbers come out and the major deviation between what the cost of capital is and what's being requested.

COMMISSIONER SAUNDERS: I said that was the last question but there is one more that's prompted by something you said. I don't know if anyone asked you this before. In your experience are you familiar with any other example, especially one where you may have been involved, of a company coming forward such as Hydro is now, seeking a much lower return on equity, and we know the circumstances, than what may be justified? Do you recall any other situation in which you may have been involved as an expert where that occurred?

MS. McSHANE: Not to the same extent, but, yes, I have been involved in situations where the company has asked for a return that's lower than what I've recommended and the rationale was virtually identical, that being that although the company believed that it was entitled to a return at the level that was recommended when it assessed that as far as what would be required in terms of rate increase. It did determine that it would be willing to live with a somewhat lower return in order to avoid increasing rates to that extent.

COMMISSIONER SAUNDERS: Okay. Thank you, Ms. McShane, Chair.

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

COMMISSIONER WHALEN: Good morning, Ms. McShane.

MS. McSHANE: Good morning.

COMMISSIONER WHALEN: I did have some questions on the dividend policy but I understand that the Chair is going to pursue that area with you so I'm going to defer to him but reserve my right to ask a follow-up question if necessary, if that's okay. I won't ask any questions at this time, thank you.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Commissioner Whalen. Once again, good morning ...

MS. McSHANE: Good morning.

MR. NOSEWORTHY, CHAIRMAN: ... Ms. McShane. Thank you for your testimony.

MS. McSHANE: Thank you.

MR. NOSEWORTHY, CHAIRMAN: I can advise that last night after being in bed and watching the World Series I rolled over and I was thinking about the cost of capital, *(laughter)* and you've provided a lot of food for thought in two and a half days or I'd have a problem. It's probably a little bit of both maybe. But I do have a few questions for you, but there are a few. Basically I think a lot of these involves themes around your testimony and I know, I noticed starting off on the first day of your testimony, and I'm just reading from the transcript here now, in response to Ms. Butler's questions, and you say, "Clearly they," and I think you're referring to the Board here, "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." And I think you go on as well on line, sorry, page 15, to say, "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." And I think there's other references that you would have made over the past couple of days to that. I wonder could you elaborate for me a little bit on what these principles would look like, what these principles would entail? I think quite clearly from a quantitative point of view you've said that 11.25, looking down the road a couple of years, could change depending on circumstances. So the quantitive *(sic)* aspect of these principles would be very fluid, again looking to the future. Could you just paint a little picture of what you mean when you talk about that, please?

MS. McSHANE: I think what I had in mind was that what I would like to see the Board do would be to establish that the same principles that it referred to when setting a return for Newfoundland Power back in **Order PU-16 1998/99** was set forward, would be equally applicable to Hydro, and I think that there is a fair overlap between the principles for setting a return on equity that I have in my testimony at page 27, starting at line 20, where the question is, "What standard should underpin the determination of a just and reasonable return on equity for Hydro?" And then I go on to set forth what those principles are, and those three main principles are at the top of page 28, lines one to four, and they are, "To earn a return on the value of the property, of its property commensurate with that of comparable risk enterprises, maintain its financial integrity and attract capital on reasonable terms," and I believe that in **Order PU-16** dated July 31st, 1998, that this Board set forth virtually these same principles, and I'm referencing page nine of that decision where it was stated, "A public utility must be able to assure its financial integrity so that it can maintain a sound credit rating and be able to attract additional capital when required. In order to maintain access to capital financing it must achieve earnings comparable to those of other companies with similar risk. The rate of return on capital must be high enough to attract capital but electric power should be delivered to customers at the lowest cost consistent with reliable service. These principles apply to all forms of capital, whether in the form of debt or equity." And so from my perspective those would be the same principles that should apply in these circumstances, and specifically then I don't think that the Board needs to, at this juncture, set a specific number for a return but wait until such time as Hydro requests a full normal rate of return and at that point I think that the Board should do what it did in the case of Newfoundland Power, which is then to look at all of the individual tests and to determine what indeed it believes is a return that's consistent with those principles.

(10:45 a.m.)

MR. NOSEWORTHY, CHAIRMAN: Okay, thank you. The next question I have really relates to the dividend policy, and I think you had commented again in your, there are references there that I won't go to, but I think I have the words right. In relation to the whole question of debt, equity and the dividend policy, and I think your words were that indeed these play off one another. I think you had made that comment at one point in time throughout your testimony, which seems to me that clearly these are linked. You also had indicated that it wouldn't be necessarily within the purview, and I agree, of this Board, to, certainly the shareholder would have the right to set whatever dividend policy it would wish, and that our focus should be on the capital structure. Given that these play off one another, I guess clearly in a test year, depending on what Government decided to do in relation to its dividend policy, it would impact, if you would, the debt-equity ratio of Hydro, and I think you referred to looking down the road to the need for, and again I believe the words are correct, but predictable, compatible and supportive dividend policy. How would you see this Board influencing that through, and clearly in the test year, through the capital structure on our approach to the capital structure? How would you reconcile those if you were sitting here?

MS. McSHANE: That's a very difficult question. The only circumstance I'm aware of where I'd know where a board actually was able to directly influence the dividend policy was in a case where the company under its jurisdiction was bought by another company and basically the acquired company has to sign undertakings that wouldn't, it would not impair the capital structure. I don't think that in this particular case that the Board has that ability, so I'm not sure that there's anything that the Board can do to influence the actions of the shareholder. I think that, you know, that role really has to be taken on by the management of the Company to interact with its shareholder to make it aware of what it is trying to accomplish in terms of actually behaving as a commercially-viable company with policies that are consistent with that. I think that effectively the Board has to ensure that it is not allowing a return on capital that is higher than would otherwise be required as a result of actions of the shareholder and I think that the way that it can do that is by the type of approach that I have put forward in terms of determining what the overall cost of capital should be and I think that Dr. Kalymon, although we may not agree specifically on the value of the equity return, but his approach would be similar so that we would ensure that the cost of capital overall is not, that's paid by customers is not greater than it should be because of actions of the shareholder.

MR. NOSEWORTHY, CHAIRMAN: Thank you. That's my only question on the dividend policy. Ms. Whalen, do you have any follow-up?

COMMISSIONER WHALEN: I may. I'll just ...

MR. NOSEWORTHY, CHAIRMAN: Okay. The next question I have relates to, you indicated that the methodology that, or the approach that you've taken indeed in looking at Hydro would be by way of proxy, looking at other similar companies. What would they be or where would they be?

MS. McSHANE: Well ...

MR. NOSEWORTHY, CHAIRMAN: You have mentioned 17 companies yesterday in respect to the comparable earnings test. Would they be the type of companies you'd ...

MS. McSHANE: Well they would be one type of company. That would be looking at unregulated companies. The other types of companies that you would look at would be other utilities with market data. The reason that you have to have companies with market data is because those are the only ones for which investors have spoken, if you will, on the relative risk from which you can derive risk values, discounted cash flow cost estimates. In this particular evidence, my samples of proxy utilities included those utilities which are publicly traded in Canada as well as a sample of low risk, electric utilities operating in the United States.

MR. NOSEWORTHY, CHAIRMAN: So this is a finite list that you would have looked at by way of comparison?

MS. McSHANE: It will change. I mean, obviously what's, you know, what's a low-risk electric utility today may not be a low-risk electric utility two years down the road because it's decided to pursue a strategy of acquiring non-regulated generation. So the criteria for selecting companies should stay pretty much the same but the actual companies that fit those criteria will change, and the criteria obviously are not standard. I mean, everybody who applies different tests has somewhat different criteria.

MR. NOSEWORTHY, CHAIRMAN: So in relation to going through this process though you would derive or develop that criteria ...

MS. McSHANE: Yes.

MR. NOSEWORTHY, CHAIRMAN: ... and you would assess that against a number of companies ...

MS. McSHANE: Correct.

MR. NOSEWORTHY, CHAIRMAN: ... which you would select.

MS. McSHANE: Correct.

MR. NOSEWORTHY, CHAIRMAN: Is that correct? Okay. Another question I have, and it's perhaps the little bit of a flip side of my first question actually, and it relates to the fact that in looking at the capital structure and the three percent, I think at this point in time, which everybody concludes is not the appropriate return at this point in time, and indeed we all understand the reasons that would be put forward, and there is certain things, I would think, that would have to be done despite the fact that Hydro is planning to come back in 2003, in two years' time, in relation to movement toward a more satisfactory debt to equity ratio. What is it that you feel that Hydro needs to be doing to, over the next couple of years, to put themselves in a position to prepare, if you will, for that application and following on any principles that the Board might lay down in relation to this application?

MS. McSHANE: One thing I think that Hydro should be doing is addressing its philosophy and concerns with its shareholder to make its shareholder aware of the importance of maintaining a dividend policy which allows it to achieve the parameters that it wants to achieve, and in that regard, you know, making them aware that in order for it to operate as a commercial entity that it needs to be able to plan for whatever capital expenditures that are required and whatever financing is required in the same framework as a company that actually is operating in a commercial context. The other thing that comes to mind is, and this is sort of generic, I suppose, in focus, is that Hydro should probably be looking, in the same way as other electric utilities are looking, at ways to make their operations as efficient as possible so that to the extent that it can achieve returns that are higher than the simple allowed return, because of efficiencies and productivity that it has produced, that internally it has set the stage for being able to build up the equity.

(11:00 a.m.)

MR. NOSEWORTHY, CHAIRMAN: Okay, thank you. My next question relates to the ... you seem to have commented on the fact that at 60/40 the guarantee fee would likely not be necessary. Am I ...

MS. McSHANE: That was ...

MR. NOSEWORTHY, CHAIRMAN: ... understanding you ...

MS. McSHANE: Yes.

MR. NOSEWORTHY, CHAIRMAN: ... to say that? Is that a sort of a straight line ratio as Hydro would move from 85/15 toward that, that the fee would actually decline?

MS. McSHANE: That would be my testimony, yes.

MR. NOSEWORTHY, CHAIRMAN: Could decline.

MS. McSHANE: But that effectively as you move closer to 60/40, the value of that does decline.

MR. NOSEWORTHY, CHAIRMAN: Okay. And I just have one final question and it relates to the belt and suspender analogy, I guess. I guess over two years I certainly could lose weight, become leaner, my belt could become too big, and consequently my pants, you know what would happen to them. *(laughter)* So I want to ... so the idea of having suspenders may not be necessarily a bad idea. Are there any other circumstances that you, that could occur indeed where a range of earnings may be appropriate? And I know you've responded to a question this morning and said, along these lines, and said if the return on rate base exceeded 9.25 percent you would feel that that might be appropriate. Are there any other circumstances where indeed you might feel that might be appropriate?

MS. McSHANE: I'm sorry, I'm not following, what circumstances you're, you might be referring to.

MR. NOSEWORTHY, CHAIRMAN: I think you were commenting on the fact that you feel that a range of earnings, in response to Mr. Fitzgerald's question yesterday, that a range of earnings really wouldn't be necessary, that the chances are remote, I believe that's the word you used, the chances are remote in terms of getting to a point where you need to stipulate a range essentially, and I'm wondering are there any circumstances that might exist? You talk about, a little while ago, the need, I guess, over the next two years for Hydro to become more efficient and presumably on that basis earnings could increase. Are there any other circumstances where a range might be appropriate, because I get the impression that you really don't feel a range of earnings would be necessary, that that's an issue that we should even be addressing?

MS. McSHANE: I guess that my conclusion that a range wasn't necessary was driven by the fact that there is such a spread between what the Company is asking for and what a reasonable upper end of the range would be, that I felt that the probability of getting to a reasonable upper end of the range was so small that it wasn't necessary to initiate an upper end of the range for the return on rate base, and when you're dealing with the Utility only, it just seems that going from 3 percent to, say, 13 1/4 percent, is so highly unlikely that it wouldn't be necessary, and I can't think of any circumstances off the top of my head that would allow the Company to go from 3 percent to 13 1/4 percent.

MR. NOSEWORTHY, CHAIRMAN: Ms. McShane, that's all I have. Thank you very much. I'll go back to my colleague now, Ms. Whalen, to see if she has any further questions on dividend.

COMMISSIONER WHALEN: Yeah, I do just ... I think it's just one question actually, and I think you alluded to it in your response to the Chair's question on what Hydro has to do to get to the commercially viable structure, capital structure. On page 25 of your direct evidence, when you're talking about the 75 percent target pay-out ratio, you make a statement that, "Given Hydro's high debt ratio relative to (inaudible) target, the dividend pay-out should be structured so as to provide Hydro the opportunity to achieve a commercially-viable capital structure." And I guess my first question would be, first part of my question would be that if we continue to see the level of dividend pay-outs that we've seen over the last three years, and I think in each case they've exceeded the 75 percent target pay-out ratio, that this would, would this affect Hydro's ability to achieve the commercially sound viable structure that you refer to?

MS. McSHANE: If the pursuit of the dividend policy is such that there is no room for improvement in the capital structure, yes, I mean, that's what's going to happen, so, I mean, in order for them, for the Company to achieve the proposed targets, I mean, it has to convince the shareholder that they work together to ensure that the targets can be met.

COMMISSIONER WHALEN: And I guess that leads into my, the second part of my question, and it relates to the comment I think you made yesterday, or perhaps it was Monday, when Ms. Butler was (inaudible), that you made the comment that the dividend policy should be based on the needs of the Corporation and not the needs of the, well in this case, the Government, which is the shareholder, and I'm wondering how that comment or that statement actually comes into play practically for Hydro and I guess your comment to the Chair a few minutes ago that the Board really has no role there, that has to be something that happens between Hydro and its shareholder, that they have to have that discussion to come up with an understanding, I guess, (inaudible) for where they're going. But would the dividend policy as it exists have to change either in substance or even in terms of the actual numbers to allow that shift from it being a policy or a demand based on the Government, the shareholder's needs as opposed to the Corporation's needs?

MS. McSHANE: I'd like to preface my answer by stating that if I said exactly what you said, I may have overstated the, what the rights of the shareholder are. Clearly the dividend policy of any corporation is going to be a balance between what the shareholders want and what the corporation needs. If, for example, we have a company that is a utility and then the shareholders expect a certain dividend policy from a utility that's different from the dividend policy of a high growth (phonetic) company which may pay no dividends. That having been said, I mean, I think you can put an additional caveat on the dividend policy which refer to the needs for, you know, capital expenditures, but at the end of the day, I mean, the policy is only a policy and perhaps there does need to be some further tightening of the policy which reflects a shareholder's understanding of what the needs of the corporation are so that it's not just, for example, and this is just an example, it's not just at 75 percent of net income but, you know, perhaps it's, the level of that may be changed to reflect the fact that there is an agreement between shareholder and management that, for the target capital structure ratios to be achieved there has to be some different amount of operating income that's paid out.

COMMISSIONER WHALEN: And just the last question on the issue of catch-up, I think it was referred to this morning on redirect by Ms. Greene, do most investor-owned utilities typically pay out the maximum dividend allowed in every given year?

MS. McSHANE: I think we have to distinguish between utilities that actually pay dividends as in a dollar per share per quarter and utilities who pay first to the corporate parent and then the corporate parent pays to the individual shareholder.

COMMISSIONER WHALEN: That would be the case of Fortis, Newfoundland Power, that it ...

