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(9:00 a.m.)
CHAIRMAN:
Q. Thank you and good morning. Good morning, Ms. Newman.
MS. NEWMAN:
Q. Good morning, Chair. I believe that counsel for Newfoundland and Labrador Hydro has a couple of undertakings that she wishes to speak to.
CHAIRMAN:
Q. Good morning, Ms. Greene.
GREENE, Q.C.:
Q. Good morning, Mr. Chair, Commissioners. There were two undertakings that were given yesterday and we have responses to both. The responses have been circulated.
The first undertaking, which is U-Hydro No. 35, is found in the transcript of December 2nd at page 55. And it was an undertaking to Mr. Browne to provide the fuel consumption in Norman's Bay, Francois and Williams Harbour before and after a program that was initiated in 2001 by Hydro with respect to compact florescent lighting and hot water pipe installation. So the first response is the

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response to this undertaking and the--it is there on the screen and it is U-Hydro No. 35.
The second undertaking that was given yesterday was to Mr. Seviour and is found on page 146 of the transcript. Mr. Seviour asked us to reproduce table 5 to Mr. Banfield's evidence with the new RSP recovery rates showing a four-year write off rather than the two-year write off. So this response is there now on the screen as well. It has been circulated in hard copy to the Commissioners and the parties and it is U-Hydro No. 36. And that completes the responses to all undertakings given to date in the hearing.
CHAIRMAN:
Q. Thank you, Ms. Greene. Good morning, Mr. Banfield.
MR. BANFIELD:
A. Good morning, Mr. Chair.
CHAIRMAN:
Q. Hopefully we'll have a short session this morning.
A. So to speak.
Q. When you're ready, Ms. Greene.
GREENE, Q.C.:

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Q. Mr. Banfield, the first question that I have for you arises from the cross-examination of Mr. Kelly when you were discussing the conversion factor for No. 6 fuel at Holyrood as it appears in Consent No. 2. I wonder, Mr. O'Reilly, if you could bring up Consent No. 2? And Mr. Kennedy had a discussion with you around this document. And what I'd like to talk about is No. C, the Test Year Cost of Service for Holyrood net conversion factor. I'd like now to go to the transcript of yesterday at page 162. Page 162 at lines 21 to 25 Mr. Kennedy asked you would the number given for the Holyrood No. 6 conversion factor change. And the question you'll see there beginning at line 21 was phrased in whether it would change throughout the duration that the RSP is in operation. And your response there on line 1 on page 163 was that that is the number that's used. I just wanted to clarify for the record, does the conversion factor change at any point in time?
A. Yes, the conversion factor will change at Hydro's next General Rate Application. In response to that answer, I had misinterpreted

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Mr. Kennedy's question and my response was related to using the 624, that's the number that the Board agrees to, would be used in the RSP until such time as there's another General Rate Application and the number would be changed at that time or at least reviewed at that time. Whether it would be changed would be obviously a decision of the Board.
Q. So like the WAC that you talked about with Mr. Kennedy, these numbers are reviewed and if-- subject to Board decision they will be changed at Hydro's General Rate Applications?
A. That's correct.
Q. The next question in rebuttal arises to cross-examination by Mr. Kelly, and it's to deal with the rural deficit. In response to Mr. Kelly's questions you advised that the rural deficit is determined only through the Cost of Service in that it includes not only the cost of the operation of the rural areas, but the revenue requirement input as well as the allocation of cost that occurs through the Cost of Service. I believe you said, is it correct, Mr. Banfield, that if the Board found it useful and appropriate, Hydro could provide

GREENE, Q.C.:
an annual report using actual costs and running an actual Cost of Service Study to show the deficit in the previous year, is that correct?
A. Yes, that's correct.
Q. However, when Mr. Kelly questioned you with respect to Hydro providing information of various capital budget proposals with respect to their possible impact on the rural deficit, you expressed some reservations with respect to that and I wanted you to expand on that today?
A. Yes. I had expressed some reservations on that and I guess they are linked directly to the fact that the deficit, as we've just discussed, can only be ascertained with certainty in running a Cost of Service. In addition, there are numerous projects each year that affect the deficit, even those projects which are built for the Island Interconnected System. For instance, even Granite Canal, there's a portion of that which gets allocated to the interconnected customers and thus affects the rural deficit. The

question would be whether or not those projects as well would fall under this guise or this guideline. As well, in reviewing these projects it would be, I think, somewhat administratively difficult, even though it could be done to provide a very rough estimate, but that's all it would be. And I really wonder myself whether or not that would be of benefit to the Board in the absence of having an accurate calculation of what the deficit impact would be. I guess in addition I believe, as well, it raises some spectre of concern regarding Hydro's obligation to serve when we start looking at individual projects and the impact on the deficit, does that lead one to conclude that because the deficit may or may not be increased that we shouldn't provide as good a level of service. That's the type of issue, I guess, that would have to be dealt with as well and does promote some difficulty in addressing that issue.
Q. And Mr. Kelly took you to NP-51 which had--and I wonder, Mr. O'Reilly, if you could bring that up? I just wanted to clarify that NP-51 does not show the full impact on the deficit

of the various ones there. It only--could you explain what NP-51 does indicate?
A. Yes. The RFI only provides the depreciation and financing for those two projects and does not provide the rural deficit.
Q. And, Mr. O'Reilly, if you could scroll down, please, I believe this is set out, which Mr. Kelly did not take you to, why that this is not the full impact of the deficit and why it's difficult to do that. And I won't take you through that, but you'll see there's something there in No. 1. And, Mr. O'Reilly, could you go to the next page? So from Hydro's perspective it is--it would be very difficult to determine in advance the impact of all projects and what--including those on the interconnected system which may have an impact on the rural deficit. Is that correct?
A. Yes, that's correct.
Q. And NP-51 does not reveal that for Charlottetown, as had been indicated yesterday during the discussion, it's only a portion of the impact on the deficit?
A. That's correct.
Q. The next question that I have arises also from

the cross-examination of Mr. Kelly and it relates to the Demand/Energy Rate structure and Hydro's position with respect to that for Newfoundland Power. And here I wonder, Mr. O'Reilly, if you could go to page 3 of Mr. Banfield's revised evidence of October 31st? And beginning there with line 18. Is it correct, Mr. Banfield, that Hydro's position is as stated there that subject to the--beginning on line 27. That subject to the resolution of the issues that are identified in that paragraph that Mr. Kelly took you through at length yesterday, that if those issues are resolved by the Board, that Hydro recommends that a Demand/Energy Rate be implemented. Is that correct?
A. That's correct.
Q. And why is that Hydro's position?
A. Hydro believes that the Demand/Energy Rate is more appropriate and is overall in the long-term has benefits to the entire system. As noted by our expert witness, Mr. Greneman, and others as well, I believe it's Demand/Energy Rate is consistent with other jurisdictions for a sale to a customer of this size, as

MR. BANFIELD:
well, I believe that it better tracks cost causation as was explained by Mr. Greneman in his testimony evidence, as well. And it also provides Newfoundland Power with a more timely pricing signal. We have discussed that the demand signal is in the energy only rate but only gets adjusted at general rate application times whereas a Demand/Energy Rate would give a more timely signal. For those reasons we believe that a Demand/Energy Rate is a more appropriate rate form.

GREENE, Q.C.:
Q. Hydro does acknowledge that there are issues, though, before the Board that would have to be addressed before that rate structure could be implemented, is that correct?
A. That's correct.
Q. And is it Hydro's position that these issues can be addressed during this hearing by the Board in its decision flowing from this hearing?
A. We believe that to be the fact.
Q. The last area for rebuttal evidence arises with respect to cross-examination, both by Mr.

Kennedy and Mr. Browne, relating to the size of the lifeline block for Isolated Customers. And I wonder here, Mr. O'Reilly, could you bring up, please, CA-13. I'd like to see the cover of the--please. Mr. Banfield, could you explain what this report is that's entitled "A Review of the Adequacy of the Lifeline Block in Diesel Electric Systems"?
A. The report has been produced to review, as the title says, the adequacy of the lifeline block on diesel systems and it was written and addressed the fact that the existing lifeline block is at a flat 700 kilowatt hours per month, whereas there had been some discussion and we also wanted to review how that matched the consumption patterns in the isolated systems. The report looked at the seasonal variation in customer consumption patterns and came to the conclusion that a lifeline block that matched the seasonal variations in customers profiles was a better fit than a flat 700 kilowatt hours per month.
Q. And this report was filed in response to direction received from the Board in the last order, in P.U. 7, is that correct?

A. That's correct.
Q. And I wonder if we could go to page 9, the summary of this report? Page 9, just before that, Mr. O'Reilly, the heading called "Summary". There we go. Can you just read the first sentence into the record, no, the first two, actually, Mr. Banfield?
A. "A review of diesel household survey and consumption data indicates that there is some merit to consider a change in the existing lifeline block owing to the continued rise in the market share for electric hot water heating, seasonal electricity use patterns and the predominance of diesel customers located on Labrador diesel systems. Changes in the lifeline block will impact upon the rural deficit."
Q. And the report actually suggested an alternative lifeline which would have an impact of increasing the rural deficit. Is that correct?
A. That's correct.
Q. Now, this issue came up during mediation and there was agreement reached primarily with the Consumer Advocate with respect to this issue.

Is that correct?
A. That's correct.
Q. And can you outline what that agreement was?
A. The agreement that was reached was that the three tier, I guess I'll call it, lifeline block that had been proposed better tracked the seasonal patterns of Rural Customers, Isolated Rural Customers, and as well met the criteria that there would be no impact on rural deficit. That is that the subsequent energy consumption over the lifeline block would be at a rate such that there would be no impact on the rural deficit.
Q. And in discussing that with Mr. Kennedy yesterday you said that the agreement was that it would be revenue neutral to Hydro, but really it was that there would be no negative impact on the rural deficit. Is that correct?
A. That's correct.
Q. And that was part of the agreement reached with all the parties during mediation. Is that correct?
A. Yes, that was a very important issue that we addressed, yes.
Q. The information note that has been filed as

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GREENE, Q.C.:
Information No. 21, was that reviewed by Mr. Bowman, the expert for the Consumer Advocate?
A. Yes, it was.
Q. And was it agreed that that note would be sent to the parties who were presented at the Happy Valley-Goose Bay public hearing process?
A. Yes, that note was sent to those people.
Q. And I'd like now just to look at the transcript, page 177, because I believe it's on this issue. Page 177, page 6. I'm--line 6, sorry, page 177. And I guess in response to the question as to whether the information had been provided I wonder if--the way it is worded beginning on line 6 it is confusing. You talked about--beginning there on line 9. "And that being even in the absence of having circulated this prior to going to Labrador to the parties." And then down later in line 13, "even in that absence". So I ask you first, was the information note circulated to the parties who had indicated their intention to make a presentation at the Happy Valley-Goose Bay hearing?
A. Yes, it was.

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Q. And that was the note that was approved by Mr. Bowman, reviewed by Mr. Bowman, the expert for the Consumer Advocate?
A. Yes, that's correct.
Q. And had it been part of the agreement that public input would be sought during the public participation days in Labrador?
A. Yes, that was the agreement.
Q. And in Hydro's view, does the recommendation of the seasonal lifeline block varying three times during the year address the concerns that were identified in CA-13?
A. Yes, we believe it does.
Q. And that it will not have a negative impact on the rural deficit. Is that correct?
A. That's correct.
Q. Okay. Thank you. That concludes the rebuttal.
CHAIRMAN:
Q. Thank you, Ms. Greene. We move now to Board questions.
COMMISSIONER SAUNDERS:
Q. Yes, just one, Mr. Chair.
CHAIRMAN:
Q. Good morning, Commissioner Saunders.

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COMMISSIONER SAUNDERS:
Q. Thank you. Good morning, Mr. Banfield.
A. Good morning.
Q. Yesterday there was some discussion about Hydro's efforts in respect of educating your customers with respect to conservation and the like. I'm wondering, looking at the other side of the picture, had Hydro received any requests from communities, mayors, municipalities in your service district, I'm particularly thinking of the Isolated Rural service centres, requesting information from Hydro or assistance in any way to install, say, energy saving devices or to install insulation or--is that a common request?
A. No, it's certainly not a common request. We've had occasional requests from schools, educational type things, but certainly we have not, to my knowledge, ever received a request from community leaders along that--along those lines that I'm aware of.
Q. Who is the ultimate winner, if you like, in terms of any conservation efforts that takes place in your service areas?
A. I guess without being too philosophical I

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guess the winner, I guess, is society at large, I would offer. And I think that's one of the difficulties with the Demand Side Management issues. Supply Side Management is rather dealing with inert objects, shall I say, in terms of physical or natural resources. Dealing with Demand Side Management is far more problematic in that you're dealing with people and different disposable incomes, different desires and it is very, very, very, very difficult to come to grips with that. But I would--everybody is a winner, I think, if we can achieve conservation to whatever degree, I think everybody is a winner from that perspective.
Q. You talked about Hydro's efforts to try and, let's say, bring about some awareness on the part of your customers in respect of conservation and the need for it. And I'm wondering if there's been any further attempt--and I'm thinking of the Market Quest questionnaire that you talked about yesterday briefly. Are there any questions in that relating to conservation?
A. Not as such. The questionnaire this time when

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MR. BANFIELD:
we went through, we've had a number of questions in there relating to our HYDROWISE Program to garner whether or not customers are, first of all, aware of the program, ie, has our advertising worked, if they are aware, what are they gaining from benefits from it. So we're hoping--we have probably, I guess, five or six different questions in there to try and determine from that response where our next probing should be and how we should probably deliver the system in as good a fashion as we can so that we can make as many customers aware. But that's where we're aiming our questions this time around from our survey perspective.

COMMISSIONER SAUNDERS:
Q. Would you agree that one of the biggest incentives for a customer to install, say, energy saving devices or to conserve energy would be the amount showing up on his monthly bill?
A. Yes, I would agree 100 percent. Rates in an of themselves are probably the best signal that one can put into the marketplace to

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affect conservation, yes.
Q. And for the record, what rates are in effect in your isolated diesel areas, for instance? I don't mean the rate specifically, but aren't the rates that are in effect those of Newfoundland Powers?
A. For the lifeline block, yes, they certainly are. And other factors have been put in place to keep the amount of revenue or to keep the rates versus what the cost is to a much lower level than would otherwise be expected.
Q. Now, there's nothing on that bill to indicate what the total Cost of Service is to that customer, is there?
A. No, there's not.
Q. No. And in reality, speaking again of the isolated diesel areas, whether it's on the island or in Labrador, the real Cost of Service--I'm sorry. But the real cost to the customer is approximately 30 percent?
A. That's a rough number, yes.
Q. Rough number?
A. Yeah.
Q. And so, would you comment on whether or not that in itself is enough of a signal for

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people to take initiative to install energy saving devices or to conserve?
A. From my personal experience with this and in dealing with our Rural Customers, I don't believe that a statement on the bill or a number on the bill showing the difference between what it cost to--what it's costing to serve the customer versus what the revenue is will in and of itself, maybe coupled with some other things, but in and of itself, I don't believe will cause people to be--to conserve. I don't think that will happen in and of itself. If that's coupled with other things, I'm not sure what they would be, but I don't believe that single statement in and of itself would be of great benefit in instilling conservation issues or ideas in our customers' minds.
Q. But you agree, I think, from what you've said, that it's a two-way street? It's not enough for Hydro to try and educate customers on how to conserve, there's got to be a--or there's got to be a reason, there's got to be an incentive, if you like, for the customers to take on that initiative themselves and to do

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the things that people normally do, like insulating windows and adding extra insulation in ceilings and insulating boilers and so on, and the reason you do that is because your electricity bill is too high, I would think?
A. You're absolutely right. And our HYDROWISE Program, if you--when you look at the document itself, some of the things that we're trying to articulate through that document is establishing that two-way street. And you're absolutely right, it's--you can't push conservation, I guess you can, but there's got to be reception on the other end to have some desire to do it. Whether that's through just the desire to conserve because it's the right thing to do, which you might be able to achieve over years in school programs and having people think from a society perspective, or if it's the fact that by conserving I can see a change on my bill or invoice each month, absolutely, it definitely has to be a two-way street established.
Q. Now, do you think there's a direct relationship between the way in which the rural subsidy shows up or doesn't show up to

COMMISSIONER SAUNDERS:
the consumer and their need or their incentive to conserve?
A. Yes, I think that there could be other ways that the rural deficit is translated to people, but I guess under the current legislation and Board orders, that's the way we're doing it, I guess, is the way it's been put to us. But there could very well be, yes.
Q. Okay. I guess there was one other question. You mentioned earlier in the hearing, actually, it was, I think, probably during the--or someone did, I'm not sure it was you. Maybe it was Mr. Roberts. There's an amount that I recall showing up of bad debt reserve of somewhere in the order of $800,000 in respect of your isolated rural operations in Labrador. Do you--are you familiar with that number?
A. I believe I was here for that discussion with Mr. Roberts, yes.
Q. Um-hm.
A. I believe that was related to a particular year.
Q. Yes. And I'm wondering what the average or

what the percentage of bad debts is in your isolated diesel areas. Would you have any idea of that?
A. Yes. There's an RFI that we had -
Q. I thought there was, but I couldn't find it overnight.
A. See if I can be of some assistance to you on that, sir.
Q. And while you're looking for that, I guess I'm going to ask you the question once you do find it, is there a relationship between the amount of bad debts outstanding in your isolated diesel area and the incentive to conserve? In other words, if the bill gets written off, it's not cost to the consumer. Do you follow me?
A. NP-22, Mr. O'Reilly.
Q. NP-22?
A. NP-22. The table, I guess there's the -
Q. Yeah.
A. The table below is the--where we give the bad debt expense for 2001 and 2002. And I guess three and four are on the other--are on page 4 or three is, for sure. And you can see that the--if you go to the next page, Mr. O'Reilly?