MS. McSHANE: Right.

COMMISSIONER WHALEN: ... that last example.

MS. McSHANE: And I'm not ... if I use Fortis and Newfoundland Power as an example, I'm only using it totally illustratively. I don't ... you know, I'm not making any comments about what they actually do but just what they can do. A company like Fortis which has various subsidiaries which will produce various flows of income in every given year may take dividends from the individual subsidiaries in very varying amounts from year to year, depending on what those particular entities are doing, what cash flows they're producing, so that it can ultimately maintain a fixed dividend per share to its individual shareholders, so typically what you'll see is that a utility like Fortis will, you know, they may pay a dividend of $1 per share and, you know, their policy is perhaps to, on balance, pay out a certain amount of income, but really what you observe is that they're going to try to maintain the dividend per share and grow it over time. They're not going to say, well, this year it's $1, but next year I made less money so it's going to be 95 cents. No, I mean, that's not the way it's going to work. It's going to at least be $1 unless for unforeseen reasons there is just no way that it can pay the dividend, but it will make every attempt to maintain and grow the dividend over time.

COMMISSIONER WHALEN: So if the owner doesn't take out the maximum that they can take out based on policy or what they are able to take, would there normally be sort of a carry over amount that is understood it could be taken at any, at a subsequent time?

MS. McSHANE: I have to say that I really haven't studied what other companies have done in that regard, but I think in principle there doesn't seem to be any reason why they shouldn't be able to.

COMMISSIONER WHALEN: I guess that's fine then.

MS. McSHANE: Yeah.

COMMISSIONER WHALEN: That's ... yeah. It was just really to, the issue came up this morning about the 40 percent since 1975 and the last three years. I was just trying to understand that in principle there's ...

MS. McSHANE: I mean, they are entitled to the earnings and, I mean, there's no reasoning in principle that they shouldn't be able to play catch-up in that sense.

COMMISSIONER WHALEN: Okay. I apologize for the disjoint ...

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Whalen.

COMMISSIONER WHALEN: Thank you very much.

MR. NOSEWORTHY, CHAIRMAN: Thank you once again, Ms. McShane. I apologize to those who have dependence on nicotine or caffeine. *(laughter)* We're running 20 minutes over but I thought it would be appropriate to try and complete the Board questions, in any event. We'll come back around 11:30 hopefully, 11:35, and we'll begin questions on matters arising. Thank you.

(break)

(11:40)

MR. NOSEWORTHY, CHAIRMAN: Thank you. We can proceed directly to questions now on matters arising. We begin with Newfoundland Power, please, Ms. Butler.

MS. BUTLER, Q.C.: Thank you, Mr. Chairman. Ms. McShane, I'm sure there won't be difficulty with anybody else in the room, this question actually arises from Ms. Greene's redirect that resulted from a correction to the transcript from a question that I had asked on October 29th, rather than a question from the Panel, if I might. Can we see the transcript for October 29th, please, and it was page 15. And the question that was put to you started at line 11 in the hard copy. There you go. The question has now been technically corrected so that it reads, "Okay. And Mr. Wells, as President, testified that the increase in wholesale rates over the five-year financial planning horizon would be at total of 26 percent." And what I need to follow through with you, Ms. McShane, is whether, in fact, with that correction, your answer to the question at page 19 remains ... I'm sorry, at line 19 remains the same?

MS. McSHANE: Well, that's sort of difficult to say, now, that the answer is the same, since we've gone back and looked at the transcript. So I'd say that my understanding is the testimony of Mr. Wells.

MS. BUTLER, Q.C.: I guess the question was, though, that an 11.25 percent return would be a significant contributor to the increase, whether it's an increase ...

MS. McSHANE: Oh, I'm sorry, you're looking at those lines?

MS. BUTLER, Q.C.: Yes.

MS. McSHANE: Yes, in principle the answer would remain the same.

MS. BUTLER, Q.C.: Thank you. Mr. Chairman, the only other question I have arises from **Exhibit KM-3** which was entered this morning. I believe it's electronically stored. What I'd like to do, Ms. McShane, if you can bear with me, is indicate the impact if the debt equity ratios were, in fact, 80/20 and the cost of debt remained at 8.35 and the return on equity remained at 3 percent. So we can do the math as we sit here, can we not?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Okay.

MS. McSHANE: We can do math. Sorry, have we gotten as far as a question yet?

MS. BUTLER, Q.C.: Well, what I'd like the Board to see is the effect on the return on rate base of debt to equity ratio of 80/20 with the costs remaining as they are in your table, at 8.35 and 3 respectively?

MS. McSHANE: So, you want me to take a rate base number and multiply the ...

MS. BUTLER, Q.C.: No.

MS. McSHANE: Sorry.

MS. BUTLER, Q.C.: No, no, I don't want you to do the rate base number, Ms. McShane. Bear with me.

MS. McSHANE: Okay.

MS. BUTLER, Q.C.: This concerns the issue of the Board deeming a capital structure appropriate. And what I'm suggesting to you was if the deemed capital structure appropriate was, rather than 85/15, 80/20.

MS. McSHANE: Oh, I'm sorry, okay.

MS. BUTLER, Q.C.: Okay. And assuming the costs, as you've indicated them in your table, remain the same. Can we just indicate to the Board, please, what the weighted components would be and what the return on rate base would be. It should be lower, right?

MS. McSHANE: Well, that follows.

MS. BUTLER, Q.C.: Okay.

MS. McSHANE: The same thing as doing 75/25 and ...

MS. BUTLER, Q.C.: Well, we can do that too, if you wish. But if you could bear with me and just follow through with the example for the benefit of the Board. The 80 percent times 8.5 would give you a weighted component of what?

MS. McSHANE: 668.

MS. BUTLER, Q.C.: Thank you. And the 20 times 3 would give you .6?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: For a total of 7.28 as the return on rate base?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Can we do it again, then, for the 75/25? Cost of debt should be 6.26? Am I correct?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: And the return in equity .75?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: For a total of 7.01 return on rate base?

MS. McSHANE: Yes.

MS. BUTLER, Q.C.: Okay. Thank you, very much. Thank you, Mr. Chairman, those are my questions on redirect.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Butler. We move now to the Industrial Customers, please?

(11:45)

MR. HUTCHINGS: Thank you, Mr. Chair. Ms. McShane, I just wanted to pick up on a point that Commissioner Powell raised arising from page 20 of your pre-filed evidence where you talk about the cost benefit to customers being the exemption from income tax, and you discussed that with Mr. Powell, to some extent, this morning. Along those lines I take it you'd be familiar with the type of financing that I understand exists in the United States which I don't believe exists in Canada which is a tax free municipal bond?

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay. How do the ... I mean, can you just explain for us what those are?

MS. McSHANE: They are bonds that are issued by municipalities for public works, typically, and they are not subject to ... the interest on them is not subject to income tax.

MR. HUTCHINGS: Okay. So no matter who holds these particular bonds there is no income tax on the interest that is paid on them, is that correct?

MS. McSHANE: Correct.

MR. HUTCHINGS: Okay. Alright. And typically, how do the yields on those sorts of bonds compare to normal taxable bonds?

MS. McSHANE: They're lower.

MR. HUTCHINGS: They are lower. Do you know by how much?

MS. McSHANE: No.

MR. HUTCHINGS: Okay. If I were to suggest to you that the yield, in fact, may be 60 percent of a taxable bond is that ... would you accept that?

MS. McSHANE: That makes sense, yes.

MR. HUTCHINGS: It makes sense, okay. Alright. So, in the case of the equity that's held by the government in Newfoundland and Labrador Hydro, there is no income tax that accrues to the government on its dividend yield out of the equity, is there?

MS. McSHANE: There's no income tax paid.

MR. HUTCHINGS: No.

MS. McSHANE: So, no, there's no tax allowance in the revenue requirement required to cover off the return on equity.

MR. HUTCHINGS: Okay. But from the point of view of the investor, let's look at an investor in an investor owned utility, a private individual, the return that that individual is getting to the extent that it shows up in his income, either as dividend or capital gain, is generally going to be taxable in some form or another?

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay.

MS. McSHANE: Unless it's in an RRSP or in a pension fund it won't be taxable.

MR. HUTCHINGS: Okay. But in general, the returns that are paid by investor owned utilities to their shareholders result in those shareholders having to pay some tax?

MS. McSHANE: I don't know that you can say that's generally true. I mean, a significant amount of the investments are held in tax free funds and are not taxable.

MR. HUTCHINGS: Do you know what the proportion is?

MS. McSHANE: Not off the top of my head, no.

MR. HUTCHINGS: Okay. You referred to RRSPs ... I don't know what the situation is with IRAs in the United States, but when one takes money out of an RRSP one pays tax on it, in any event.

MS. McSHANE: Right, that's correct.

MR. HUTCHINGS: So that even if the gains accrue without tax for a period of time there's ultimately a tax associated with it?

MS. McSHANE: Ultimately, yes.

MR. HUTCHINGS: Okay. So what other sorts of tax free funds were you talking about?

MS. McSHANE: There are registered education savings plans and there are all sorts of major pension funds, like the teachers' pension fund, the KESS (phonetic) in Quebec, all those kinds of funds.

MR. HUTCHINGS: Yeah. And those funds, to the extent that they ultimately pay out a pension, those pensions are taxable, are they?

MS. McSHANE: Then pensions would ultimately be taxable.

MR. HUTCHINGS: Okay. So one way or another the tax man gets his cut?

MS. McSHANE: At some point, yes.

MR. HUTCHINGS: At some point, yeah, okay, but in terms of the return that an investor would require, if the investor, at some point, as I say, has to pay some tax, the investor needs a return that's going to cover his tax as well as what he really wants to put in his pocket, correct?

MS. McSHANE: That's true for individual investors, yes.

MR. HUTCHINGS: Yes, okay. The individual's investor focuses on after tax returns?

MS. McSHANE: The taxable individual retail investor?

MR. HUTCHINGS: Yes.

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay. And so, to the extent that the universe of investors in IOUs are taxable they need a larger return than they would need if they were not taxable, do you agree?

MS. McSHANE: Generally speaking, that's true, but that's not the way that the required returns on equity for investor owned utilities are typically evaluated. I mean, we do not, in the context of regulatory proceedings, try to determine what the tax position is of the individual investors.

MR. HUTCHINGS: No, because it would be practically impossible to do that.

MS. McSHANE: Right, and a significant number of them are not taxable.

MR. HUTCHINGS: Yeah. There would be some that would be not taxable, others that would be taxable at different rates?

MS. McSHANE: That's correct.

MR. HUTCHINGS: But overall, would you agree with me that the effective universal tax rate for the universe of investor owned utility investors is not zero?

MS. McSHANE: That's probably true.

MR. HUTCHINGS: Yes, okay. On the other hand, we do know that the effective tax rate for the shareholder of Newfoundland and Labrador Hydro is zero, correct?

MS. McSHANE: Yes.

MR. HUTCHINGS: And have you adjusted your required rate of return downwards to take into account the fact that Hydro doesn't need to recover ... the Government of Newfoundland doesn't need to recover any tax?

MS. McSHANE: No, I have not.

MS. GREENE, Q.C.: Excuse me, I would like to object to the line of questioning. I wonder if Mr. Hutchings could indicate how this relates to a clarification of a question arising from the Panel. This is not supposed to give the opportunity to do cross one may have forgotten to do, and I think I've been indulgent, to date, with this, and I wonder if he could indicate how this does relate to a clarification and how much more he has with this line of questioning?

MR. HUTCHINGS: Mr. Chair, Commissioner Powell raised, this morning, the issue that is raised at the bottom of page 19 and the top of page 20 as to what are the actual cost benefits to customers from the fact that Hydro is, in fact, a Crown corporation. And this is one aspect of those benefits, from our point of view, that was not raised by Ms. McShane, in her discussion this morning with Mr. Powell. I mean, I'm effectively very close to the end, if not at the end of my discussion with Ms. McShane, but I don't think that's relevant one way or the other. I think it is very appropriate that this is a question that arose out of the issue raised by Mr. Powell this morning which had not been raised with Ms. McShane earlier.

MS. GREENE, Q.C.: But it certainly was raised in Ms. McShane's evidence. And the opportunity was there of Mr. Hutchings, as counsel, if the Industrial Customers wished to pursue it. My concern is with respect to questions arising from questions of the Commissioner, we not sway back into cross-examination, which has happened before with the Industrial Customers and which, in my view, is happening again. Ms. Butler, with respect to hers, did ask a question which, again, not necessarily from redirect, but I didn't object at that time because it is helpful to the Board from time to time for lawyers not to rely on their strict legal rights and to ensure that all the information is there before the Panel. However, I am concerned with respect to the scope that has occurred twice now on questions arising from the Commissioners. And I'll leave it at that if Mr. Hutchings has said he's near the end of this particular line of questioning.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Greene. Mr. Hutchings.

MR. HUTCHINGS: Thank you, Mr. Chair. I'm trying to get back to exactly where we were, Ms. McShane. Did you answer my question as to whether or not you had, in fact, made any adjustment to your proposed allowed rate of return to take into account the fact that the Government of Newfoundland, as shareholder, did not need to recover any tax allowance in respect of this investment in Hydro?

MS. McSHANE: No, I did not.

MR. HUTCHINGS: Okay. Thank you. I want to refer, also, to a question that you discussed with the Chair this morning in terms of how the Board could deal with the issue of payment out of dividends by Newfoundland and Labrador Hydro, and you said this was, in fact, a very difficult question. Would you agree with me that dividends can only be paid out of Hydro from retained earnings?

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay. Would you agree with me that the Board, in fact, has the power to direct the manner in which Newfoundland and Labrador Hydro keeps its code of accounts, keeps its financial accounts?

MS. McSHANE: Yes.

MR. HUTCHINGS: Okay. So, would there be a possibility to accommodate the Chairman's request by the Board directing Hydro to retain certain amounts in certain accounts, which would, therefore, not be available out of the retained earnings account for the purpose of payment of dividends?

MS. McSHANE: I don't think I'm qualified to answer whether that's in the Board's purview or not.

MR. HUTCHINGS: Okay. Alright, that's fine. That's a question that you would defer, perhaps, to an accountant or, I mean ...

MS. McSHANE: Well, no, I'm not sure it's a question for an accountant. I mean, I think it's a question for somebody who ... perhaps a lawyer who understands what the Board can and cannot do.

MR. HUTCHINGS: Okay. That's fine. Thank you, Ms. McShane. Thank you, Mr. Chair. Those are all my questions.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Mr. Hutchings. Consumer Advocate, Mr. Fitzgerald, please?

MR. FITZGERALD: Thank you, Mr. Chairman. Ms. McShane, just one area. And this question really arises from a line of questioning that was pursued by Commissioner Powell and the Chair, again, regarding the range of a rate of return on rate base. And just to go through it, I think this morning you mentioned that if you were pressed to put a range on the upper limit of rate of return on rate base that that would be a figure of 9.25 percent?

MS. McSHANE: Yes.

MR. FITZGERALD: Did you say that? And that's based on a capital structure of 85/15?

MS. McSHANE: Yes.

MR. FITZGERALD: Yes, okay. So now, I think you've also given evidence that you believe that a range is not something that the Board should be concerned with, it's probably irrelevant in this case, because of, in your estimation, the unlikelihood of Hydro achieving such returns in the test year?