Q. That's not the number I recall.
A. No.
Q. I thought the number was in the area of three quarters of a million dollars.
A. I believe the 2003 is a forecast number.
Q. Okay.
A. In there. 2002, here's the number I think you were looking at down here. The total amount was a million dollars.
Q. Yes.
A. For bad debt. And we had a write off in that year of a large amount for some of our Rural Customers above and beyond what we would normally expect.
(9:30 a.m.)
Q. But what happens to those Rural Customers, do they get disconnected?
A. Yes, if there's a bad debt and it's uncollectible. In a lot of cases they are people who move and don't settle up their final accounts. There are some that are unable to pay and are disconnected after we go through our disconnection procedures. They can only be reconnected again when pay their account in full. From that perspective, so I

don't know--getting back to your question as to whether or not it has an impact on the requirement to conserve, I would suspect not.
Q. You would suspect not. I wondered if it would.
A. No.
Q. Or wondered what your opinion was.
A. Yeah.
Q. Okay. Thank you, Mr. Banfield, Mr. Chair.
A. You're welcome.
Q. Thank you, Commissioner Saunders. Commissioner Whalen?
COMMISSIONER WHALEN:
Q. Good morning, Mr. Banfield. I can't see you again, but that's fine.
A. It's difficult at the best of times, but, good morning, Commissioner.
Q. I wouldn't agree with you. I just had a couple of questions. Actually, most of my questions that I had yesterday have been canvassed by Mr. Kennedy and Commissioner Saunders. I had a question in respect of the Demand/Energy Rate and it may lead into a couple of questions. If the Board orders implementation of Demand/Energy Rate with this

COMMISSIONER WHALEN:
decision, could you step me through what has to happen internally within Hydro to put such a rate in place? I'm thinking again in terms of the timing. And I understood Mr. Greneman, I think it was on redirect, to confirm that such a rate could be put in place with a relatively short time frame, a month or so. Because it's my understanding that there still has to be some discussion between Hydro and Newfoundland Power once the decision is made that we're going to go with the Demand/Energy Rate structure?
A. Yes. There are a number of items. And I guess in my testimony I had listed, I think it was four different items that had to be resolved. They're on page 3.
Q. Yeah.
A. Towards the bottom of page three, I guess lines, around 23.
Q. Yeah.
A. And of those, depending on the Board's order, the degree of risk, we believe we put forward a reasonable approach to that with the--our 98 percent and the--as a bottom line for

ourselves. The appropriate Weather Normalization methodology has to be decided with Newfoundland Power and obviously agreed to by the Board. The treatment of Newfoundland Power's generation, we believe, has been, well, resolved from our perspective in that we put forward option A within the REG-2, which was attached to Mr. Greneman's evidence and the appropriate costing of billing determinants. And we believe the only issue that needs to be clarified there, and I'll say clarified as opposed to resolved, is on the metering aspects. And I believe we've had some preliminary discussions with Newfoundland Power on that and they were very early in the game, and I don't believe that that's problematic at all. So in concert with Mr. Greneman's estimation of a month, I believe we can agree to finalizing those couple of items which are outstanding in order to put a Demand/Energy Rate into place.
Q. So really the largest piece of work, perhaps, would be the Weather Normalization methodology?
A. Yes. And we believe we have a model which can

be used, could be used on an interim basis barring any further studies that both parties might want to do to make it more accurate or whatever. But we believe it's a reasonable method to use in normalizing the demand.
Q. In terms of the Demand/Energy Rate itself to Newfoundland Power, I think the points that keep getting raised really relate to the incentive for Newfoundland Power to--providing the incentive to Newfoundland Power to reduce its peak?
A. I'm sorry, could you repeat that again, I'm sorry?
Q. Just thinking in terms of the key issues that keep getting raised, well, it's the price signal issue to Newfoundland Power, that that's one of the key drivers for implementing a Demand/Energy Rate?
A. Sending an appropriate and proper price signal, yes.
Q. To Newfoundland Power?
A. Yes.
Q. Where does the incentive for Newfoundland Power actually arise, is it in the way Newfoundland Power responds to that price

signal, is that where the incentive arises?
A. That's where the incentive arises. I mean, as we discussed, I discussed yesterday with Mr. Kelly, that Hydro, our obligation as Hydro, I believe, is to ensure that that signal is in place. Whether or not Newfoundland Power can respond or is economic for them to respond, that's a Newfoundland Power issue.
Q. Um-hm.
A. But at least the signal is there for them to respond to.
Q. Okay. Bear with me for one second now, I want to make sure.
A. Sure.
Q. Yeah, I think that was all I had outstanding as of now. Thank you, very much, Mr. Banfield.

CHAIRMAN:
Q. Thank you, Commissioner Whalen. Thank you, very much for your testimony, Mr. Banfield, indeed, in Labrador as well. I just have a couple of questions. One is a follow-up on Commissioner Saunders' questions. One of the amounts that I recall in terms of the collection of bad debts is quite high,

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CHAIRMAN:
following Mr. Roberts' testimony, I think, in terms of that issues, was Sheshatshiu. There was an amount there which was in the order, as I recall, I don't have it, of $350,000 that was written off. I guess you're the person that's responsible for customer relations and customer services in Hydro. Do you see that as being a recurring thing or what is it that you or Hydro are doing from a customer services response perspective to address that issue?
A. In terms of the collections in Sheshatshiu, yes, there's no doubt that collections are problematic in the -
Q. Is it higher there, is that--it would seem to be.
A. It's much, it's much higher in that area than it is elsewhere. We have been dealing with the Provincial Government in that area and believe that we can collect the outstanding bad debts in that area at sometime in the future, depending on the arrangements that might be made with the Lower Churchill development or land claims settlements, those

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types of issues. So we are dealing with that issue. It's problematic, and I agree, but we are doing our best to try and keep those to an absolute minimum.
Q. Your collections in Sheshatshiu, is that different than some of the other communities like Postville? I mean, do you deal with individuals there in terms--or do you deal with the band council, or how does that work in Sheshatshiu?
A. We deal with individuals in the Sheshatshiu area. And as customers, whether it's a band council is the customer or the individual is the customer, there's no difference in our collections policies or our collection procedures in those areas, no.
Q. I see. I guess the second question relates, as well, to coastal Labrador. Clearly when we--at the last GRA the public participation days that we held in Happy Valley-Goose Bay there was indeed some criticism, I guess, in terms of the quality of service, particularly in coastal communities and we noted that in P-7. That was followed up by a report. I think I commented on that up in Happy Valley-Goose

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Bay during our public participation days there last week. And it seems to me outside of Ms. Jones who commented on the blackouts or brown outs that indeed we didn't hear a repeat of that. Again, as the customer service, the person who's responsible for customer service, would that be your overall sense of what's happened in coastal communities in Labrador, that there has been an improvement, a considerable improvement in the quality of service there and do you get any complaint or criticisms these days on that service?
A. I think that's a reasonable conclusion and that's the one that I think I would have--I have come to as well is that over the last--since the last rate application, when we did hear those concerns in Labrador and we did undertake that study and review, I think we have made strides in improving the level of service in those coastal communities. That's not to say there are not periods, whether it's storm related or weather related that we don't have our hiccups, but in general, I think we have made an effort and made more than an effort, I think we have achieved and improved

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reliability. Based on the number of complaints or calls, I would have to say, as well, that that leads me to that conclusion. I think Mr. Martin, when he was on the stand, had mentioned in the L'Anse-au-Loup area that we were still having some difficulties, but we believe we have those resolved now in dealing with Hydro Quebec on the supply of that secondary hydro power and we are looking for even greater improvements in that area. So yes, I would have to say that improvement has been achieved in those areas.
Q. The third question I have, now we'll probably hear substantially more on this on Monday, but it relates to the Federal Energuide Program and it was my understanding from your testimony that there's a company Enerplan delivering that. Is that correct now?
A. That's my understanding and we have talked to Enerplan about that service. Again, my understanding is that the Federal Government are in the process, if they have not already done it, of going out for another request for proposals to try and solidify that delivery of that service to Newfoundland.