MS. McSHANE: Correct.

MR. FITZGERALD: But you have said, if pushed, it would be nine and a quarter?

MS. McSHANE: Correct.

MR. FITZGERALD: Now, obviously that's a weighted figure that would include a return on equity and a return on debt. Could you quickly, for the Board, calculate what return on equity would be if the weighted average rate base was nine and a quarter? Would you have a figure in mind?

MS. McSHANE: What, what the upper end of the range of the return ...

MR. FITZGERALD: Well, what would that wash out to, to give Hydro on a rate of return on its equity alone?

MS. McSHANE: It's 13 and a quarter, approximately.

MR. FITZGERALD: Thirteen and a quarter?

MS. McSHANE: Right. The idea was that they would have a spread of 200 basis points on the rate of return on equity which represents about 15 percent of the capital.

MR. FITZGERALD: Okay. So you would say that, just to get this straight, now, that if ... based on a capital structure of 85/15?

MS. McSHANE: Right.

MR. FITZGERALD: Based on a total return rate base of nine and a quarter?

MS. McSHANE: Correct.

MR. FITZGERALD: That if you spit that out the rate of return on equity is only going be 13 percent?

MS. McSHANE: The idea was that to determine what a range would be.

MR. FITZGERALD: Yeah.

MS. McSHANE: Okay. I would say that given the fact that 85 percent of the capital is debt, and most of the debt cost is embedded, that you don't need to make allowance for a significant deviation from the forecast cost of debt in the guarantee fee. So, what I did was took the 8.35 percent debt cost and said, well, a reasonable allowance would be at 25 basis points on the debt cost. So, perhaps the debt cost could be as high as 855. That's ...

MR. FITZGERALD: Okay. I would suggest to you that we've calculated that and we arrive at a figure that's significantly higher than that as a return on equity. So I'm wondering if I could request an undertaking from you to actually illustrate your calculation for the Board?

MS. McSHANE: Absolutely.

MR. FITZGERALD: Okay. So, you would indicate, however, to the Board, that based on your figures that the rate of return on equity would be 13 and ...

MS. McSHANE: And a quarter.

MR. FITZGERALD: And a quarter?

MS. McSHANE: That was the intention.

MR. FITZGERALD: Okay.

MS. McSHANE: And so, I will go through and produce a schedule showing how I arrived at that.

MR. FITZGERALD: Okay. Now, your evidence to the Board, though, has been that a reasonable rate of return on equity for Hydro, and I think this morning you said you might even be prepared to put the mid range at 11 percent?

MS. McSHANE: That's correct.

MR. FITZGERALD: Eleven percent. Which you have categorized as a fair and reasonable return on rate basis ... I'm sorry, on equity?

MS. McSHANE: Correct.

MR. FITZGERALD: Correct. So, by implication, then, what would a 13.25 percent return on equity be defined as?

MS. McSHANE: I'm not sure you'd define it as anything.

MR. FITZGERALD: Would you still classify it as a fair return on equity?

MS. McSHANE: It's not unreasonable to expect the returns for utilities to vary plus or minus two percent from the level that's allowed.

MR. FITZGERALD: Have you presented any illustration, whatsoever, indicating that any of your selected companies have achieved a return like that on equity?

MS. McSHANE: Of 200 basis points above what's been allowed?

MR. FITZGERALD: Um hm.

MS. McSHANE: Not to my knowledge, in this evidence, but clearly, that's ... I mean, that's been the case in the past.

MR. FITZGERALD: Okay, but not as your evidence as filed here?

MS. McSHANE: I have not presented a table in here which does a comparison of actual and allowed returns, no.

MR. FITZGERALD: Okay, those are my questions, Mr. Chairman.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Mr. Fitzgerald. Mr. Kennedy, Board counsel, do you have any?

(12:00)

MR. KENNEDY: I have no questions, Mr. Chair.

MR. NOSEWORTHY, CHAIRMAN: Thank you, very much. Ms. Greene, anything arising from that?

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

MR. NOSEWORTHY, CHAIRMAN: Thank you, very much, Ms. McShane, for your testimony. Thank you. It is five after. We have 25 minutes. I'm just trying to establish now, would you be prepared to bring on your next witness, Mr. Hall?

MS. GREENE, Q.C.: Yes, Mr. Chair, Mr. Hall is available as the next witness to start at this time.

MR. NOSEWORTHY, CHAIRMAN: Okay.

MS. GREENE, Q.C.: I will not be very long with Mr. Hall.

MR. NOSEWORTHY, CHAIRMAN: Okay. Do you, Ms. Butler, have an element or a component that you could get through in 25 minutes.

MS. BUTLER, Q.C.: Sure, no problem, no problem.

MR. NOSEWORTHY, CHAIRMAN: Okay. Thank you, Ms. McShane, once again. Good morning, Mr. Hall.

MR. HALL: Good morning.

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

MR. HALL: I do.

MR. NOSEWORTHY, CHAIRMAN: Thank you, very much. You can be seated. I'd ask Ms. Greene to continue.

MS. GREENE, Q.C.: Mr. Hall, pre-filed evidence was filed in your name with Hydro's application on May 31st. Do you adopt this pre-filed evidence as your evidence for the purpose of this hearing?

MR. HALL: Yes, I do.

MS. GREENE, Q.C.: That concludes the direct examination of Mr. Hall by Hydro.

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

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

MR. NOSEWORTHY, CHAIRMAN: Newfoundland Power.

MS. BUTLER, Q.C.: Good afternoon, Mr. Hall. I noticed in your pre-filed evidence you work with the Royal Bank Financial Group?

MR. HALL: Yes, that's correct.

MS. BUTLER, Q.C.: And you hold a chartered financial analyst designation?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Can you advise the Board, please, how long RBC Dominion Securities has been advising Hydro?

MR. HALL: That's actually in the filed testimony. I went back 50 years and got tired, so it's more than 50 years.

MS. BUTLER, Q.C.: In excess of 50 years?

MR. HALL: Yes.

MS. BUTLER, Q.C.: And during that time period did you also check, Mr. Hall, to see what advice had been given to Hydro on the capital structure that they should maintain?

MR. HALL: I haven't done an extensive review, although partners of mine in the past have testified in previous rate hearings.

MS. BUTLER, Q.C.: And the answer is, what advice has been given in relation to the debt equity ratio?

MR. HALL: To my knowledge, we have not been asked on debt equity ratios in the past because of the interest coverage form of regulation in the past.

MS. BUTLER, Q.C.: Can you tell us, then, what form the advice did take?

MR. HALL: Again, I'm sorry, I'm recalling it was the partners rather than myself having done this, but the testimony in the past was an adequate interest coverage ratio that would allow the Company to access the capital markets.

MS. BUTLER, Q.C.: And the form that that advice would take, was it annual letters or what?

MR. HALL: No, I'm sorry, I'm referring to formal rate hearings.

MS. BUTLER, Q.C.: Yes. But was there, in addition to advice or a testimony at formal rate hearings, any reports that were submitted to Hydro on an annual or other basis in relation to financial advice?

MR. HALL: Not to my knowledge, but I could check for that.

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

MR. HALL: Not to my knowledge, no.

MS. BUTLER, Q.C.: Much of your testimony surrounds credit ratings, is that correct?

MR. HALL: Yes, it does.

MS. BUTLER, Q.C.: Okay. And can you tell the Board, please, the purpose of obtaining credit ratings?

MR. HALL: Now, the general purpose of a credit rating for a corporation is to provide investors, potential investors in the bonds of that company, with a snapshot of the credit strength, credit worthiness of that company so they can be compared on a fairly easy basis with other companies of similar risk, so that the investors can determine whether they wish to purchase those bonds or not.

MS. BUTLER, Q.C.: And specifically, can you tell us who or what DBRS is?

MR. HALL: DBRS stands for the Dominion Bond Rating Service which is one of the services that ... actually, it's now the only service available in Canada that does that sort of credit rating work on behalf of potential investors.

MS. BUTLER, Q.C.: I wonder if we might turn then electronically, to your evidence, Schedule 1, and have a quick glance of what you provided here? Schedule 1 has three pages, which is up to the top right-hand corner. So we have page 1 of 3, which is indicated as Provincial Ratings, Long-term Debt, Province of Newfoundland and Labrador. And then page 2, if we might? A different document. Commercial Paper and Short-term Debt Ratings, Newfoundland and Labrador Hydro. And then as page 3, again, a third distinct document, Bond, Long-term Debt and Preferred Share Ratings for Newfoundland and Labrador Hydro, correct?

MR. HALL: Yes.

MS. BUTLER, Q.C.: And, Mr. Hall, am I correct in suggesting that each of these distinct documents would be generally longer than one page and that what you've attached to your Schedule 1 summary ... I'm sorry, Schedule 1 evidence, is a summary page from each of these three distinct documents?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Can we go back, then to page 1 of 3? And, of course, all three of these are by the same DBRS Bond Rating Service. The first one is dated, in the top right-hand corner, July 13th, 2000, indicating previous report July 22nd, `99. So when this report is dated July 13th, 2000 it covers the period, the 12 month period in between?

MR. HALL: Generally, no. That's the date that it's been produced and they usually are covering the fiscal year 1999, which in that case is what they were doing. They have to wait that long for the financial results to be available.

MS. BUTLER, Q.C.: Okay. And given that this is now October, 2001, I presume that this document, of which you've provided us with the summary page only, would have been redone?

MR. HALL: Yes, it has been.

MS. BUTLER, Q.C.: And do you have, with you, the revised document?

MR. HALL: I have the Company's and I have the commercial paper. I'm not sure, because I was just looking while you were talking, whether I have the Province or not, but it's easily obtainable, yes.

MS. BUTLER, Q.C.: Okay. Well, in fact, we have it with us. Do you agree that generally that would be the current version of the same information for the benefit of the Board?

MR. HALL: If it's dated around October.

MS. BUTLER, Q.C.: Of 2001?

MR. HALL: Of 01, yes, it is.

MS. BUTLER, Q.C.: Okay. Well, I wonder, since we've got that available and to be copied I'll just get that handed out. The report is actually dated July 24th, 2001, Mr. Hall?

MR. HALL: Yes, I see that.

MR. NOSEWORTHY, CHAIRMAN: Do we need to mark this?

MR. KENNEDY: Yes, Chair. It's NP No. 5.

EXHIBIT NP-5 ENTERED

MR. NOSEWORTHY, CHAIRMAN: Thank you.

MS. BUTLER, Q.C.: So you would be familiar with this report, Mr. Hall?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Okay, and to the extent that it is the most current report, similar to the front page of what we have on the screen, we'll just take a look. I think it's eight pages in length?

MR. HALL: Is that a question? Yes, it is.

MS. BUTLER, Q.C.: The first four pages are text and the last four are tables?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Now, the asterisks at the top of the page, please, page 1, in reference to the long-term debt?

MR. HALL: Yes.

]MS. BUTLER, Q.C.: Indicates that this is, of course, issued and guaranteed by the Province including Newfoundland and Labrador Hydro and the Municipal Financing Corporation?

MR. HALL: Yes. On this particular report that's just highlighting for the reader that the Province also guarantees those other two entities.

MS. BUTLER, Q.C.: Yes. Under the heading of Rating Update as well as under the heading of Rating Considerations, Strengths and Weaknesses, can you tell us, please, what reference you note of the Province's debt rating, including a consideration of Hydro's long-term debt?

MR. HALL: There is no consideration of Hydro's long-term debt on this report because it's dealt with on a separate report for Hydro itself.

MS. BUTLER, Q.C.: Okay. And if you looked through the remainder of the text of the report at pages 1 to 4 the only other reference I noted to Hydro was on page 3 in the second column. Towards the bottom one third of that second column is a paragraph beginning with "The difference between," do you see that?

MR. HALL: Yes, I do.

MS. BUTLER, Q.C.: The Bond Rating Service indicates that the difference between the DBRS forecast and the Province's 31 million budgeted deficit reflects adjustments made by DBRS and the fourth of those adjustments is to include the net income of Newfoundland and Labrador Hydro instead of its dividend?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Correct?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Which is how the Province records its return from Hydro on its own books?

MR. HALL: That's my understanding, the Province records the dividend that it receives and not the net income, but Dominion Bond Rating Service considers this to be a wholly owned subsidiary of a company, and therefore it's entitled to the entire net income of the company the way a normal corporation would account, so they've made an adjustment.

MS. BUTLER, Q.C.: Okay, and I think similar notes follow in the tables on pages 5 through 8. Start with page 5, first. There's a footnote about halfway down. Can you just read that for me, Mr. Hall, please, "Historical DBRS"?

MR. HALL: I was afraid you were going to do this. Now I have to get my reading glasses out and tell you how old I am. I'll try it when I'm working. "Historical DBRS suggested the fiscal results have been revised to be comparable with other provinces. The revisions include converting to a modified accrual basis and including the net income of Newfoundland and Labrador Hydro rather than the dividends paid. However, the budget and projected numbers continue to be on a modified cash basis."

MS. BUTLER, Q.C.: And a similar note at the bottom of page 6, note 3, I believe. You want to try that?

MR. HALL: I'm ready. Oh, you want me to read that too?

MS. BUTLER, Q.C.: Please.

MR. HALL: Okay. I'm sorry. "DBRS includes, in revenues, the net income of Newfoundland and Labrador Hydro rather than the dividends paid to the Province. The adjustment converts back to dividends. It includes dividends in excess of less than earnings and special dividends fees."

MS. BUTLER, Q.C.: Okay. Can we conclude, Mr. Hall, from the few references in the Province's long-term debt rating by DBRS to Hydro, that DBRS does not appear to consider Hydro to be a significant strength or weakness in establishing the Province's bond rating?

(12:14)

MR. HALL: No, I wouldn't say that. They clearly have considered Newfoundland and Labrador Hydro's financial results. In fact, they've created two separate reports which talk very specifically about the Company. And I think that's evidence that this is an important consideration for DBRS in determining the Province's own credit rating.

MS. BUTLER, Q.C.: Okay. In terms of Hydro's debt equity ratio currently, the range of 85/15 or 83/17, depending on what time of year we take, certainly dealing with the current debt equity ratio, do you have any indication that there has been a negative effect on the Province's debt rating of Hydro's debt equity ratio?

MR. HALL: That's a very difficult question to answer, because, as you would expect DBRS to do, they don't have formulas that are easily duplicated to determine their ratings. They use a combination of quantitative and qualitators (sic.) or subjective factors and come up with the rating that they apply. And so, it's very difficult, indeed, it's impossible for anyone outside of DBRS to determine the specific strength of any particular factor that they use in the rating they come up with. As I said, I think it's important to recognize that they think it's important enough to do individual credit analysis of those companies ... sorry, of this Company, which is an indication that they consider it quite important. But what weight they would apply and if there was pressure on the rating because of that is impossible for outsiders to tell.

MS. BUTLER, Q.C.: Well, do you have any evidence to suggest that Hydro's debt equity ratio had negatively impacted upon the Province's debt rating by DER?

MR. HALL: No, there has been never ... sorry, to my knowledge, there has never been a downgrade which would be clear evidence of the Province's rating because of Hydro's performance. It's as heavy handed as that in terms of being able to find an example. It is true, however, that this particular rating agency has spent the last four or five years emphasising to governments that have high leveraged utilities like this that they are concerned.

MS. BUTLER, Q.C.: Concerned about?

MR. HALL: The level of the debt equity ratio.

MS. BUTLER, Q.C.: Okay. Perhaps we can just leave Schedule 1 for the moment. I'm going to turn, now, to the other two, but I need to break for a second and just go back to the President, Mr. Wells' testimony on September 24th. I think what I'm looking for was at page 32, lines 26 to 30 of the hard copy. It turns out to be the same here. The question I had put to Mr. Wells at that time, Mr. Hall, was whether, to his knowledge, Hydro's operation with a debt equity ratio of 80/20 or 83/17 had any negative impact on the credit rating of the Province, and he indicated, "No, nor should it, at that level for that term." Are you saying something different?

MR. HALL: I don't think so, no.

MS. BUTLER, Q.C.: Okay. Do you agree with President Wells when he suggests that with a debt equity ratio of 80/20 or 83/17 Hydro's debt equity ratio should not have a negative impact on the credit rating of the Province?

MR. HALL: Yes, with a caveat, if I may. An 80/20 debt equity ratio, in and of itself, does not mean that there would be a negative impact on the credit rating of the Province, so in that respect, he's right. I would have to assume that in addition to that, however, that there's a proper rate of return on the 20 percent equity that would allow sufficient cash flow to make that so. In other words, that 80/20, by itself, if the equity portion, the 20 percent was earning no return, just to take an extreme example, then I would have to disagree. But I don't believe that's what he is saying.

MS. BUTLER, Q.C.: Let's turn, then, if we might, to page 2 of your Schedule 1. Now, we have the Company's, that's Newfoundland and Labrador Hydro's Commercial Paper and Short-term Debt Rating, September 20th, 2000. And just take a quick glance at page 3, the Company's bond, etcetera, ratings, September 20th, 2000. You indicated that both of these have been updated?

MR. HALL: Yes.

MS. BUTLER, Q.C.: And do you have either handy for the Board?

MR. HALL: I have both here. You can make copies if that's ... if you want them.

MS. BUTLER, Q.C.: If they're not yet copied then we shouldn't give them out, but we have one of them copied. I believe it to be the Company's Bond Long-term Debt and Preferred Share Ratings, which is page 3. So perhaps we'll just pass out page 3 and over the lunch maybe we can accomplish page 2?

MR. HALL: Oh, sure.

MS. BUTLER, Q.C.: Okay.

MR. KENNEDY: NP No. 6, Chair.

EXHIBIT NP-6 ENTERED

MR. NOSEWORTHY, CHAIRMAN: Thank you.

MS. BUTLER, Q.C.: Now I want to take a very brief minute to compare, because the format of the most recent report, which is now dated October 2, 2001 is slightly different. Looking at the screen we'll see that under the reference to Newfoundland and Labrador Hydro the asterisks indicates that the rating is a flow through of the rating of the Province of Newfoundland and Labrador which guarantees the Utility's debt, and this report analyses the Utility. On the hand-out now **NP-6** I wonder, Mr. Hall, if you might just read in the sentence that's in brackets under?

MR. HALL: "The rating is based on the Provincial guarantee. This report specifically analyses Newfoundland and Labrador Hydro."

MS. BUTLER, Q.C.: Okay. But under the update section of **NP-6**, I believe they do indicate that Newfoundland and Labrador Hydro's rating is a flow through of the rating of the Province of Newfoundland?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Okay. Am I correct in saying that although the report presented here analyses Hydro's financial situation, the rating afforded to Hydro is what it is because the Province guarantees Hydro's debt?

MR. HALL: Yes.

MS. BUTLER, Q.C.: And the Company then gets the same rating as the Province?

MR. HALL: Correct.

MS. BUTLER, Q.C.: And looking at the rating history on the screen in comparison to the one that's in our hands we'll see that historically it was low Triple D and that changed between `97 and `98 to Triple B and remains at Triple B. And Mr. O'Rielly, if we might just go back to page 1 of 3 of the Schedule 1? The same thing happened to the Province in the same year, correct, it went from low Triple B to Triple B?

MR. HALL: Yes.

MS. BUTLER, Q.C.: I'm going to move away from the Schedule 1, for the moment, and into your testimony on page 2, that's your pre-filed. Now, at line 23 when asked what business entity you were reviewing you indicated that you were reviewing the regulated portion of Hydro's business, including the supply of power to its customers?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Can I ask you where you obtained the regulated business information, given that Hydro, as a company, has both regulated and non-regulated portions?

MR. HALL: Yes. I just looked at the material that the Company had prepared to file for this hearing.

MS. BUTLER, Q.C.: And can you be a little more specific in terms of where we might look to find the portions that were regulated and the particular documents on which you concentrated or focused that would have assisted you in determining what was regulated?

MR. HALL: No, I can't. Although, I didn't make the determination of what was regulated and what was unregulated, the Company itself did, and the reason for that comment that I have put in there was to ensure that people were aware that I was looking at the regulated assets that this Board is concerned with and not the unregulated assets. But the determination of that distinction was a Company one.

MS. BUTLER, Q.C.: This is a point, though, that I need to understand myself in going forward with your cross-examination, Mr. Hall. So can you tell me, please, what you understand to be a description of the regulated operations?

MR. HALL: Yes. The business of Hydro as pertaining to the generation and transmission and small distribution arm of the business that provides electrical service to customers in Newfoundland and Labrador is the purpose of this hearing, in my understanding. And it specifically excludes the ownership that this company has in the Labrador Hydro ... I said that wrong, Churchill Falls developments.

MS. BUTLER, Q.C.: And the recall sales to Hydro Quebec, are they, to your understanding, included or excluded?

MR. HALL: Excluded.

MS. BUTLER, Q.C.: And have you personally assessed, from a financial statement point of view, what assets are regulated verses non-regulated in the sense of perhaps taking apart the consolidated financial statements of the Company, was that an exercise that you, yourself, engaged in?

MR. HALL: No, I did not.

MS. BUTLER, Q.C.: Was information provided to you by Hydro in instructing you, that set out the regulated assets?

MR. HALL: Well, as I said, the materials that were filed for this hearing, to my understanding, are the regulated assets and the regulated business, so I reviewed those materials.

MS. BUTLER, Q.C.: Included in what you reviewed, Mr. Hall, would have been the consolidated financial statements though?

MR. HALL: I have seen the consolidated financial statements, yes.

MS. BUTLER, Q.C.: Yes, which includes regulated verses non-regulated?

MR. HALL: Correct.

MS. BUTLER, Q.C.: Right. And, as I understand it, Mr. Hall, there are no such things as non-consolidated financial statements for the regulated operations, are there?

MR. HALL: I'm not aware that there are any specific non-consolidated or just regulated assets, no.

MS. BUTLER, Q.C.: Or just the non-regulated?

MR. HALL: Or just the non-regulated.

MS. BUTLER, Q.C.: That being the case, Mr. Hall, can you tell us how you reconciled regulated verses non-regulated assets for the purpose of the task or assignment given to you by Hydro?

MR. HALL: I didn't reconcile them because I didn't feel that I need to. I was looking at the regulated assets with the materials filed by the Company and considered what I believe to be an appropriate capital structure and cost of debt for that entity.

MS. BUTLER, Q.C.: I'm sorry, for what entity?

MR. HALL: The regulated entity that's been filed in this hearing.

MS. BUTLER, Q.C.: Okay. So, and we'll break in a moment, Mr. Hall. But just so we're clear, the entity is, of course, Newfoundland and Labrador Hydro, that is the incorporated body?

MR. HALL: Okay. Sorry, I'll stop using that word.

MS. BUTLER, Q.C.: Alright. And there is no separate company that contains the regulated assets, correct?

MR. HALL: Not to my understanding, no.

MS. BUTLER, Q.C.: Right. Which I know may be somewhat unusual for this business, but that is the case. So ...

MR. HALL: Actually, it's not unusual, no. There's a number of companies in the utility world that have legally separated their businesses between regulated and non-regulated.

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

MR. HALL: So as to avoid confusion on the part of the Board in determining what to look at and what not to look at.

MS. BUTLER, Q.C.: Right.

MR. HALL: But there are also a number of companies that have not done that, and it's, I'm sure, a cause of some confusion from time-to-time, but generally speaking is not a big issue.

MS. BUTLER, Q.C.: Is not a what?

MR. HALL: Is not a big issue.

MS. BUTLER, Q.C.: It's not a big issue?

MR. HALL: No.

MS. BUTLER, Q.C.: Okay. Because in preparing for general cross-examination, on a generic basis, of various witnesses, I must say, I had some difficulty trying to separate out from the consolidated financial statements what may be regulated and non-regulated. So if there is something that you have found more helpful to you in sorting out that confusion I'd be obliged if you could refer us to it so that perhaps we might refer to that during the course of your cross-examination. And, Mr. Chairman, I can stop there for the lunch break.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Butler. Thank you, Mr. Hall. We'll reconvene at 2:00.

(break)

(2:00 p.m.)

MR. NOSEWORTHY, CHAIRMAN: Thank you and good afternoon. Any preliminary matters, Counsel, before we begin?

MR. KENNEDY: Not that I'm aware of, Chair.

MR. NOSEWORTHY, CHAIRMAN: No undertakings, Ms. Greene?

MS. GREENE, Q.C.: There were no undertakings yesterday, Mr. Chair, but we do have a copy of the third of the three reports referred to by counsel for Newfoundland Power just prior to the break, completed by DBRS, and I have copies of that to distribute at this time, I believe that was a request.

MR. NOSEWORTHY, CHAIRMAN: Thank you.

MR. KENNEDY: We should label that DH No. 1, Chair.

MR. NOSEWORTHY, CHAIRMAN: Thank you.

EXHIBIT DH-1 ENTERED

MR. NOSEWORTHY, CHAIRMAN: (inaudible), Ms. Butler, thank you.

MS. BUTLER, Q.C.: So Mr. Hall, the exhibit that's now been entered as DH-1, for the benefit of the record, represents the full and updated copy of what was Schedule 2, page 2, of your pre-filed?

MR. HALL: Yes, I believe so.

MS. BUTLER, Q.C.: Thank you. Can I ask you whether you gave any thought during the lunch break to my request that you, or give me any references to any portion of the cases you reviewed that may be particularly helpful to resolving any confusion between consolidated versus the regulated only portion of Hydro's financial statements?

MR. HALL: Yes, I thought about it. I'm sorry, I didn't come up with anything that I think would be helpful to your request, except for what's been filed by the company.

MS. BUTLER, Q.C.: I wonder if we might look then to **NP-6**, which was the updated version of the DBRS rating on

Hydro bonds, and what I'm pursuing here is your evidence, of course, Mr. Hall, that in giving your evidence, and reviewing information provided by Hydro, of course, you were concerned about regulated operations only.

MR. HALL: Yes.

MS. BUTLER, Q.C.: And the DBRS bond rating for Hydro, under the heading of "update", and this is the hard copy, of course, because ... oh, okay, grand, you've got it entered already ... indicates about halfway down, the sentence starting with ... oh, sorry, no halfway down the update section. The utility's net earnings and cash flows fell significantly in 2000, largely due to the revenue cap on export sales to Hydro Quebec under the three year recall agreement which ended in March 2001, is that correct?

MR. HALL: It's funny, I can't see that but I remember reading it. Yes, that's right.

MS. BUTLER, Q.C.: Okay, and at the end of that same section, update, the favourable renegotiation of the recall agreement with Hydro Quebec for another three years such result in a rebound in the utility earnings in 2001 and a further increase in 2002, correct?

MR. HALL: Yes.

MS. BUTLER, Q.C.: These references tell me that, of course, DBRS is looking at Hydro's consolidated situation as opposed to its regulated only situation.

MR. HALL: Yes, I believe that's correct.

MS. BUTLER, Q.C.: In the section, Considerations, which is just below. Yeah, there you go. The DBRS indicates that it considers one of its strengths, that is Hydro's strengths, is two thirds interest in Churchill Falls.

MR. HALL: Yes.

MS. BUTLER, Q.C.: Which is also not something that you've considered because you're looking at regulated only?

MR. HALL: Yes.

MS. BUTLER, Q.C.: And in the Challenges section, likewise, it makes reference to large Labrador projects which could pressure key debt ratios should construction commence. Is that outside what you reviewed as well?

MR. HALL: Yes, though, I don't think those are in or out of regulation because they're not in existence yet, but I did not consider them, no.

MS. BUTLER, Q.C.: Now, in the DBRS report, in the table at the bottom there, the net debt in capital structure for, and it's the second line there, yeah, percentage net debt in capital structure for 2000 is 66.4 percent.

MR. HALL: Yes.

MS. BUTLER, Q.C.: And of course, in your evidence, we don't need to look at it specifically, but you are referring to the debt ratios being, or the debt to equity ratios being 83.2 percent.

MR. HALL: Yes.

MS. BUTLER, Q.C.: The difference between the 66.4 percent and the 83.2 percent represents the non-regulated operations?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Does DBRS or any other rating service, to your knowledge, rate Hydro's regulated only operations?

MR. HALL: No.

MS. BUTLER, Q.C.: So how do bondholders obtain information on the regulated only portion of Hydro?

MR. HALL: They don't.

MS. BUTLER, Q.C.: Can I turn now, Mr. Hall, to your evidence on the debt guarantee and the fee that's paid for it, and page 5 of your pre-filed addresses this in part, line 8.

MR. HALL: And while you're finding that reference, I should qualify that any potential bond investors that really wanted to find the regulated business portion could read the transcripts and the filings from the Public Utilities Board and they could find it. I don't imagine many of them do.

MS. BUTLER, Q.C.: Sorry, Mr. Hall, while you're back at that point then, can I ask you whether in your experience, bondholders actually do that?

MR. HALL: No, they don't.

MS. BUTLER, Q.C.: What we're addressing now in terms of the debt guarantee and the fee that's paid for it, is that your evidence at line 8 here, which addresses the question of whether there are advantages associated with a provincial guarantee, and which, of course, you say, provides a number of benefits, all of which you list there, and I don't think I'm going to ask you to read them all but can I suggest to you, Mr. Hall, that in fact, you are in favour of the provincial guarantee of Hydro's debt?

MR. HALL: I'm going to have to ask you in what context you would want me to judge whether I'm favourable or not.

MS. BUTLER, Q.C.: I don't particularly have a context. You addressed the benefits that are provided by the guarantee, so perhaps you could just tell me whether you, in the capacity for which you're called today, support the fact that there is a guarantee?

MR. HALL: Yes, I do think it's favourable in that context because with the guarantee of the province, the company can access the capital markets using the provincial credit rating and therefore can raise the funds that they need when they need them, and that without that provincial guarantee, given the financial results of the company and the leverage that it has, there would certainly be times when that was questionable, and it would be more expensive.

MS. BUTLER, Q.C.: Do you also support the guarantee fee as reasonable?

MR. HALL: I listened with great interest to analysis that comes up with a conclusion that it does, because it's a first time I've seen a calculation that rationalizes the percentage, but it certainly doesn't seem out of line, particularly in the context of other utilities in Canada that pay a similar fee.