CHAIRMAN:
Q. So are Enerplan delivering throughout the Province or is that on a regional basis, do you know that?
A. To be quite frank, when we did discuss this with them and when we had talked to Enerplan, they were a little bit hesitant about exactly what they were going to be doing in the interim. I think they're trying to act as a stop gap until such time as the Federal Government can come to grips with a full service provider for that guide.
Q. So have the Federal Government actually called for proposals for that at this point, do you know?
A. I'm not sure. I can't answer that. My last update and briefing that I had on this issue, my understanding was that they were in the process of or going to be going shortly. Whether that's actually taken place or not, I'm not sure, sir.
Q. Okay. Thank you once again, Mr. Banfield, very much.
A. Thank you.
Q. We'll move now to any matters arising from

Board questions. Mr. Browne, good morning.
BROWNE, Q.C.:
Q. Good morning. Yes, in the coastal areas of Labrador, you were asked some questions and in reference to the community of Sheshatshiu, does anyone pay their utility in Sheshatshiu?
A. Yes, the Band Council are paying all of their general service accounts. There are some domestic accounts being paid, but there's a considerable number of the native accounts that are not being paid.
Q. When you say there's some domestic accounts being paid, can you put that on a percentage basis? Five percent, ten percent, twenty, more?
A. I would suspect that it's five percent or less.
Q. So it's five percent or less of domestics and the Band Council pays for their general service?
A. That's correct.
Q. Has anyone been disconnected in Sheshatshiu?
A. Not at the domestic level, no.
Q. And has Hydro got a point person there to try to deal with that situation?

A. I deal with it in terms of disconnections of the Band Council accounts, et cetera. The issue, as I discussed with the Chair on that, is being dealt with at the management level in the sense of trying to determine how we can recover those bad debt expenses, either through some agreement, land claims settlement or the Lower Churchill development issues.
Q. And that amount of bad debt, is that reflected in the rural debt, the rural subsidy that's required?
A. Yes, it is.
Q. And if there's a change in the lifeline block as recommended, have you done any estimate as to what the cost will be in reference or will it reflect that at all?
A. No.
Q. There's no one on diesel in Sheshatshiu, right?
A. No, they're on the Interconnected Labrador System, so that won't have an effect at all.
Q. You were asked in reference to the coastal communities, and if I'd be allowed, I'm sure Ms. Greene wouldn't want to mislead in reference to the mediation agreement, but

wasn't there a clause in the mediation agreement saying it was subject to the participation of people in Labrador?
A. Absolutely.
(9:45 a.m.)
Q. Okay. You filed an undertaking yesterday, Undertaking No. 35, and Undertaking No. 35 indicates the before and after diesel fuel consumption, the relevant point being the conservation methods that were undertaken in these communities, and I notice in Francois, that after you implemented their conservation program, the consumption actually went up. Is there a reason for that?
A. I'm sorry, Mr. Browne, can you repeat that again, sir?
Q. Yes. In Undertaking No. 35 filed just this morning, in Francois -
A. Yes.
Q. - the fuel consumption actually went up after you implemented conservation methods. Was there any reason for that?
A. No. As I had explained yesterday, I think one of the problems in looking at the fuel before and after is that load growth or other factors

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MR. BANFIELD:
may very well mask the benefits and it could very well be that the fuel consumption would have been higher had we not done this. So there's no--I don't have any answer as per se as to why that happened in that particular community.
BROWNE, Q.C.:
Q. And in reference to Williams Harbour and Norman Bay, the fuel consumption went down. Do you know if the population varied during that 12-month period? Did people leave those communities or was there more households you were servicing or less?
A. I'm not aware of that data, no. I should note that Williams Harbour was the first time that we have done this program in Williams Harbour and therefore that's why you see the greater savings. Norman Bay and Francois had already been canvassed and had had CFLs, pipe wrap, et cetera, put into them in the 90s and this was as we had used here, a bit of a top up program to try and keep that flowing. So that's why those numbers are slightly--are very low for Norman Bay, and again, as we just discussed,

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for some reason there's an increase in Francois.
Q. Thank you, Mr. Banfield.
A. If I could, just a point of clarification, if I might. Mr. Browne had asked me a question on the Sheshatshiu and the rural deficit. I think I may have mis-spoke myself on that. In terms of rates, okay, what is--what goes into the rate is what's in our Cost of Service Study, and we have forecast an allowance of $325,000 in there. So that bad debt is indicative of what we would expect to be an average year. Any other bad debts that are incurred during subsequent years would just go to Hydro's bottom line. So I'm not really sure if that's--if it's fair to leave the impression that the--from a rural deficit perspective.
Q. And by the way, reference to Sheshatshiu and that bad debt, when we were in Labrador, I think one of the presenters gave information concerning an expansion in Sheshatshiu. That they were putting an outdoor facility there for skating or something. I'm just going by my memory now. And there were new homes being

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constructed there. Is Hydro undertaking to find ways to collect for these expanded services before they are brought on stream?
A. The expanded services for the ice rink, I think which was mentioned, would be fully paid for in the community. The Band Council will pay for that. And we are always trying to find ways and means to make sure that the domestic accounts are being paid.
Q. Thank you, Mr. Banfield.
CHAIRMAN:
Q. Thank you, Mr. Browne. Good morning, Mr. Kelly. Would you have any?
KELLY, Q.C.:
Q. No questions, Chair.
CHAIRMAN:
Q. Good morning, Mr. Seviour. Did you have any?
MR. SEVIOUR:
Q. No questions, Chair.
MR. KENNEDY:
Q. No questions, Chair.
GREENE, Q.C.:
Q. No questions, thank you.
CHAIRMAN:
Q. Thank you very much, Mr. Banfield. You have

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three or four binders there. Maybe Ms. McShane might require a couple of minutes to get ready as well, so we'll just take five minutes, if we can.
GREENE, Q.C.:
Q. Thank you, Mr. Chair.
(9:49 a.m. - BREAK)
(10:01 a.m. - RESUME)
CHAIRMAN:
Q. Thank you. Once again, good morning, Mr. Young, I guess?
MR. YOUNG:
Q. No.
CHAIRMAN:
Q. Ms. Greene, would you like to present your witness please?
GREENE, Q.C.:
Q. Good morning, Mr. Chair, once again. Our next witness is Kathleen McShane who is with Foster and Associates and she will be giving evidence on the cost of capital.
CHAIRMAN:
Q. Good morning, Ms. McShane. Welcome back.
A. Thank you very much.
MS. KATHLEEN MCSHANE (SWORN)

CHAIRMAN:
Q. Thank you. Just before we start, Mr. Browne, would you like to introduce your--or Mr. Fitzgerald?
MR. FITZGERALD:
Q. Thank you, Mr. Chairman. This is Dr. Basil Kalymon, who has joined us at counsel table this morning. He's our cost of capital expert.
CHAIRMAN:
Q. Good morning, Mr. Kalymon, and welcome back once again, sir.
MR. KALYMON:
Q. Good morning, Chair.
CHAIRMAN:
Q. When you're ready, Ms. Greene, please.
GREENE, Q.C.:
Q. Ms. McShane, pre-filed evidence was filed in your name with Hydro's original filing in May of 2003 and it has not been updated since that time. Do you adopt the evidence filed in your name with the May filing as your evidence for the purposes of your testimony today?
MS. MCSHANE:
A. Yes.

Q. Now, at this time, I would ask if there was any data in your pre-filed evidence that you would like to update or change the market conditions from the time that you filed this report to today?
A. Yes, there would. First, I'd like to update the forecast of long Canada yields. In the pre-filed testimony, I had anticipated a six percent long Canada yield. The most recent consensus forecast provided by Consensus Economics, which provides the ten-year Canada forecast, this being the November 2003 forecast, anticipates that the 10-year Canada will be five percent three months forward and 5.3 percent 12 months forward, which would give an average of approximately 5.15 percent. The spread between 10 and 30-year Canadas for October of 2003 has been approximately 50 basis points, which would indicate a long Canada yield for 2004 of approximately 5. 6 percent, which is the same yield that was used by the Board in setting the allowed return in Newfoundland Power's decision.
In addition to the long Canada yield, I would point out a couple of updates that I

made in respect of RFIs to which I responded and which would have an impact on what my recommendation today for a fair return would be. I would first point to an update to the market risk premium which I made in conjunction with the response to IC-132, in which I concluded that with the addition of 2002 data, that I would reduce my estimation of the market risk premium from 6 to 6 1/2 percent to 6 percent, which based on what I call the market or the risk adjusted market risk premium test, that utility risk premium would now be 3.75 percent. At the same time, the fact that the long Canada yield forecast is lower than at the time I prepared the initial evidence, I would also update my discounted cash flow based risk premium test to reflect the lower long Canada yield, which would result in a risk premium from that test of approximately 4.9 percent, which is somewhat higher than in the initial evidence given the inverse relationship that that test indicates between interest rates and the level of the risk premium. So that on balance, the risk premium itself would, in my view, be

approximately equal to what it was when I initially filed the testimony, so that being 4 to 4.75 percent. Based on the 5.6 percent long Canada yield that I would now anticipate for 2004, the equity risk premium test result, including 50 basis points for finance and flexibility, would be in the range of 10.1 to 10.85 or approximately 10 1/2 percent.
I also provided some updated DCF results in response to PUB-74. These results indicated material decline in the DCF costs for a sample of electric utilities to approximately 10 percent on a bare-bones basis and 10 1/2 percent including a finance and flexibility adjustment. I have not formally updated the comparable earnings test. I would note that the results for 2002, which were not included in the pre-filed evidence, because they weren't available, but if those results were added, the results of the comparable earnings test would be somewhat higher than they were originally and would certainly support the comparable earnings test result remaining at approximately 13 percent. Given those changes in the DCF and risk premium