MS. BUTLER, Q.C.: And you're referring to Kathleen McShane's evidence today or yesterday?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Back one page then, I think to page four, lines 9 and 10 of your pre-filed, you state that a reasonable target for Crown corporations without guarantees is a debt level of 55 to 60 percent?

MR. HALL: Yes.

MS. BUTLER, Q.C.: And on the same page at lines 22 to 25, I think you suggest that Hydro should, in your view, target a debt level of 55 to 60 percent?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Currently with the guarantee in place, are there any debt rating implications to Hydro of not reaching the 60 percent debt level?

MR. HALL: No, if you're at 83.17 and don't deteriorate further, the answer is no.

MS. BUTLER, Q.C.: And have you prepared any studies to determine the impact to consumers of eliminating the debt guarantee?

MR. HALL: No.

MS. BUTLER, Q.C.: Okay, the province pays one percent for the ... I'm sorry, Hydro pays the province one percent for the debt guarantee?

MR. HALL: Yes.

MS. BUTLER, Q.C.: And accepting what you heard this morning or yesterday from Ms. McShane as reasonable, have you seen the May 1995 report prepared by Scotia McLeod?

MR. HALL: Yes, I've read that. I'm sorry, is that on the dividend policy?

MS. BUTLER, Q.C.: It does address the dividend policy, but I think it also addresses the guarantee fee.

MR. HALL: Okay, yeah.

MS. BUTLER, Q.C.: Perhaps we might get that on the screen. It's **NP-169**, page 5 of 11, please? Okay, here we have a Scotia McLeod review of electric utility dividend compatibles, at least as it stood in 1995, and the column that's headed up, Guarantee Fee, Long Term Debt ... just queue right over, thank you ... suggests BC Hydro had no guarantee fee, nor did Sask Power. Manitoba Hydro paid a half a percent and so did Ontario Hydro, Hydro Quebec. New Brunswick Power pad .65 percent, and Newfoundland and Labrador Hydro paid one. Were you aware of that comparable?

MR. HALL: Yes.

MS. BUTLER, Q.C.: And in column eight, Scotia McLeod looks also at the long-term debt to capital ratios which at that point ranged from 68.9 for Saskatchewan Power, to as high as 93.7 for Manitoba Hydro.

MR. HALL: Yes.

MS. BUTLER, Q.C.: Looking at this comparable table, Mr. Hall, I wonder if you can tell us what relationship there appears to be between the guarantee fee to the level of long-term debt to capital?

(2:15 p.m.)

MR. HALL: I'm not sure, I know I can't answer that question in any completeness because the method of determining what the guarantee fee is is a mystery to me because it's within the provincial government's negotiation with their Crowns. I would say one influence would be the relative business risks of those utilities, for example, comparing Manitoba Hydro to this utility would be ... Manitoba Hydro is almost entirely hydroelectric, a stable business that probably one could argue had a lower business risk and therefore less risk of financial disaster, and therefore the fee could be slightly lower, but I'm not aware of any calculation or any report that's ever been done to explain the difference.

MS. BUTLER, Q.C.: On the basis of this table, clearly Newfoundland Hydro paid the highest guarantee fee.

MR. HALL: Yes.

MS. BUTLER, Q.C.: And at the time that it paid the highest guarantee fee, I believe it had the second lowest debt to capital ratio.

MR. HALL: Yeah, I'm not sure whether that was the regulated utility numbers that Scotia Capital put in that letter, or whether that was consolidated, so I wouldn't be able to comment on that 71 percent. I could check it, but I just don't know.

MS. BUTLER, Q.C.: Well let's look at another example. Ontario Hydro paid only one half a percent to its guarantor while it had a debt of 91.6 percent.

MR. HALL: Yes.

MS. BUTLER, Q.C.: I guess what's jumping off the table at me is that Hydro paid the highest rate, while it had the second lowest debt to capital ratio, and I'm wondering whether if other guarantors accepted less, why should our ratepayers pay more?

MR. HALL: Well, as I said, I have to caution on the 71 percent because it looks similar to the 66 percent which the company now has which is consolidated, not regulated, so I'm not sure that that comparable is as direct as it might be. The only thing that I might say is that there are all of five data points on that chart and so to determine that it's the right rate because of another province in Canada is probably a little too easy, but there should be some analysis of what advantages there are to the, sorry, to the guarantee fee ... to the guarantee, and therefore what fee should be paid for it, and that's the analysis that I think we've done here reasonably well to justify the one.

MS. BUTLER, Q.C.: Have you done any independent analysis or study in assessing the fee that Newfoundland and Labrador Hydro pays to the government for its guarantee?

MR. HALL: No, I should also point out on that chart, just to clarify that Ontario Hydro since 1995 no longer exists as it did then, and of course, does not pay a guarantee fee any longer. It has restructured.

MS. BUTLER, Q.C.: Great. I'm going to turn now if I might to issues of capital structure which are also addressed in your testimony at page 11, line 29, and here, I think, Mr. Hall, if you don't mind, I'd like you to read, starting with, "There are two", which is the sentence at the end of that line, going to page 12.

MR. HALL: There are two parameters that are seen as integral to the assessment by rating agencies of its financial self-sufficiency ... it is Hydro. The first is a history of consistent and healthy financial ratios. The second is an adequate equity base supported by an appropriate return on equity, and a reasonable dividend payout ratio. Both factors are necessary to provide a level of protection against unforeseen events.

MS. BUTLER, Q.C.: Okay, I'd like to address the second of the two first, and that is the adequate equity base. In your opinion, and we already saw this, I believe, at page five of your testimony, the debt level of Hydro at 83.2 percent is too high.

MR. HALL: I believe it is, yes.

MS. BUTLER, Q.C.: Okay, and the reverse of that has to be that the 15.3 percent equity component, or 17.3 is too low.

MR. HALL: Yes, in general. Are you asking in context of financial self-sufficiency?

MS. BUTLER, Q.C.: I'm asking in the context of the reference made by yourself at page 11 and 12.

MR. HALL: Yeah, okay, well in the context, there is a slightly different definition of financial self-sufficiency which is used in this context, and it doesn't require, let's say the 60/40 debt equity ratio that I do recommend that this company operate under. In order to attain financial self-sufficiency, you can get there with a higher leverage and lower equity base.

MS. BUTLER, Q.C.: Okay, but looking at the evidence that's on our screen, we're talking about parameters integral to the assessment by rating agencies.

MR. HALL: Yes.

MS. BUTLER, Q.C.: And you talk about an adequate equity base and the question is is 15 or 17 percent an adequate equity base?

MR. HALL: In isolation it's difficult to answer that question, as I alluded to earlier, because you need to ask the return on equity that comes with that low equity base as well. In other words, you have to look at the three things actually that are in that sentence in order to answer the question, but in danger of leaping ahead somewhat, with a reasonable rate of return, I think that the 80/20 or 83/17 ratio would be considered by the rating agencies to be sufficiently financially self-sufficient, and that's evidenced by the fact that they are not downgrading or impacting the province at these levels.

MS. BUTLER, Q.C.: To be fair to the evidence as you gave it in your pre-filed, wouldn't you also have to say that there would have to be a reasonable dividend payout ratio too?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Okay, so you're suggesting that the second of your parameters has to be a review of not only the adequate equity base, but an appropriate return on equity and a reasonable dividend payout ratio?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Okay, now you did suggest in your pre-filed, a 75 percent debt to equity ratio as a reasonable short-term goal for Hydro?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Can you tell us what you define as short-term?

MR. HALL: Well, I'm an investment dealer, so my definition of short-term is different than Ms. McShane's.

MS. BUTLER, Q.C.: Yes.

MR. HALL: I thought that two or three years was, at least in my world, two or three years is considered a short-term, call it five to seven medium-term, and anything longer than that is long. I wasn't specifically suggesting 2.3 or any particular number but just a directional move towards the 75/25.

MS. BUTLER, Q.C.: Okay, that's fine. Now in your pre-filed you did say that an IOU or a Crown corporation operating in commercial terms with no guarantee should have a 40 or 45 percent equity component.

MR. HALL: Yes.

MS. BUTLER, Q.C.: Is that the short-term goal, or medium term goal, or long-term goal that you recommend for Hydro?

MR. HALL: Again, my perspective is from a financial side only and so as soon as it's practically possible to get to that level, I think it would serve the province well. The mechanics of getting there and the time it takes and the impact on rates that comes with that is something that I did not judge, or didn't make a recommendation on.

MS. BUTLER, Q.C.: Okay, I accept that and I accept that your perspective is from the financial side only but do you have a perception of what you meant in terms of achieving that goal, five, seven, ten years?

MR. HALL: The 60/40 or the 75/25?

MS. BUTLER, Q.C.: The 45 percent equity component.

MR. HALL: No, I didn't have a particular time, but I think it's reasonable to say in the mid-term as defined as five to seven years, but I haven't worked out the numbers that would get you there, and it does obviously depend upon the economic activity in this province.

MS. BUTLER, Q.C.: Okay, I accept that. I also accept that you, as you say, have not looked at the mechanics of getting there, or the effect on rates of achieving the goal, but are you aware of any specific plans that Hydro has to move towards 40 percent equity?

MR. HALL: No, I am not aware of any, I don't believe there are any in place. My understanding is that the company is waiting for some direction from this Board as to their indication of what the Board would like to see before they formulate a formal plan.

MS. BUTLER, Q.C.: So to the extent that Hydro awaits the determination of this Board which is fair, to implement a particular, or develop and implement a plan, they may very well accept your advice, that is Hydro may accept your advice to move towards that target if the Board also accepts that target as reasonable. Is that what you're suggesting?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Are you aware that in a previous hearing, Hydro was directed by this Board, as previously constituted, to move towards an 80/20 debt to equity ratio?

MR. HALL: Yes, I am.

MS. BUTLER, Q.C.: I wonder if we can look at **IC-197** please? The attached schedule, thanks, and can you enlarge it a bit? I think we'll have to go back to about 150, Terry. Okay. Now here we have the equity portion of the debt equity ratios for the period '92 to 2002, starting at 1992, the company was at 17.61, and managed to get in 1995 as high ... I'm sorry, 1994, 19.55, almost to 20, and '95, 19.43. And then 1997 and 1998, 1999, they were actually above the 80/20 ratio in the sense that equity was over 20 percent, but in 2000 it slipped and the forecast for 2001 and 2002 is significant slippage to 17.7 or 12.93. You're obviously aware of this forecast and this history. Can you tell us, Mr. Hall, whether you have given Hydro any advice with respect to their forecasts for 2001 and 2002 relevant to the equity component of their debt equity ratio?

MR. HALL: No, I have not.

MS. BUTLER, Q.C.: Do you accept that the large dividends forecast for 2002 is the primary contributor to the decline in the equity portion of the ratio?

MR. HALL: That and the inadequate earnings, between the two of them, yes.

MS. BUTLER, Q.C.: Okay, thank you. I wonder if I can just go back to Schedule 2 of your pre-filed testimony, and here we have the financial ratios, first of all of government owned utilities, and then towards the bottom of the table, investor-owned utilities, from the DBRS report. I believe this report speaks from 1999, is it, Mr. Hall?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Now can you just read Newfoundland and Labrador Hydro's figure there for 1999?

MR. HALL: 63.1.

MS. BUTLER, Q.C.: Okay, and the group average?

MR. HALL: 70.3.

MS. BUTLER, Q.C.: And of those utility companies, government owned, that had higher debt equity ratios, can we just identify them?

MR. HALL: Higher ... the 63.1 is the consolidated, I believe. It's not the ... (inaudible) higher than that 63.1.

MS. BUTLER, Q.C.: Thank you, yeah.

MR. HALL: BC Hydro, Manitoba Hydro, Hydro Quebec, New Brunswick Power.

MS. BUTLER, Q.C.: Now Schedule 6 of your testimony, we see the common dividend payout ratio, but before I actually get into this, I should ask you on Schedule 2 that we were just looking at, when you spoke of the ratio for Hydro being ... I'm sorry, consolidated.

MR. HALL: Yes.

MS. BUTLER, Q.C.: Do you have any information to assist us in how Hydro's regulated only debt equity ratio compared to the electric industry?

MR. HALL: Well, we have the ratios of the regulated utility available as filed testimony. I'm not sure that they would be as easily dropped into that table because you'd have to be careful about what was in the other ones in terms of comparability.

MS. BUTLER, Q.C.: Okay, but in terms of suggesting to me that maybe the 63.1 may not be an appropriate figure for comparison purposes, if you've got some other document that you can refer me to ...

MR. HALL: No.

MS. BUTLER, Q.C.: That might make it clear ...

MR. HALL: I don't.

MS. BUTLER, Q.C.: ... then we can look at that. Okay, looking at Schedule 6 of your testimony as it relates to common dividend payouts, and this is relevant, of course to the first parameter that you had addressed, being the evidence that I had you read a moment ago at page 11, and that was healthy financial ratios, and ... I'm sorry, maybe I'll just get the actual quote here ... a reasonable dividend payout ratio, I think. Have you seen Hydro's dividend policy, Mr. Hall?

MR. HALL: I don't have it with me, but yes, I've seen it.

MS. BUTLER, Q.C.: Okay, the one for 2000 as well as the one for 1995?

MR. HALL: Yeah.

MS. BUTLER, Q.C.: So you're aware that it was 75 percent payout ratio with a caveat on the effect on the debt equity ratio?

MR. HALL: Yes.

MS. BUTLER, Q.C.: In your pre-filed evidence you said that Hydro's dividend policy was reasonable when compared to various peer group companies.

MR. HALL: Yes.

MS. BUTLER, Q.C.: And are these the peer group companies that we see on the screen?

MR. HALL: Yes.

MS. BUTLER, Q.C.: We saw a moment ago that there were four companies, I believe ... and just go back to Schedule 2 for one second ... with higher debt equity ratios than Newfoundland Hydro's ... BC, Manitoba, Hydro Quebec, and New Brunswick Power?

MR. HALL: Yes.

(2:30 p.m.)

MS. BUTLER, Q.C.: And can we look at those same four companies on the Schedule 6? Of the four companies that had higher debt equity ratios than Hydro, BC Hydro had a common dividend payout of 62.9 percent.

MR. HALL: Yes.

MS. BUTLER, Q.C.: Manitoba Hydro paid no dividend at all. Hydro Quebec paid 50 percent and New Brunswick Power paid no dividend at all, is that correct?

MR. HALL: Yes.

MS. BUTLER, Q.C.: And can you just turn, with that background, to **NP-72** which shows the dividend history for Newfoundland Hydro? Page 2, thank you, and we saw from earlier evidence, Ms. McShane and others actually, that Grant Thornton, in their 2001 report spoke of the dividend proposed for 2002 as being a primary factor in deriving the debt equity ratio to the level that it is forecast to be. Have you provided any advice to Hydro relative to the dividend proposed for the test year 2002?

MR. HALL: No, they haven't asked me for advice on that.

MS. BUTLER, Q.C.: Can you tell us in the capacity in which you were retained, what signal it gives to the capital markets of the world if Hydro pays a dividend of 730 percent in 2002, with the effect that we saw on the debt equity ratio which obviously moves below 20 percent for equity?

MR. HALL: I'll try to put it into two contexts. One is what signal does the actual payment of the dividend and excessive earnings in one year, if that's alright. That's certainly not unprecedented even with investor-owned utilities for that to happen. Trans Alta utilities for a number of years did that and I think if you look back on that table that screamed by, that there was a number of years when BC Hydro was doing the same, and so the payment of the dividend in excess of 100 percent of earnings in one particular year is not necessarily a red flag for capital market participants. I have to confess that I've never seen 730 percent before, but the other signal that I'm presuming that you want to comment on is whether this payment of this dividend is inconsistent with the direction to maintain an 80/20 debt equity ratio, and in fact, to move it towards a recommended 60/40 that certainly I have recommended, and I would say that the market would identify that as being inconsistent.

MS. BUTLER, Q.C.: It would develop (inaudible) market would see that it's inconsistent?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Yeah, clearly, and although you say, Mr. Hall, that of course the company hasn't sought your advice on the issue, you have advised them with respect to what is a reasonable target, and this does take them away from that target, so have you offered anything gratuitously?

MR. HALL: I'm always good for gratuitous comments. No, I mean I was, I was giving a comment about the 75 percent payout ratio which, as I pointed out in the first part of the previous answer, is to me a policy over time, not a policy on a year-by-year basis, to be slavishly kept, and that's because there are circumstances in any company where sometimes it makes sense to pay out the dividend and sometimes it does not. It's my understanding with this company that there have been a number of years actually prior the ones shown here, where there were no dividends paid out, and then there were a number of years where there are reasonably large dividends paid, so I wasn't looking at any one particular year when I was providing my gratuitous comment, but simply saying that 75 percent payout in a utility of this nature with relatively stable business operations is not unusual.

MS. BUTLER, Q.C.: Okay, can we turn now to what you said in your evidence at page 9 please, and this relates to the return on equity? I think it's line 28. This is relevant to a point that was actually made by one of the Commissioners earlier today. You say lowering the measurement criteria results in the taxpayers of the province subsidizing the consumers of the region because they are accepting a lower than reasonable rate of return on their equity investment, so you're, of course, talking about the three percent return on equity.

MR. HALL: Yes.

MS. BUTLER, Q.C.: Now in saying that, are you familiar with the social policies that Hydro might execute on behalf of the province such as the subsidization of the rural deficit?

MR. HALL: Yes, I'm aware of those.

MS. BUTLER, Q.C.: And are you aware of Mr. Brickhill's schedule which calculates the deficit at $30 million?

MR. HALL: I heard the testimony about that yesterday so, yes, I'm aware of that.

MS. BUTLER, Q.C.: Okay, we can get that on the screen if you wish, it's **Brickhill Schedule 1.2**. It may be one of the ones that's not electronically entered. If it's not electronically entered I won't bother.

MR. HALL: I'm happy to wing it if you just want to confirm that it was his 30, that's fine.

MS. BUTLER, Q.C.: I think it was $30.6 million at a 318 cost of service. This is an example of a social policy directive to Hydro by government. You accept that, do you?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Okay, so in this case, or in this example, Mr. Hall, do we not have some consumers subsidizing taxpayers, the opposite of what you're suggesting on page 9, line 28 of your testimony?

MR. HALL: Now you've got me there. Some consumers are subsidizing taxpayers. How do they do that? I'm not supposed to ask you questions, sorry, but I don't understand, sorry.

MS. BUTLER, Q.C.: Okay, let's look at the screen. What you've said is that if the shareholders, or the taxpayers of the province, because the shareholder is the Province of Newfoundland ...

MR. HALL: Correct.

MS. BUTLER, Q.C.: ... only gets three percent return, then you say taxpayers are subsidizing the consumers?

MR. HALL: Correct.

MS. BUTLER, Q.C.: Okay, and I'm saying if there are some consumers who don't pay the full cost of service in your region, and in fact cause Hydro to run a deficit of $30 million which other customers, Newfoundland Power and Labrador Interconnected, pay ...

MR. HALL: Right.

MS. BUTLER, Q.C.: Newfoundland Power and Labrador Interconnected ratepayers are actually subsidizing taxpayers?

MR. HALL: No, I'm still not with you. If there is a cross subsidization of rates between different classes of customers, which is very typical within a jurisdiction, in my view there are some consumers in the province paying more than they should, if you take should to be the cost of service, and there are some consumers who are paying less than they should because of whatever circumstances are germane, and that that's a cross-subsidization between ratepayers, not anything to do with the taxpayer. For example, if Newfoundland Power was told, and I believe there must be some cross-subsidization within Newfoundland Power's jurisdiction, between rate classes, that that is between the ratepayers within the region, not anything to do with the shareholders of Newfoundland Power.

MS. BUTLER, Q.C.: Your answer though assumes that there wasn't the option of government as shareholder not passing the deficit on.

MR. HALL: That is correct, and that's my position, that there should not be that option, that there should be a complete isolation between the role of government as a shareholder of a business which this is, in a very comparable business to Newfoundland Power, and the role of government as a developer of social policy, and when the government chooses to give a social policy directive to other companies, let's take Newfoundland Power as an example, they don't absorb the cost of that, at least I'm not aware that they've done that, and I don't believe they should do that here.

MS. BUTLER, Q.C.: Okay, and I'll just go to another quote from there then and see if we can address it in a slightly different way, page seven, lines 24 to 26, but it's the same point ... you say, my view is that Hydro operates a commercially viable energy business that happens to be owned by the province. The province's shareholder is no different than any other investor. How does the social policy of incurring a deficit in one area which the government then passes on to other customers fit into that view? How is the province then the same as any other investor?

MR. HALL: Because if the, if the policy of sharing costs between one region and another region is something that this province and this Board thinks is appropriate, it doesn't have to affect the shareholder of the utility that implements that policy in the same way that it doesn't affect Newfoundland Power in their jurisdiction to do that cross-subsidization if it affects the consumers of Newfoundland Power but not the company, so in my view, if the government or the Board said we want a particular outcome for social policy reasons they could state that policy reason overtly and direct both utilities within their jurisdiction to implement that policy. If Newfoundland power assessed that social policy directive and said it's going to cost shareholders of our company a certain amount of money to implement this social policy, they would quite rightly, in my view, appear before this Board and ask for recovery of that from ratepayers, and in the same context, this company, in my humble view of the world, should do the same.

MS. BUTLER, Q.C.: Okay, but I think your answer assumes that this Board has given some direction on the covering of that deficit.

MR. HALL: Yes.

MS. BUTLER, Q.C.: And to what do you refer when you say that?

MR. HALL: I don't know. Your question was do I assume it, and yes I do.

MS. BUTLER, Q.C.: You do assume it?

MR. HALL: Yeah.

MS. BUTLER, Q.C.: Are you aware of any other shareholder of an investor-owned utility who requests the utility to undertake significant social policy on behalf of their shareholder?

MR. HALL: No.

MS. BUTLER, Q.C.: Now in recommending a return on equity range of 10 to 12 percent as appropriate for Hydro, which is at page 9 of your testimony, can I ask you whether you considered the equity risk premium model, discounted cash flow model, and comparable earnings model, or any other model, a similar analysis to what Ms. McShane did?

MR. HALL: No, I didn't. I'm coming at this from the perspective of the capital markets and that would be redundant to what Ms. McShane did.

MS. BUTLER, Q.C.: Okay, so can you just assist me with how you determine the recommended range of 10 to 12 then?

MR. HALL: I tried to say it's reasonable to suggest rather than recommend so that you wouldn't press me too hard on this point, but the truth of the matter is, from a capital market perspective are level of analysis of the recommended return would be slightly different. We tend to be much more simplistic in the approach, because we're not asked to make specific recommendations, and so my analysis was contained to looking at Newfoundland Power which I considered to be a perfect example of a comparable utility in the same jurisdiction and subject to the same Board that we're before here, and saying what's different about Hydro that would make their reasonable request for a return on equity different than what Newfoundland Power has been successful in achieving, and it's largely on the basis of that overview and then comparison to other utilities in Canada which was listed in the schedule that I came up with, that range. I did not want to put a range down at all but it was suggested that maybe something like this would be helpful, so that's why the range is so wide. 10 to 12 percent is quite a wide range.

MS. BUTLER, Q.C.: Alright, can you look at page 9 of your

... I'm sorry, page 8 of your testimony, line 30, and this is where you start some discussion on business risk, etcetera. I wonder could you just read for me, starting with, "In general, generating companies"?

MR. HALL: In general, generating companies in the electricity industry seemed to be exposed to greater business risks than distribution utilities, since they are subject to operational challenges, commodity price fluctuations, market demand variability, service requirements under all conditions in many regions an increasing inability to recover these costs from their customer base due to competitive pressures.

MS. BUTLER, Q.C.: Okay, so what you're discussing here are four factors that you say in general cause generating companies to be exposed to greater business risks, and the first is operational ... sorry, operational challenges, and you have commodity price fluctuations, market demand variability would be three, service requirements under all conditions would be four, and then the fifth, I think, is increasing inability to recover these costs from their customer base due to competitive pressures, five. Let me ask you first about commodity price fluctuations and whether you're aware of the operation in this jurisdiction of the Rate Stabilization Plan?

(2:45 p.m.)

MR. HALL: Yes, I am.

MS. BUTLER, Q.C.: And does the Rate Stabilization Plan to your knowledge protect Hydro from fluctuations in the price of No. 6 fuel?

MR. HALL: Yes, it does.

MS. BUTLER, Q.C.: So the issue of commodity price fluctuations is really not of concern for Hydro.

MR. HALL: It's still of concern but these are general comments about a general utility, sorry, a generation utility versus a distribution utility. They weren't stated to be in reference to Hydro.

MS. BUTLER, Q.C.: Okay, market demand variability, which is at line 2 there at page 9. Are you aware that the Rate Stabilization Plan also protects Hydro from fluctuations in demand for the energy it sells?

MR. HALL: Yes, with a lag time in both cases, yes, it does.

MS. BUTLER, Q.C.: And finally, competitive pressures, line 4 of page 9. Relevant to that, I wonder if we might look at the **DBRS report**, Schedule 1, page 3 of 3? Okay, and this is the bond for Hydro which has been updated by Exhibit DH-1. I don't think that has yet been entered, has it, Terry?

MR. O'RIELLY: Yes, it has.

MS. BUTLER, Q.C.: Okay, in the considerations section, just below where you are ... strengths, there you go. The DBRS acknowledges as its fourth bullet there, the geographic isolation and unavailability of gas minimizes competitive pressures and the impact of industry deregulation, so they're not as big an issue for Hydro.

MR. HALL: Well, it's still a big issue for Hydro to the extent that the company provides electricity as a residential load and is therefore competitive with fuel oil and wood for that matter. I don't think anyone would presume that Hydro is not subject to competitive pressures. Indeed, I don't. I think that the rationale for the company asking for a revenue requirement which resulted in a lower than acceptable rate of return on equity, in my view, was driven by their concern about the ability of their customers to pay those revenue increases and that to me is a competitive issue. Granted, competition is not as intense as it is in other jurisdictions, that's true.

MS. BUTLER, Q.C.: And in your evidence, your pre-filed evidence, what I think you were talking about was the generic comparison of the generating companies to a distribution company.

MR. HALL: Yes.

MS. BUTLER, Q.C.: And to the extent that Hydro is the generation company in this province, it has little or no competition.

MR. HALL: I believe Newfoundland Power generates.

MS. BUTLER, Q.C.: Some.

MR. HALL: Thank you, and I also think there are independent companies that generate their own power.

MS. BUTLER, Q.C.: Uh hum, some, that's correct, but in terms of percentages, I don't know whether you're familiar with how that sits.

MR. HALL: This is definitely the largest utility and the largest generator, but it doesn't take away from the competitive generation model because it's the incremental power that causes prices to be set.

MS. BUTLER, Q.C.: Alright, are you aware that Dr. Basil Kalymon who is the cost of capital expert for the Consumer Advocate disagrees with your view on risk and states that the overall risk of Hydro would be comparable to that of the average utility and somewhat below that of Newfoundland Power?

MR. HALL: I don't think that Dr. Basil Kalymon disagrees with, or sorry, I don't think I disagree with him.

MS. BUTLER, Q.C.: You don't disagree with that?

MR. HALL: No, I wasn't arguing in the evidence that there is a higher, when all is said and done, a higher business risk, because if you go back to my testimony, I did go on to say that the RSP can offset a great number of those risks, so I didn't come out (inaudible) conclusion, but what I was trying to do was direct the Board toward the concept that if you begin your analysis with Newfoundland Power and consider the differences, that that's a reasonable way to approach the problem of what to do about Hydro's debt equity and rate of return.

MS. BUTLER, Q.C.: Okay, so if you're pre-filed evidence doesn't actually state a conclusion there, can you tell me whether your conclusion is, in fact, the same as Dr. Kalymon's?

MR. HALL: With the availability of the RSP I wouldn't disagree with his assessment.

MS. BUTLER, Q.C.: Okay, Mr. Hall, can I ask you now about the rate of return which Hydro has requested, of course, in the test year, which is three percent?

MR. HALL: Yeah.

MS. BUTLER, Q.C.: And do you know what the interest coverage ratio on regulated operations is in the test year?

MR. HALL: I believe it's 1.08, subject to check if it isn't.

MS. BUTLER, Q.C.: Okay, and because I believe that it is also 1.08, and I'll move on. Is that not the same interest coverage ratio that Hydro was previously allowed by this Board in 1992 to your knowledge?

MR. HALL: To my knowledge it was 1.10, but it was certainly close to that.

MS. BUTLER, Q.C.: Okay, and if we turn to the DBRS bond ratings, Schedule 3 of 3 ... well the new one is DH-1, and the DBRS, of course, rate on the basis of interest coverage ratios, correct?

MR. HALL: That's one of the factors they consider in coming up with the rating.

MS. BUTLER, Q.C.: And then the commentary section of this one, can you just assist the Board with what they said in relation to the interest coverage ratio?

MR. HALL: No, because I can't find it, sorry.

MS. BUTLER, Q.C.: You can probably find it on the old one, and maybe we can scroll over. Terry, can I just get you to scroll to the top so I can see where you are there please? Okay, go back to page one of the older version, which is Schedule 1, page 3 of 3, and in the commentary section. Debt to capital ratio compares favourably, do you see that there, Mr. Hall?

MR. HALL: Yes.

MS. BUTLER, Q.C.: Okay, and can you just read what it says so that we can see what it says about interest coverage ratios there?

MR. HALL: The debt to capital ratio compares favourably to the 70 percent government utility average but remains well above the 48 percent typical of the private sector, while interest coverage ratios are in line with government utility group averages.

MS. BUTLER, Q.C.: Okay.

MR. HALL: That 70 percent that they're comparing is the consolidated number.

MS. BUTLER, Q.C.: Yes, well I think, as you've made clear, there is no DBRS document that helps us compare the regulated only.

MR. HALL: Right.

MS. BUTLER, Q.C.: Right. The last area I want to address with you, Mr. Hall, if I might, is at page 13 of your testimony pre-filed, and this is lines 5 to 8, and could you read that first sentence for us please?

MR. HALL: If there is evidence of continually declining performance measures with no positive regulatory or corporate moves to address the problem, there will be mounting concern about the self-supporting characterization of Hydro's debt.

MS. BUTLER, Q.C.: Okay, and what I'm interested in, Mr. Hall, is what you mean by corporate moves?