MS. MCSHANE:
test, today I would recommend a fair return on equity of approximately 11 to 11 1/4 percent.
GREENE, Q.C.:
Q. Thank you. So if for a moment we could go to page 60 of your evidence, I just wanted to confirm the summary of what you just outlined. Page 60?
A. I have that.
Q. Okay. I'm just waiting for it to come on the screen. Beginning there on line 27, you had indicated your recommendation at the time of filing your evidence was 11 1/4 to 12 or approximately 11.5 and as result of your updating, you are now recommending in the range of 11 to 11 1/4? Is that correct?
A. Correct.
Q. Did that conclude what you had wanted to update, Ms. McShane?
A. Yes, thank you.
Q. I have one additional question for you and it relates to Dr. Waverman's pre-filed evidence. You have now had the opportunity to read the opinion expressed by Dr. Waverman in his pre-filed evidence and I wanted you to advise the

Panel and the Commissioners your position with respect to the opinion expressed by Dr. Waverman that the appropriate test here for Hydro for its fair return is the opportunity cost of debt?
A. Yes. Just to reiterate what my understanding of Dr. Waverman's conclusions is, he concludes that the opportunity cost associated with Hydro's shareholder's equity is equal to the marginal cost of provincial guaranteed debt, and my understanding of his rationale for this conclusion is as follows: there is no common stock equity, rather only shareholders equity; and two, the only capital that Hydro raises in the market is debt.
In my opinion, the differentiation between common stock equity and shareholder's equity for the purposes of determining what a reasonable return is, is not a substantive one. Shareholder's equity in Hydro reflects the earnings that have been retained for purposes of financing rate base assets, in lieu of being used for some other purpose. The shareholder's equity, which is subordinate to the debt issued by the Corporation, is

subject to greater risk than the debt. In principle, the retained earnings could be used somewhere else and the return that the shareholder and Hydro should have the opportunity to earn should, under the standards expressed and established in the Hope decision that is actually cited by Dr. Waverman, that is they should be commensurate with the returns on investments in other enterprises having corresponding risks. Put differently, the shareholder's equity should be allowed a return that reflects the opportunity foregone of not investing those funds in an alternative enterprise.
And just as a further point, I would note that there are a number of Crown corporations in this country that have rate base rate of return regulation. In BC, in Alberta, in Ontario, in Quebec, in New Brunswick, in the Yukon and in Northwest Territories, all of those companies are regulated on the basis of rate base rate of return regulation and all of them are regulated on the premise that the return should be--the return on the shareholder's equity should be commensurate

with the returns available in similar risk enterprises. None of them have a return that has been set on the basis of the marginal cost of debt.
Q. Thank you, Ms. McShane. I take from that answer you certainly don't agree with Dr. Waverman's opinion or his recommendation to the Board in this regard?
A. No, I do not.
Q. Thank you. That concludes Ms. McShane's direct examination.
CHAIRMAN:
Q. Thank you, Ms. Greene. Good morning, Mr. Fitzgerald. When you're ready, you can begin your cross-examination please.
MR. FITZGERALD:
Q. Thank you, Mr. Chairman. Good morning, Ms. McShane.
A. Good morning.
Q. Just to get this--you've just revised your evidence and just to get a global view of this now, you've revised what your earlier recommendation was. Your earlier recommendation was for the return on equity for Hydro was 11 1/4 to 12 percent. That was

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MR. FITZGERALD:
the range?
A. Correct.
Q. And you've now revised that to 11 to 11 1/4?
A. Correct.
Q. Right direction. Can you just briefly--and I
know that you have just described why the
upper end of your range has dropped by 75
basis points, but can you please reiterate for
us, in a nutshell, why the change?
A. The primary three reasons are lower long
Canada yield, lower DCF costs, and a lower,
slightly lower market risk premium.
Q. You're still aware, of course, that Hydro, in
this application, is only looking for a 9. 75
percent ROE?
A. I am.
Q. Okay. How do you reconcile their application?
Presumably their CEO and CFO are acting in the
best interest of Hydro, we could assume that?
A. Yes.
Q. However, they are only asking for 9.75 percent
and you've recommended a range of 11 to 11
1/4. Does that suggest to us that your
recommendation may be excessive?

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A. I think what it is intended to suggest is that
this Board recently reviewed evidence on cost
of equity and made a finding for Newfoundland
Power and it was Hydro's conclusion that
rather than ask this Board to review all of
that evidence again, just to ask for a return
that was the same as the Board had allowed for
Hydro--excuse me, for Newfoundland Power.
(10:15 a.m.)
Q. Okay. If you could just go briefly to CA-92
please? And at CA-92, yes, here you were
asked, "in reference to the pre-filed evidence
of Kathleen McShane for each regulatory
proceeding which McShane made recommendations
with regard to the cost of capital in the past
five years, provide the following" and at page
two, we have a table here that indicates your
recommendation over the past several years,
your recommendation to various boards, and the
allowed returns or the returns allowed by the
various Boards that you've presented evidence
before, and would you agree that if you have a
view of each of these allowed returns,
compared to what you recommended that
generally your recommendations are not

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accepted by Boards and they are on the high
side?
A. I would agree with you that generally the
regulators have looked at evidence of various
parties and come to a conclusion that is
somewhere in between what companies have
proposed and what intervenors have proposed
and as a result, the results are somewhat
lower than the numbers that I've proposed.
Q. Okay. Are you aware of any companies that
you've represented or you've given evidence on
behalf of who have suffered any financial
distress as a result of not obtaining your
recommended levels of return?
A. As a direct result, not to my knowledge.
However, there are few, if any, I can't even
think of one company who is totally dependent
on regulated operations for purposes of being
able to access the equity markets. So for
example, if you look at companies like
Canadian Utilities Limited, their allowed
returns have been in the 9 1/2 to 10 percent
range, but their earned returns are in the 14
to 15 percent range. So I mean, it's very
difficult to isolate the effect of just the

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regulated returns.
Q. The simple answer is no, I guess, you're not
aware of any?
A. If you recognize that there are other factors
involved, I mean, I would have to say no, I
can't identify any company that specifically
has been unable to attract capital as a result
of the allowed returns that have been recently
approved by regulators.
Q. Okay, Ms. McShane, if I could direct you to
page 25 of your pre-filed evidence, please?
And here, I just want to review the tests that
you have employed in your evidence, and the
familiar tests of studying the equity risk
premium, the discounted cash flow test, and
the comparable earnings test, and you would
agree with me that in applying each of these
tests, you've exercised a significant measure
of judgment?
A. There is judgment that is exercised. Every
expert must exercise judgment in applying the
test.
Q. And you state, at line 8, "the concept of a
fair and reasonable return does not reduce to
a simple mathematical construct."

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MS. MCSHANE:
A. I say that, yes.
MR. FITZGERALD:
Q. So it's possible that in making your--or exercising your judgment that your results may be higher than another expert may say?
A. Yes, that's true.
Q. Just if you could go forward then to page 27 of your evidence?
A. I have that.
Q. Okay. This is a reference to your risk premium test and you've made some adjustments to this this morning. You had indicated firstly in your pre-filed evidence that, at line 3, I'm just reading there, "when added to the 10-year forecast indicates that a long 30-year Canada yield of 5.94 rounded to 6, a 6 percent 30-year Canada yield is reasonable forecast of the risk-free rate for the 2004 test year." Now you revised that this morning?
A. Yes.
Q. And you revised that to 5.6 percent?
A. Correct.
Q. Okay. And do you know the current 30-year

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Canada bond rate?
A. Yes.
Q. Can you tell us what that is?
A. I'm sorry, I was just being a little facetious.
Q. That's all right.
A. This morning it was 5.32 percent.
Q. 5.32 percent. And that is still somewhat lower than your forecast 5.6?
A. It is. We're still in a relatively low interest rate environment and the expectations are for interest rates to rise.
Q. Okay. The question then becomes, if the current trading for a bond yield is--for a bond is 5.26 percent or sorry, 5.32, and it's forecast to be at 6 percent, then why would a current investor invest in bonds knowing that that investment is going to create or be a better yield in the future? Won't he be losing money upfront by investing at 5.3 percent now?
A. Possibly.
Q. So, but your forecast, you believe that the 5.6 percent is a better reflection of the expectation of investors at 5.32 percent?