MR. HALL: I had nothing specific in mind, but just to say that there are two influences that can address performance issues, and one is the regulatory side, and one is things that were within the ability of the company to do itself. Presumably that could be rate design which would require regulator approval, but could be brought forward by the company itself. It could be pricing, competitive pricing versus the alternative sources of energy in the province.

MS. BUTLER, Q.C.: Okay, would corporate moves include reducing costs, operating costs?

MR. HALL: That's certainly a corporate move, yes.

MS. BUTLER, Q.C.: Would managing capital structure differently be considered a corporate move?

MR. HALL: I don't know how you'd manage the capital structure differently without getting into the regulatory side and the performance measures that I spoke of, but yes.

MS. BUTLER, Q.C.: Okay, well I'll accept your answer, but just to elaborate a bit, in terms of perhaps management and the shareholder getting together on the hill to discuss the dividend, would that be a corporate move?

MR. HALL: I didn't specifically reference that one, so sure, that would be a corporate move.

MS. BUTLER, Q.C.: Mr. Chairman, thank you very much, those are my questions for Mr. Hall.

MR. NOSEWORTHY, CHAIRMAN: Thank you very much, Ms. Butler, it's close to 3:00 and we'll break for 15 minutes, and then we'll come back with cross of the Industrial Customers. Thank you.

(break)

(3:15)

MR. NOSEWORTHY, CHAIRMAN: Good afternoon. Could we proceed with the Industrial Customer's cross. I guess Mr. Hutchings, will you be ...

MR. HUTCHINGS: Yes.

MR. NOSEWORTHY, CHAIRMAN: ... doing this? Thank you.

MR. HUTCHINGS: Mr. Hall, a couple of questions initially arising out of points you discussed with Ms. Butler. The three ratings that we've had before us now, the three new ones, I'd just like to ask you, as a general point, do you or officials at Newfoundland and Labrador Hydro get any opportunity to have any input or reaction to these documents before they're finalized?

MR. HALL: Certainly I don't. I'm just a member of the capital market community, so they don't ask me. It is typical for ... I don't know the answer to whether Hydro does. It's typical for the rating agencies to present a draft of their materials for factual error correction, but I'm not at all sure whether this happens here because it's a flow through guarantee, they may not.

MR. HUTCHINGS: Okay. So it's more likely, perhaps, that there were discussions between officials of government and DBRS about the Provincial rating?

MR. HALL: I think that's a reasonable assumption, they would have had those conversations, yes.

MR. HUTCHINGS: Yeah, okay. I noticed, for instance, that on the Newfoundland and Labrador Hydro rating, which, looking for comparison purposes at the bond, long-term debt and preferred ratings for Newfoundland and Labrador Hydro, it's your page 3 of 3 in Schedule 1 and **NP-6** which is the updated version. I had highlighted that the first of the challenges that are listed in the consideration section which said, in the old version, "Earnings sensitive to water levels and oil prices", and I had regarded that as being inaccurate, given the existence of the RSP, and I notice that on the new version it doesn't say the same thing. It says cash flows are sensitive to water levels and oil prices. Do you have any idea of how that change came about?

MR. HALL: I don't have any specific idea that can help you. I would say that the author of the report is recorded as a different individual from one to the other and she presumably has a slightly different turn of phrase. I don't think there's anything necessarily to read into the difference between cash flows and earnings. And I would also point out that challenges of water levels and oil prices is a challenge for Hydro. It's mitigated by the RSP, but it's there. And the RSP, although it's seen as a reducer of risk, which it is, it only defers those costs and puts them back on the ratepayers, as you know, over the next three years, and that means that the Company still has to be concerned about their competitive pricing position. So, yes, they can recover it, but even regulated utilities need to worry about how much their customers can pay, as evidenced by this application, so it's a residual concern and it's not one I would have raised.

MR. HUTCHINGS: No, I mean, it strikes me as an odd one to top the list of challenges in this rating, given the existence of the RSP which makes Hydro fully whole in respect of variations in water levels and oil prices within a fixed period by reason of an order of this Board.

MR. HALL: Yeah. I can only speculate that it certainly is true about the capital market observers, that although they can take great comfort in a Rate Stabilization Plan such as this, they don't have as much confidence as perhaps you do that it will be there forever. And so, they are concerned about the fundamental risks that the company has, and then they're mitigated, as you see in number 5 on the other side is the Rate Stabilization Plan. So it's a proper offset, probably, in their minds, but I'm just speculating.

MR. HUTCHINGS: Okay. You indicated to Ms. Butler that you did not agree with her suggestion that Hydro was regarded as either a significant strength or weakness in the Provincial rating. Am I correct in that statement?

MR. HALL: I was really trying not to disagree with anything, but I don't think I said that it wasn't either way. I said that you can interpret the existence of a separate credit analysis as being indicative that it was pretty important to them, but only in the narrow sense.

MR. HUTCHINGS: Alright. I've looked at the two Newfoundland and Labrador Hydro ratings that we have here, and each of them, in the first sentence of the update, in parenthesis, says ... refers to the Province of Newfoundland, and it says "see separate report dated July 24th, 2001." I don't find any reference in the Provincial report to the existence of the Newfoundland and Labrador Hydro report. Do you find that to be significant?

MR. HALL: No. But let me explain, if I can, what I think is the process that the rating agencies take with respect to Crown corporations such as this, commercial Crown corporations, because it probably helps with that view. When you're rating the Province of Newfoundland and Labrador as an entity, the rating agency will consider their tax income and their expenditures and promises and so on, and when it comes to the Crown corporations that they own and control, they will look at the ones that the debt has been guaranteed and they test it for this financial self-sufficiency measure that we chatted about earlier today. And the financial self-sufficiency test tends to be, is this company being run in such a fashion that it's going to get into financial trouble to the point where it's going to turn to its parent, and/or guarantor, in this case and say help, I need some money, which would then be a credit impact on the Province of Newfoundland and Labrador. So they do an assessment of Hydro to say, how well are they doing in this relatively tight test called financial self-sufficiency and say is it probable that they're going to come within the forecast period to the Province and say we're in trouble. And if the answer to that question is it's not likely that they will do that because they're operating at, let's say an 80/20 debt equity ratio with reasonable earnings, and therefore, reasonable interest coverage, then the rating agency will put that aside and continue with the Provincial rating and finish it off. In other words, it's not an impact because they seem to be holding their own.

MR. HUTCHINGS: Uh hum.

MR. HALL: What I alluded to this morning was that with Dominion Bond Rating Service that New Brunswick Power, which managed to successfully get to 100 percent debt through a reduction in earnings, the Dominion Bond Rating Service, many times, was pointing out that this was just about to go on the provincial credit, and I would obviously be subject to check, but I think if you looked at the Province of New Brunswick's main credit report in those days, there would have been a reference to it.

MR. HUTCHINGS: Okay, and I seem to recall many years ago seeing a report from the Province of Nova Scotia that made a similar reference to Nova Scotia Power, as it then was, which was perceived to be a drain on the Provincial credit?

MR. HALL: Well, it was a danger.

MR. HUTCHINGS: Yes.

MR. HALL: It represented, I believe, half of the entire loans outstanding of the Province of Nova Scotia was Nova Scotia Power.

MR. HUTCHINGS: Uh hum, okay. This is, undoubtedly, an overly simplistic approach, but the potential bond purchaser who reads the rating of the Province of Newfoundland is not thereby told that there exists another rating for Newfoundland and Labrador Hydro, is it?

MR. HALL: No, that's correct.

MR. HUTCHINGS: But if one is looking at Newfoundland and Labrador Hydro it becomes immediately obvious that there is another rating for the Province of Newfoundland?

MR. HALL: Yes, because it's, of course, far more relevant in that latter case.

MR. HUTCHINGS: Yeah. So the Province is much more important to Hydro than Hydro is to the Province?

MR. HALL: Yes.

MR. HUTCHINGS: Okay. A small point that I want to clarify in respect of your Schedule 2. These are the financial ratios that you looked at with Ms. Butler, and there is a ratio there at 63.1 percent for Newfoundland and Labrador Hydro which you, I think you referred to as likely being the consolidated ratio. I just question that, given that there's a separate ratio listed there for Churchill Falls and a group average taken. Does that change your view of whether or not that's, in fact, a consolidated ratio?

MR. HALL: No. I think it still is. I said likely because it never seems to be exactly the number that the Company produces, which presumably is an accounting argument between the credit rating agency and the Company, but I think that Churchill Falls is separated out simply because it is available to be separated out and looked at separately, but it is included in the one above it.

MR. HUTCHINGS: So you're saying that the 63.1 for Hydro actually includes the effect of Churchill Falls and then Churchill Falls itself is put in separately?

MR. HALL: That's my understanding.

MR. HUTCHINGS: As a separate entity?

MR. HALL: Yeah.

MR. HUTCHINGS: And then they take a group average?

MR. HALL: It's not my table.

MR. HUTCHINGS: Yeah. But that's a bit of an odd thing to do, you'd agree with that?

MR. HALL: Yes.

MR. HUTCHINGS: Okay. Looking at your evidence, then, at page 2, and at line 30 one, of the items that you're commenting on is the appropriate level of debt and equity in the capital structure. Can you define what you mean when you say the appropriate level, how do we know what the appropriate level is?

MR. HALL: Not what I feel (inaudible) on the day that I was asked. Appropriate in that sense is with reference to the business risks, at least that's the way I look at it. That there is a company that ... a company has a combination of business and financial risks. And once you've assessed the business risks of the company and determined what their competitive position is and what their cost of generation is relative to other energy sources and so on that we've discussed, then you look at the financial leverage that that company is therefore able to absorb, and that's an appropriate debt equity ratio. You know, it's not surprising that companies in the technology area don't have very much, if any, debt, because the appropriate debt equity ratio is usually zero because of the volatility of their business and earnings. And it's equally not surprising, in this business, that there's quite a bit of debt because of the more stable nature of the cash flows in the business. That's what I meant.

MR. HUTCHINGS: All right. Do you take the view that there is a single optimal debt equity structure for a utility such as Hydro?

MR. HALL: No, I don't. I think there's a ... I always think of it in terms of targets that companies are ... or should, I'm sorry, have targets for payout ratio, targets for return on equity and targets for leverage within the company that they work towards, hurdle rates for the capital spending budgets and so on. And that the recommendation that I did put in here of 60/40 is a target, that is something that is, in my view, appropriate for this company to work towards. Once they got to 60/40, if they went to 59.9 I wouldn't, you know, ring a bell and say this is the end of life, no.

MR. HUTCHINGS: No. But I guess from a theoretical point of view is there a debt equity ratio that has advantages to Hydro above all others?

(3:30)

MR. HALL: Well, yes. I think that if Hydro was operating this Company with a 60/40 debt equity ratio and a return on equity that was similar to the one recommended by Ms. McShane and, therefore, had an interest coverage ratio which would be favourably compared to others in the industry, then not only, in my view, could the Company consider removing the guarantee, because it wouldn't be necessary or cost effective for them to have it at that level, but it would also be a clear indication, and this is more qualitative, to the Company that this is a business that they run and that they are competing with other businesses in the marketplace. And that has a saluatory (sic.) effect, in my opinion, on the way that the Company is run in terms of the management decisions that they're able to make.

MR. HUTCHINGS: When you refer in that answer to competitive with other companies in the marketplace, do you mean in competition for capital or in business competition with other entities?

MR. HALL: I meant in business competition because the competition for capital only are as is once the guarantee is gone. But if you go to my (inaudible) that I just described, yeah, it would be competition for capital, as well.

MR. HUTCHINGS: But your principle reference, at the time that you gave the answer, was to refer to the competition that Hydro is subject to in its own markets?

MR. HALL: Yeah.

MR. HUTCHINGS: And who do you regard the competitors of Hydro to be?

MR. HALL: I think that anybody that provides a source of energy is a competitor. So that's people who own trees, Newfoundland Power, to the extent they generate as well as distribute, Abitibi, anybody that generates power for their own site and could easily sell that power into the grid in circumstances that would make it effective for them to do that. Anybody that generates an energy source.

MR. HUTCHINGS: Okay. In terms of competitors in the field of electricity generation, are you familiar with what would be required for someone like Abitibi or Corner Brook Pulp and Paper to become involved in actually selling power into the grid?

MR. HALL: I'm familiar, generally speaking, with the concept, but not those specific situations, no.

MR. HUTCHINGS: Okay. But I mean, in terms of going into business in competition with Hydro there would be a necessary implication that these companies would themselves become public utilities, correct?

MR. HALL: I'll take your word for that.

MR. HUTCHINGS: Okay. Alright.

MR. HALL: The reason I would take your word for that in this jurisdiction, if I may interject, is because in most jurisdictions that's no longer the case.

MR. HUTCHINGS: No, quite so, but you don't disagree with that in the context of the Province of Newfoundland?

MR. HALL: No. As I say, I'll take your word.

MR. HUTCHINGS: Yeah, okay. Just to follow along from where we were, then, and this notion of operating Newfoundland Hydro, you know, as a utility on commercial terms. You refer in your evidence to there being meaningful and tangible benefits to doing so. Can you just elaborate for us on what you feel those meaningful and tangible benefits are?

MR. HALL: Don't tell me I said tangible benefits, because then I have to give you one. Can you refer me to that?

MR. HUTCHINGS: Page 4, line 17. "Meaningful and tangible," I was right.

MR. HALL: Oh, darn. I'm sorry, I just can't find it.

MR. HUTCHINGS: Line 17.

MR. HALL: Thank you. The second sentence, I think, helps to give you meaningful and tangible benefits in terms of what I was referring to, and that is, for example, that in most jurisdictions it is standard practice for a company in the private sector, investor owned companies, to complain about inappropriate competition from companies that are owned by governments and therefore have various different structures and perceived advantages and therefore argue for level playing fields. For example, in Ontario, where they have deregulated the marketplace, the government owned utility has been told very explicitly by the way it's structured that it must operate on a commercial term the way I'm ... terms the way I am recommending, and that there are tangible and meaningful benefits to doing so, so much that they have asked them to pretend that they pay income taxes and calculate their results accordingly. Because they truly believe, as do I, that there are such benefits from providing the Hydro 1 management with the same incentives as investor owned utilities have. And my strongly held view is that that would be the case in this province if the management of Hydro had the same dynamics as the management at Newfoundland Power did, that that would result in meaningful and tangible benefits to everybody, including them.

MR. HUTCHINGS: So primarily we're dealing with the elimination of any potential public subsidization of the operation and the incentive to management to show profit? Is that fair?

MR. HALL: Yeah. Your subsidization, you mean accepting a less than adequate rate of return, is that what you're referring to?

MR. HUTCHINGS: Yes.

MR. HALL: Yes, those would be the key ones. There's certainly lots more. It's the intangible, which is what I was rather hoping I'd said, benefits that are also difficult to define, but very much there, and that's evident in my own experience with Nova Scotia Power that you referred to. I participated in the privatization of that company and, therefore transformed it from a Crown owned utility to an investor owned utility. It's difficult, obviously, in hindsight, to see exactly what would have happened had another set of circumstances occurred. But to most viewers it's been a quite good experience for, not only the shareholders of (unintelligible) it's now called, but also to the ratepayers of Nova Scotia. So I think there is some advantage to that process.

MR. HUTCHINGS: Are you talking about an attitudinal change on the part of management?