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A. Well, I understand what you're saying is that the theory is that all available information is already impounded in the current level of interest rates, and if interest rates were actually expected to rise, they would be higher. But experience has shown us that interest rates do go through cycles and it's clear, based on where the economy is expected to be that the probability is for higher interest rates within the next year rather than interest rates at the level they're currently at.
Q. Okay. And are you aware that this Board recently uses actual yields on bonds to set the cost of equity capital in its adjustment formula?
A. I am.
Q. And they rejected the use of forecast data?
A. Yes, they did.
Q. Okay. However, you still believe that the 5.6 percent should be used in your risk premium test?
A. That would be my recommendation.
Q. Moving forward, Ms. McShane, to page 32 of your pre-filed evidence.

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A. I have that.
Q. Okay. At line 10, you say "sixth, from 1947 to 2001, the achieved risk premiums in Canada were two percentage points lower than in the US."
A. Yes.
Q. Now that's a long time span, is it not, 1947 to 2001, relatively speaking?
A. It depends on relative for what purpose.
Q. Well, to understand trends or to spot trends.
A. Again, I think it depends on what you're trying to accomplish. If you're talking about establishing an equity risk premium, which is what this discussion is about, no, it's not too long a time period. If you look at what other analysts have done who are looking at risk premiums, some of them are looking at periods as long as 200 years. Some of them are looking at periods from the beginning of the 20th century. I think what we are trying to accomplish by choosing a period is balancing the need to focus on a period that I would describe--to paraphrase the words of another expert in this area, Dr. Kryzanowski, who has said that what you're trying to do is

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MS. MCSHANE:
to make sure that you don't go beyond regime shifts, as he calls them. So that, you know, if you go back too far, you're looking at data that precede the gold standard or you're looking at data that only have, let's say, in the index ten stocks, and those are railroad stocks.
A. At the same time you want to make sure that you're covering enough types of periods that you're not just looking at something that is unlikely to be repeated anytime in the near future. So that if we only focused on the last 20 years let's say, within that period we've got a very major shift in the bond markets. So that we had very high achieve returns on bonds which we're not apt to see again because we're now sitting with bond yields in the low 5s as opposed to 20 years ago when we were looking at bonds in the 12 to 14 percent range. So that as those yields came down, there were major increases in capital appreciation on the bonds which we're not likely to experience again anytime soon. So there is that balance that we're trying to

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achieve.
Q. I guess, when we look at that time frame, 1947 to 2001 and you've indicated that over that time frame Canadian returns have or achieved risk premiums have lagged behind the American risk premiums by two percent.
A. Right.
Q. Right. I guess during that same period of time has there been, you know, have investors fled from the Canadian investment scene. They're still investing in Canada we could assume.
A. Well certainly they're investing in Canada and they're investing elsewhere as well.
Q. So, I mean it could be possible that due to economic differences between the Canadian experience and the US experience that Canadian investors are willing to accept lower levels of return.
A. Well that's certainly not the indication that was given or has been given by all of the material that's been produced that suggests that Canadian investors should look to the global markets to be able to enhance returns. So I don't think the fact that there have been

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lower achieved returns in Canada should be taken as an indication that investors require lower returns, simply that they achieved the lower returns.
Q. The bent of your evidence, if I could put it that way, on this issue, you've chosen to rely heavily on the performance of the US market, correct?
A. I rely somewhat on the performance of the US market, yes. It's a much larger market, it's a more diversified market. It hasn't had the impact that the Canadian market has had with the influence of a couple of very large stocks, those being Nortel and BCE. So there's certainly a significant support for putting reliance on the closest market in a more diversified market, than just the Canadian market.
Q. And it is true that the US market has performed markedly better than the Canadian -
A. It has performed better than the Canadian market, that's correct.
Q. Or indeed any other market globally.
A. I don't think that that's true. It's not necessarily performed better than any market

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globally.
Q. Which is it secondary to, do you -
A. Well it really depends on what period you're looking over.
Q. Well let's speak of 1947 to 2001. It has probably performed better than -
A. I mean, it's certainly within the top tier. I can't put my finger at the moment on specifically which equity markets have performed better, but I have read the results of a study that Dr. Kalymon has cited called the "The Triumph of the Optimist" which talks about various large markets and there are, at least several of the markets, the equity markets that have performed better than the US market.
Q. Certainly during the time period and this is getting back to your statement, it's clearly out performed the Canadian experience.
A. Absolutely, it outperformed the Canadian market.
Q. So by relying upon the US experience though, wouldn't you agree that that perhaps creates or introduces an upward bias in your analysis of the risk premium?

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MS. MCSHANE:
A. No.
MR. FITZGERALD:
Q. Let's have a look at page 36, table 5.
A. I see that.
Q. Okay, this table shows a risk premium over different time periods for the US market. Now you say that, or I mean we have a range here of risk premiums, 13.2 risk premium during the time period 1952 to 1967 and as low as 2.4 in 1968 to 1982, correct? I'm just reading from your table there.
A. I know and I'm trying to see it.
Q. Your eyes are down, okay.
A. So sorry, you said that there's a risk premium as low as -
Q. Okay, if we look at the second last column -
A. Yes.
Q. And then the third set of numbers down, 13.2, that's the highest risk premium that I see in this column and this is a risk premium deriving from the period 1952 to 1967.
A. Correct.
Q. And the following risk premium is 2.4 and that's for the time period 1968 to 1982.

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A. Correct.
Q. So the simple point I guess is that risk premiums will change their form or their amounts, depending upon which time period you look at.
A. Certainly they will be different and they will tend to reflect the specific circumstances in the economy in the capital markets that were prevailing over that specific time period.
Q. Okay. The question, the further question I have arising from this is that when we look at this, all the figures in this second last column of table 5 going from the period 1926 to 2001, it appears that the median of the risk premium for this time period, if you include the 13.2 and the 2.4 is approximately 4.75 percent.
A. So, you're just taking--irrespective of how many years are included in each period or -
Q. That's right, I'm just -
A. That's probably the case.
Q. Well then the next--beneath the table you conclude at line 11, starting at line 9, said, "In conclusion, based on the above analysis with consideration for both compound and

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arithmetic average returns and for both the Canadian and US data, a reasonable estimate of the market risk premium is approximately 6.0 to 6.5 percent." So I'm just--if you could take us to how you go from this table 5, the figures that are illustrated there, how you jump from the median of 4.75 to 6 percent?
A. I don't. And that was your analysis. I haven't done that at all. I was simply trying to point out that depending on what the circumstances are in a particular time period, that you're going to get very different achieved risk premiums. But to say that you just picked the median on that table is not how I came to my 6 to 6-1/2 percent. I mean it includes the analysis that precedes the table starting back on page 27. So I mean I can't say that picking a median out of those five numbers or six numbers is the way you would go about looking at the risk premium. I mean the fact of the matter is that if you go back and look at, for example, let's look at the 1992 to 2001 period where you've got a match of stock returns in the 14 percent range and bond returns in the 9 percent range where

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the 9 percent bond returns were generated by this phenomenon that I was talking about earlier where we had the steep decline in interest rates and the high capital appreciation in bonds. So, yes, there was a particular risk premium generated by those specific results but I wouldn't say that the 4.7 percent risk premium for that particular period is one that you could just take and put it with, you know, four or five others in covering other periods and take a median on those values.
Q. Well then how much weight do you yourself then put to this table 5, what does it--has it been included in your evidence, why is it there?
A. It's been included in my evidence to illustrate how the risk premiums can change and how they can differ depending on the type of economic circumstances we're in. But on balance, I mean we're looking at a risk premium that reflects the experience of the entire period.
Q. Just to follow up on that, if I could direct you to PUB-63, please. The question was referring to page 36, Table 5 which is the

MR. FITZGERALD:
table we're speaking about now. "Please provide a corresponding table for Canadian risk premiums" and if we go to page two of this IR, I just want you to confirm for us-- Mr. O'Reilly, if you could scroll to the bottom of the page, the very bottom. Here we have a reflection of the same time periods that you had in your table 5. We have a similar array of numbers here. In the second last column we have a series of numbers indicating risk premiums, for example, the 1926 to 1939 period we have 4.2 percent, are you with me?
A. Yes.
Q. And just going through the same time periods that you have set out in table 5, for example we go down to 1983 to 1991 we have actually negative risk premiums, is that correct?
A. Yes it is.
Q. And 2001 of course it's negative as well. And these are Canadian risk premiums.
A. These are Canadian achieved risk premiums, correct.
Q. And when we look then at your--the US risk

premiums for the same time period, let's say 1983 to 1991 the US risk premium is at 4.2 percent whereas the Canadian risk premium is actually negative, 2.2 percent correct?
A. Correct.
Q. So does this particular bit of information enter into your judgment at all when you're trying to determine what an appropriate risk premium is in this jurisdiction?
A. Yes, in the sense that if you look at the first two columns of the bottom of this table, what you see is that there has been a significant increase over time in the bond returns. And the major factor which has determined in Canada the decline in the experienced risk premium is the fact that, for example, in 1992 to 2001, the bond returns were, total returns were at 12.1 percent and the yields themselves which is in the third column at 9.1, percent are considerably higher than what we see today and what we would expect in the future whereas in the left hand, most left hand column you can see that the market returns have been in the 11-1/4 to 11-1/2 percent range in the last four sub

periods.
Q. So that illustrates, or does it, that the Canadian experience has been vastly different than the American experience, when it comes to actually risk premiums?
A. Well, I said at the outset of this discussion that we were having that in the testimony there has been a two percentage point difference in the risk premiums.
Q. Yet you still maintain that an appropriate risk premium is six percent. Although did you change that this morning?
A. I changed it to six percent.
Q. To six.
A. Yes.
Q. Ms. McShane, if we can go now to page 39 of your pre-filed evidence.
A. I have that.
Q. To discuss beta factors, if you will. Table 6, this indicates the unadjusted beta factors for Canadian utilities since 1995.
A. Yes, it does.
Q. And does this data not suggest that the utility investments have become relatively less risky over the 1995 to 2002 period?

A. No, it doesn't.
Q. Can you explain that?
A. Yes, I can. What happened, beginning in 1998 and will carry through to 2002 is that the market in Canada has been very much affected by the performance of technology stocks, particularly Nortel and BCE. So that if you want a technology stock your beta is not correlated--or your price was not correlated to the same extent to the rest of the market as it had been in the past. And this was not just true of utilities. This was true of virtually every other sector in the economy, so that if you look at betas of, say, the consumer staples industry, or the non-tech consumer durables that you would have seen the measured betas over these periods decline to similar extents as the measured betas for the utilities did. And because that period was characterized by this market bubble, I would suggest that once the experience of the market bubble has disappeared from the data, that you will see the betas of not only utilities but other non-tech stocks return to the levels that they were at prior to the market bubble.

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MR. FITZGERALD:
Q. Just leaving betas aside for the moment, is it your understanding or is it your belief that in light of the recent changes in the stock market or things that have happened, that utility stocks are in fact less risky?
A. No.
Q. They're of the same level of risk.
A. Approximately the same level of risk going forward as they have been in the past.
Q. If--I'm just trying to understand your answer to my previous question. Are you suggesting that the beta analysis is perhaps not applicable to utilities?
A. I would say in a global sense--no, global is not a very good choice of words. Generally, I would say that specific problems with the overall market aside, that reliance on betas as an input to determining the equity risk premium has always been problematic and I think it's more problematic with the experience of the capital markets that we've seen in the 1998 to 2002 framework with the market bubble and burst, so to speak.
Q. Problematic but you still rely upon it.

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A. I use betas as an input but there are other measures of risk that I look at as well.
Q. Would you agree that perhaps by using the beta input that that may be introducing an upward bias to your results?
A. No.
Q. The beta measure that you use actually is at page 43 of your evidence.
A. Yes.
Q. And perhaps you can explain to us briefly how you arrive at .6 as compared to the betas that are illustrated in table 5.
A. This is what this whole piece of testimony which starts at page 36 and goes over to page 43 is explaining, that in the first instance I show what the recent betas have been. I explain why the recent betas are as low as they have been, and I suggest at page 40 that in light of the infirmities of beta that we should be looking to some extent at the total market risk which includes diversifiable and non-diversifiable risk and the relationship between the total risk measures for utilities which are the standard deviations of market returns and the standard deviations of the

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other sectors of the market is approximately 62 to 69 percent. I show what the betas are as reported for US utilities which are in the range of 60 to 70. I calculate betas or relative risk adjustments using the methodology that's used by the major providers of betas and from that analysis I come to the conclusion that an appropriate relative risk adjustment is in the range of .6 to .65.
Q. Okay. From a layman's perspective, if you could bear with me for a moment then, if I look at your table on page 39 which represents Canadian utility betas -
A. Yes, it represents the correlation between the prices changes in a small number of utility stocks and the rest of the market.
Q. And that figure in table 6 is .12 in 2002.
A. It is.
Q. Then if I go then to page 43 of your evidence at line 4 where you say, "At a market risk premium of 6.0 to 6.5 percent and a relative risk adjustment of 0.6 to 0.65", from a layman's perspective, if I was going to use the Canadian utility betas, I would put in .12 there. However, because of your analysis,

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what you've just gone through, the Bloomberg analysis and all that, you have chosen to put in .6 to .65, is that in a nutshell what your evidence is showing?
A. Well, it's a rather simplistic way of looking at it but yes, the number was 1.12 and I believe, and I believe there are many other experts who would agree with me that those numbers are meaningless in terms of developing a relative risk adjustment.
Q. Moving on to your discounted cash flow analysis, page 43.
A. I have that.
Q. Lines 21 you say, "A forward looking equity risk premium test was also performed using the discounted cash flow model." Do you acknowledge that this test does not reflect the actual achieved risk premiums of investors?
A. No, it does not reflect the actual achieved risk premiums of investors.
Q. In fact, a DCF test is based on, as you say yourself further down that same paragraph, it's based on consensus, analysis, forecasts, correct?

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MS. MCSHANE:
A. It is based on the dividend yield for a sample of utilities plus a gross estimate in each and every month for the period that the test covers that is reflective of analysts' forecasts of earnings growth for each of the utilities that form the sample.
MR. FITZGERALD:
Q. So, just reading your words here at line 25 it says, "It uses the consensus of analysts' forecasts plus the corresponding expected dividend yield to measure the expected utility returns."
A. Correct.
Q. So these are forward looking tests -
A. Yes.
Q. So, if the forecasts of course are biased, if their results are biased, your use of the DCF test obviously would be then biased as well, correct?
A. If the results are biased?
Q. If the forward looking forecasts are biased, your DCF test is based upon that information, then obviously your results would be biased.
A. I'm going to use a word that we were sort of

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throwing around the other day. I think that's a tautology. Yes, if they're biased, the results are biased.
Q. Would you say that the results that you have or the forecasts were accurate based on the subsequently achieved rates?
A. First of all, it's very difficult to determine exactly what period the subsequently achieved rates should cover. Since the forecasts are intended to cover a normalized long period of growth, they're often called five-year growth rates but they don't--they're not intended to start from say a particular point in a business cycle and go to another point in a business cycle, say from the trough to the peak. I mean they're supposed to smooth out any specific downturns or upturns in the cycle. So it's always somewhat problematic to try to compare the achieved rates over a particular period to the forecast. But having said that, I would agree that on average, the forecasts have been somewhat higher than the achieved growth and earnings.
Q. And just to confirm your answer to CA-95, if we can go to that, please. Here the question

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was, "In reference to the pre-filed evidence of Kathleen McShane, Schedule 15, b) provide any studies which you have made to determine the accuracy of the analysts' forecast which you have used in this schedule", and your answer of course is that you've not made any such studies to determine the accuracy, correct?
A. True. But the purpose really is to try to capture investor expectations and not to determine how accurate the specific forecasts were and in fact as I said, I mean it's really difficult to try to match any particular point in time over which actual earnings growth rates are achieved to the forecast.
Q. If I could just take you now, Ms. McShane to page 49 of your evidence. This is continuing with the theme of the discounted cash flow test. At page--sorry, lines 28 to 30, you say in applying your DCF test you've chosen to use US integrated electric utilities as proxy utilities for Hydro, correct?
A. Yes.
Q. And, isn't it true that US utilities operate in a vastly different regulatory environment

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than Hydro?
A. Depends on the utility. Yes, if it's specific gas and electric; not necessarily if it's southern companies where there has been no restructuring of the utility industry. And, plus I'm talking about electric utilities which have similar debt rating so they're viewed as similar risk. They have similar business risk profiles to Canadian utilities. For example, you know, Standard & Poors looks at in a fine business risk profile scores to utilities in both Canada and the US and the low risk electric utilities in the US, integrated electric utilities have business profile scores of approximately four. So does Nova Scotia Power. So, you know, I've concentrated on companies that are low risk electric utilities not the broad spectrum of US electric utilities.
Q. Mr. Chairman, it's getting on to 11, I'm not sure exactly when our break is scheduled.
CHAIRMAN:
Q. It's now 11:00, I'd like to break. Appropriate time for you?