MR. HALL: Yes. Not so much the attitude of the management as the guidelines and constraints that the management has to work under, yes. For example, if I may dig the hole a little deeper, a commercially run utility tends to get social policy directives more overtly, so it's easier to deal with them, and that just makes it easier for the company to get on with what they do than when those directions are not as clear.

MR. HUTCHINGS: So, we have to identify and be explicit, I guess, about such differences that exist from the actual situation of Newfoundland and Labrador Hydro and an investor owned utility, is that fair?

MR. HALL: I'm sorry, we have to do that?

MR. HUTCHINGS: I mean, in terms of this Board regulating and coming up with appropriate returns and capital structures and all of the other issues that it has to deal with relative to Hydro, your suggestion is that it should, to the greatest extent possible, be treated as if it were an investor owned utility. But I'm taking from you that if there are differences then they do have to be accommodated in some fashion?

MR. HALL: Yes, I would agree with that. I mean, as I said earlier, in my simplistic view of the world, the Board could treat Hydro in the same way they treat Newfoundland Power in the same industry in the same province doing virtually the same things with differences, of course, that need to be identified, and that only in those areas where there are clear differences do they need to treat them any differently. For example, the return on equity that's required by Hydro, assuming it was 11 percent in both cases, if I may, for the moment, that that would require a higher revenue requirement for Newfoundland Power because they're taxable and less for Hydro. But that should be the only distinctions in my view.

MR. HUTCHINGS: I'm probably not quite accurately paraphrasing Ms. McShane in her evidence, but is it fair to say that to the extent that Hydro is treated like an investor owned utility it should act like an investor owned utility?

MR. HALL: Well, I think it would act like an investor owned utility.

MR. HUTCHINGS: And it should act like an investor owned utility?

MR. HALL: Yes.

MR. HUTCHINGS: Yeah, okay. But you recognize there are differences simply because it is a Crown owned utility?

MR. HALL: My length of differences is very narrow, but yes, there are differences.

MR. HUTCHINGS: Yeah, okay. I think you were fairly specific in answer to Ms. Butler in saying that there should be complete isolation between government as owner of the business and as the setter of legal policy or social policy, rather?

MR. HALL: Yes.

MR. HUTCHINGS: Yeah, okay. Are you familiar with the provisions of Section 5.1 of the Electrical Power Control Act?

MR. HALL: Not if you'd like me to quote them, but I've looked at it, yes.

MR. HUTCHINGS: Okay. Do you know the intent of that, do you recall what 5.1 deals with?

MR. HALL: All right, I give. I'll have to look it up.

MR. HUTCHINGS: It's not a section that I can recite from memory, either. But can we just bring up Section 5.1? 5.1, yeah, okay. That section provides for the Lieutenant Governor in Council who, I think we'll agree, is effectively the shareholder of Newfoundland and Labrador Hydro, to direct the Public Utilities Board with respect to policies and procedures to be implemented by the Board with respect to the determination of rate structures of public utilities and without limiting the generality, the direction as to the setting and subsidization of rural rates, fixing of debt equity ratio for Hydro and the phase in of rate of return determination. And the Board shall implement those policies and procedures. Is that the section you were thinking about when I mentioned 5.1?

MR. HALL: No, it wasn't, so I'm glad you found it.

MR. HUTCHINGS: No, okay. There are a lot of sections in there.

MR. HALL: Yes.

MR. HUTCHINGS: Okay. In light of that, would you agree with me that the legislative framework that this Board has to operate under is not necessarily consistent with your view that there be complete isolation between government as shareholder, and government as legislator?

MR. HALL: No, I wouldn't agree with that at all.

MR. HUTCHINGS: No? Do you feel that it is still open to this Board to deal with Hydro as if it was not owned by the Crown?

MR. HALL: Yes.

MR. HUTCHINGS: Okay.

MR. HALL: Because ... can I dig a hole?

MR. HUTCHINGS: Sure.

MR. HALL: Do you mind? Okay. Because what I read into that, which is not surprising to see, is that the government, in their legislation, has said let's be very clear, we own this Company, and if we want to direct the Board to do certain things on behalf of the people of the Province we will do so and the Board will do what they're told. That seems to be a reasonable directive to an entity that operates on behalf of the government. That's the way I interpret that, that they can direct the Board to make certain things done. That's not inconsistent with telling the Company to operate on commercial terms, and to the extent that the government and, indeed, the Board itself, either of those entities, to the extent that they direct the Company to do things that are different then they do them, because they're owned by the government. But they're explicit directions and they're not inconsistent with telling the Company to continue to operate under commercial terms.

MR. HUTCHINGS: Uh hum. Does the existence of something like Section 5.1 affect your view of the business risk of Hydro?

MR. HALL: We tend to call that regulatory risk, not business risk. So, I mean, the fundamental business risks that the Company is exposed to, I don't think are changed by this, unless they were directed to do something that would enhance those risks.

MR. HUTCHINGS: Okay. So do you regard ... well, maybe we're having a terminological problem here. Would you regard regulator risk as being part of business risk for a utility?

MR. HALL: I see. You can throw it into a basket, yes, okay.

MR. HUTCHINGS: Okay. So, would you agree, then, that 5.1 effectively, from the point of view of the shareholder of Hydro tends to seriously reduce its regulatory risk?

(3:45)

MR. HALL: No, I guess I'm not ... sorry. I guess I am misunderstanding where you're going here, and maybe I need to read this more carefully again, but this is the kind of direction that I wouldn't have been surprised to see the legislation in Alberta have, which is to say that the Province of Alberta, where they're all investor owned utilities, could say we reserve the right to direct the Public Utilities Board to do things on our behalf and you will do them. That doesn't seem to me to be counter to anything to do with Trans Alta's (phonetic) operations or Canadian Utilities Operations.

MR. HUTCHINGS: But isn't it clear that under Section 5.1 if this Board is moving in a direction that government, which is the shareholder, doesn't particularly like, government has the power to undo the Board's decision?

MR. HALL: Oh, absolutely, but not as shareholder. It's not the government, as shareholder, that has that right, it's the government as the legislator of this Province.

MR. HUTCHINGS: But it's still the same government?

MR. HALL: That's a coincidence, because they can do this to Newfoundland Power, too. They don't have to be a shareholder to do this.

MR. HUTCHINGS: Okay. There is specific reference in the section to Hydro but ...

MR. HALL: I'm sorry, not in this particular clause.

MS. GREENE, Q.C.: I think, in fairness to the witness, Mr. Hutchings should allow him to read it. It says "may give direction to the" ... "with respect to the policies and procedures to be implemented by the Board with respect to the determination of rate structures of public utilities." And then they go on to say "without limiting the generality of the foregoing." And in the specific there's examples of Hydro, but the direction is with respect to determination of rate structures of public utilities as defined under the Public Utilities Act which would be broader than Hydro.

MR. HUTCHINGS: We can, no doubt, address all that in argument, Mr. Chair. It'll ...

MS. GREENE, Q.C.: But I think, in fairness to the witness, you should allow him to understand what the section says.

MR. HUTCHINGS: The significance, I think, is found in the fact that it's the same government that is the shareholder that has the power under 5.1. But as I say, we'll undoubtedly address that at another time. At page 7 of your evidence, Mr. Hall, at line 20, you speak of the situation if a utility gets into financial difficulties of any kind the taxpayers are exposed to any liabilities. Is this intended to be a general statement in respect of all Crown owned utilities?

MR. HALL: Yes, I think it would apply to any Crown owned utility.

MR. HUTCHINGS: Would you agree with me that it would really only apply to a Crown owned utility that had a debt guarantee from government?

MR. HALL: No. It would apply to any Crown owned utility where there was any equity invested in the company which would be exposed to repayment to those liabilities. This company has $250 million, approximately, in retained earnings, which is exposed to liabilities to creditors if there were financial problems.

MR. HUTCHINGS: Okay. So if we read your comment to say that the taxpayers, to the extent of their investment in the utility, are exposed to the liabilities that would be correct?

MR. HALL: That would certainly be correct.

MR. HUTCHINGS: Yes.

MR. HALL: It's probably somewhat limiting, because governments tend to have more non-legal exposure, but, yes.

MR. HUTCHINGS: Yes. Okay. No, that's fine. There was a remark at page 9 of your evidence at line 16, line 13 to 16, I guess. You're speaking of your review of actual rates of returns on equity of Canadian utilities, and you refer to your schedules where investor owned utilities reported results near 10 percent and government owned utilities reported results for the same period at considerably higher levels. What degree of confidence should we have in the reported results of ROEs of government owned utilities?

MR. HALL: You have to be cautious about that, because the variability is quite high, and that's largely because the equity component is quite low, and so, you can see huge variability. It was, in this context, a gratuitous comment, not the focus of the sentence.

MR. HUTCHINGS: Okay. And I raise the question, obviously, because if we look at the Schedule 5 it specifically states exactly that, that the thin equity base of government owned utilities distorts this ratio. It also goes on to say, "and unduly raises the return." So, the bias is, in fact, an upward one in respect of government owned utilities? That's correct?

MR. HALL: I'm sorry, I'm not sure I quite got what you said at the last there. I read the note, yes.

MR. HUTCHINGS: Yes. You said in your answer that you had to be careful of looking at the numbers because they were so thinly capitalized. The note, in fact, goes on and says that the result of this is, in fact, a bias upward in the reported returns?

MR. HALL: I didn't see that in the note.

MR. HUTCHINGS: "And unduly raises the return."

MR. HALL: Oh, there, I'm sorry. Yes, that's what I said, as well, yeah.

MR. HUTCHINGS: Yeah, okay. And you agree with that?

MR. HALL: Yes.

MR. HUTCHINGS: Yeah, okay. Getting back to this notion of being treated like an investor owned utility and acting like an investor owned utility. Is it fair to say that investor owned utilities, when facing any significant capital expenditures, are more likely to look at some restriction in dividend payments?

MR. HALL: No. I don't know that there'd be much difference between the two. Restricting dividend payments is a source of capital, yes, and it would be the same whether you're investor owned or Crown owned, but that's only one source of capital, as you would know.

MR. HUTCHINGS: Yes.

MR. HALL: And you can access the capital markets in different ways.

MR. HUTCHINGS: Uh hum. But one option that most private corporations would look to in facing capital expenditures would be whether or not they should retain additional retained earnings, is that fair?

MR. HALL: It is an option, although you will be aware that in the electric utility business in investor owned companies it's an option that is used at the very last moment and only under significant duress. I refer you to Trans Alta Utilities, which has had the same dividend of a dollar per share for the last seven or eight years now, through a period of time when they could not afford to pay that dividend in terms of the earnings of any particular year and were paying out more than their reported earnings in years because they were so reluctant to reduce the dividend payout. So they don't do it easily, no.

MR. HUTCHINGS: Yeah. No, I understand that. But are there not generally categories of companies, one of which pays, as you say, like Trans Alta, fixed dividend dollar per share and others that pay a certain proportion of their incomes?

MR. HALL: I think there are, actually, but it's quite an unusual event for a company to declare a dividend payout ratio as a firm policy and pay that amount out year after year. I do recall Great Lakes Forest Products, which is going to age me a little bit, that did that in the mid 1980s, but it was quite unusual to do that. Most companies will set a dividend level that they feel comfortable that they're able to maintain over a period of time through cycles in the business world and pay that dividend out, just like utilities do, frankly.

MR. HUTCHINGS: It is fair to say, I presume, though, that most investor owned utilities are not in a position where they simply respond automatically to any demand by their shareholder/shareholders for a particular dividend?

MR. HALL: It's difficult to answer that. I think you're right, but it's difficult to answer that because there's nothing written and there's nothing ... there's no formal directions that come to the shareholders meeting to please pay us more dividend or if they are they're ignored. But it's difficult to answer that in respect to single shareholders, because single shareholders, of course, don't publicize their conversations.

MR. HUTCHINGS: Uh hum, quite so. Okay. I think, Mr. Chair, that might be a good time to break. I won't be very much longer, but I may have another few questions in the morning.

MS. GREENE, Q.C.: Mr. Chair, if I could have your indulgence for a few moments?

MR. NOSEWORTHY, CHAIRMAN: Sure.

MS. GREENE, Q.C.: We do have the update of the 2002 cost of service that we had talked about earlier. I'd like to distribute it now and take just a couple of minutes to explain what we've done, because I think it would be easier to understand the documentation if I do that.

MR. NOSEWORTHY, CHAIRMAN: Sure.

MS. GREENE, Q.C.: Because I do have copies which we thought for the Halloween treats earlier.

MR. NOSEWORTHY, CHAIRMAN: Thank you.

MS. GREENE, Q.C.: If everyone has a copy I'll just take you briefly through what's included in the package. The first document that you should have is an update of the 2002 capital budget which should be the first document that's in the package. You will recall that we had agreed to file this update on the basis of actual experience to the end of August. So this would reflect updates based on our experience and revised forecast as of the end of August, 2001. For simplification, we've tried to identify all of the changes. For example, if you look on page A-1, which is the second page in on the 2002 capital budget, you will see that there is a reduction in the capital budget being proposed for 2002, the test year, and there's a reduction from $48 million to $43 million, which is indicated on the bottom of page A-1.

What we have done is to file a revised page for each of the pages that gets changed as a result of the two changes shown on the bottom of page A-1. While there are only two changes it affected a number of pages in the proposed 2002 capital budget, so we have filed only the revised pages and have indicated with an asterisks where the changes are.

We have also filed supplementary evidence of the relevant witnesses to explain the changes. For example the change in the 2002 capital budget I just mentioned affects a number of things, such as the rate base. You will see that flow through in the evidence of Mr. Roberts. And similarly, in the next document that you have, which is a second supplementary testimony of Mr. Budgell. You will see in there, for example, how he explains the change in the 2002 capital budget which ... the responsibility of the production division, and he explains the other changes that were relevant to his pre-filed testimony such as the changes in the load that have occurred as a result of this update.

I won't take you through each of the others, but the idea was that for each of the remaining witnesses where there are changes required as a result of this update we have filed supplementary evidence and have attempted to identify what the change is as a result of this update.

The other thing that I wanted to mention is to remind the parties that, as I had said when we agreed to do this, this is another what I call snapshot. It's still not the final picture of what the base rates will be following the completion of the hearing. There will still have to be an another cost of service filed which will include such matters as any direction received by the Board on the price of No. 6 fuel, as an example, to be used for setting base rates around the ROE. So these numbers are still only illustrative, and as I mentioned earlier, reflect actual experience to the end of August. It would not, for example, reflect any change in forecast interest rates or fuel prices that may have occurred post September 11th, and as I mentioned, the reason for doing this was the amount of time required to complete the cost of service run, including all of the updates. So hopefully this will ... that helped explain what we filed. And the first witness who will be affected by the revised evidence is Mr. Budgell, who is scheduled to start his testimony on Monday coming. Thank you, very much.

MR. NOSEWORTHY, CHAIRMAN: Thank you, Ms. Greene. Do we need to mark this, counsel?

MR. KENNEDY: I was going to ask counsel. I don't think so. It's all revisions to previously filed documents, so will be included as just part of the application material that's already been filed.

MR. NOSEWORTHY, CHAIRMAN: Thank you, very much. We'll reconvene at 9:30 tomorrow morning.

(hearing adjourned to November 1, 2001)