MR. FITZGERALD:
Q. That's fine.
(BREAK - 11:00 a.m.)
(RESUMED AT 11:23 a.m.)
CHAIRMAN:
Q. I guess it's my understanding from Ms. Newman that given the timing of the cross-examinations to come that, indeed, the possibility presents itself, in any event, for a 1:30 or thereabouts finish to today's proceedings. So, we'll see, I guess, where we are at 1:30 or so with regards to either this afternoon or tomorrow morning. Thank you, Mr. Fitzgerald, when you're ready, please.
MR. FITZGERALD:
Q. Thank you, Mr. Chairman. Ms. McShane, I just want to pick up where we left off there at page 50 of your pre-filed--testimony, please. And again, this is continuing theme here of what we were discussing earlier this morning. At line 24 you have, regarding your investors growth expectations, you say, "the estimates of investor growth expectations rely on consensus forecasts of long term earnings growth, specifically, the two widely available

sources referenced above in conjunction with the sample selection criteria, I/B/E/S International and Zacks were utilized. Again, the DCF test again, relies not on historically achieved results, but on analysts forecasts and growth and this confirms that, correct?
A. Yes.
Q. And to repeat the tautology that you've referenced this morning, of course, it's their off and your off, is that -
A. Well, but let's be clear about what I was trying to say. If they are a biased estimate of investor expectations, then the results are biased, but just because the forecasts are different from what's achieved doesn't make them biased estimates of investor expectations.
Q. Let's move on to page 54 of your testimony.
A. I have that.
Q. Okay, lines 4 and 5, starting at line 3 really, "the market price of that utility stock would tend to decline to book valued so that investors experience a capital loss of 43 percent. The idea that investors are willing to pay a price equal to 165 percent of book

value in order to see the market value of their investment drop by 43 cents is illogical". It's your belief then that the DCF test understates the appropriate return on equity since the DCF test measures the returns on market value?
A. Yes.
Q. So, if the returns on book value exceed the returns on market value, then the Board or a Board or regulator should award the higher level?
A. No, that's not my testimony. My testimony is simply that when market value exceeds book value and you're using a market derived test that the result, applying the results of a more market derived test in and of itself without any kind of adjustment or without any consideration to comparable earnings will understate a fair return on book value.
Q. Let's turn then to the comparable earnings test that you've just referenced, it's page 55.
A. I have that.
Q. At lines 17 and 18, you suggest "that the comparable earnings test provides a measure of

the fair return based on the concept of opportunity costs", correct?
A. Yes, in the context that is referenced on that page.
Q. And it's our understanding that you have chosen to apply this test by considering the return on book equity which is being achieved by other firms of comparable risk.
A. Correct, and returns that would be expected to be achieved by those same firms.
Q. From, on a theoretical level, suppose that comparable risk firms are earning 15 percent on their book equity, then would you recommend that the investor, in Hydro in this case, should be allowed to earn 15 percent on its equity?
A. No, because I don't simply give weight to comparable earnings. Comparable earnings isn't one of the tests to which I give weight.
Q. To a certain extent though, by using the comparable earnings test, unadjusted for book value, that that's what you are doing?
A. What do you mean by unadjusted for book value?
Q. Well, going back to your previous answer to me, you indicated that you do use comparable

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MR. FITZGERALD:

earnings test, how should I put it? You indicate that if comparable utility, say, is earning 15 percent on its book equity, you're indicating that Hydro, for example, should perhaps be approaching that level of return?

A. That is one of the factors that would determine what a fair return is. Also the cost of attracting capital which is given primary weight.

Q. I just refer you to CA 97 briefly.

A. Yes.

Q. Now, here you are asked, "in reference to the pre-filed evidence of Kathleen McShane, Schedule 21, provides market-to-book ratios for each of the low risk Canadian Industrial companies shown in Ms. McShane's schedule for each of the years from '92 to 2001". And here we have the results and here we see that--I'm wondering if Mr. O'Reilly could scroll down a little bit there? Here we have a sample of comparable Canadian Industrials are trading market-to-book ratios well above a hundred percent, in many cases, above 200 percent. And we have the case of Rothmans there at 681

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percent, correct?

A. Yes.

Q. The return that Rothmans is achieving on this is somewhere in the range of 39 percent, I believe that's the case.

A. Yes.

Q. So, when you refer to the opportunity costs that investors should expect, when you employ the comparable earnings test, surely you're not suggesting that returns should be in that type of range?

A. I'll repeat what I said before, that the comparable earnings test forms in part of the return or the estimate of what a fair return is.

Q. The 39 percent figure, that would be a fair return for the present investor?

A. Well, we're not talking about a number of 39 percent. I mean, we're talking about a sample of companies, and sure some of the companies in the sample may have relatively high returns and some of them have relatively low returns, but we're looking at the typical return for a sample of low risk companies.

Q. And these are, these companies that you

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include in the sample, of course, are trading well above 100 percent of book value.

A. As are virtually every company in the TSC 300, as are virtually every company in the S&P 400. If you look at the average market-to-book ratios of these companies, they probably, on average, over the '92 to 2002 period would have been two times the median value. The average for the S&P industrials, for example, has been about three and a half times. So, I don't see that, in the market that we have been experiencing, and the fact that there is no theoretical reason that the market-to-book ratios of industrials should be one. You know, I don't see that the fact that these companies are trading at two times book on average is a concern.

Q. Just referring then to the Rothmans Inc. example of the trading above book of 681 percent. If an investor buys Rothmans at 681 percent of book value, are they still, that investor, going to achieve a return on book value which is shown on Schedule 12, market value rather of 39 percent?

A. They may not, no. Rothmans will achieve

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returns on book value in the range that is on the Schedule.

Q. I guess the issue is what is the true cost of capital and does that investor who buys at 681 percent of book value, does he require 39 percent as a fair return?

A. On his market value, no.

Q. Mr. Chairman, those are our questions.

CHAIRMAN:

Q. Thank you, Mr. Fitzgerald. Good morning, Mr. Kelly, once again, when you're ready, please.

KELLY, Q.C.:

Q. Good morning, Chair. Good morning, Ms. McShane.

A. Good morning, Mr. Kelly.

Q. Ms. McShane, in order to look at the area that I'd like to explore a little bit with you, can we go first to P.U.7 to page 42. I just want to give you two references to start. And the piece that I'd ask you to note, Ms. McShane, is the part in bold which deals with whether NLH or Hydro should be considered at an investor owned utility.

A. I see that.

Q. Okay. If you could just have a quick read

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KELLY, Q.C.:
through that paragraph, I won't read it into the record. And then when you're finished that, we'll go to the next page. Just indicate when you're ready.
A. I'm ready.
Q. Okay. Page 43 at the bottom of the page, and this deals with Hydro's debt equity ratio, its short-term target and a potential capital structure of 60/40. Have you had a chance to read that?
A. Yes.
Q. Now, in the last Hydro GRA, I understand that you provided recommendations for a 60/40 debt equity ratio as a long term objective for Hydro.
A. I did.
Q. And if I take you now to page 6 of your current testimony at line 9, you indicate there that Hydro has addressed this issue and concluded that a 60/40 debt equity capital structure is not practicably achievable. Can you elaborate on what you understand the reasons were for Hydro concluding that it was not practicably achievable. We have your

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understanding -
A. My understanding is that based on what they viewed as a reasonable return, and a reasonable dividend pay out ratio, that it would be impossible for them to retain sufficient earnings in the medium term, at least, to achieve a capital structure with 40 percent equity.
Q. What did you understand that dividend pay out ratio to be?
A. My understanding is that the way that the dividend policy is currently or as it currently stands, it's at 75 percent of operating income, subject to making sure that the debt equity ratio of Hydro is not unduly affected. But that the plan would be to reduce the pay out ratio so as to be able to achieve the short term targets of 80/20.
Q. Okay. Do you know whether any change from a 75 percent pay out ratio has, in fact, been adopted by Hydro?
A. It is my understanding that it has been proposed, but that no action has been taken.
Q. Okay. Now, can I take you next to page 14 of your testimony.

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A. I have that.
Q. And in particular, to line 20, and you say there, "assuming that the Province continues to guarantee Hydro's debt", and that's the debt guarantee that you talked about in your evidence, "in my view, a capital structure containing 80 percent debt provides the minimal equity cushion compatible with being a self supporting enterprise". Could I just get you to explain what you mean by that?
A. What I mean by that is that there's, it should be viewed as a maximum that would be, over time, consistent with being fairly certain that Hydro could cover its operating expenses and its debt obligations and not be required to have any transfers from the shareholder to make up the difference.
Q. Would we conclude if Hydro does not have an 80 percent, has greater than an 80 percent debt, that it would not have a sufficient equity cushion to be self supporting, in your view?
A. I think that a debt ratio in excess of that is not, to my view, compatible with being a self supporting entity.
Q. Okay. If we just go to page 16, you deal with

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some other crown corporations?
A. I do.
Q. And as I read page 16, many of those have minimum equity requirements. Can you just give us a quick summary of these, BC Hydro, Hydro Quebec and Saskatchewan Power.
A. When you say minimum requirements, they're not minimum requirements in the same sense as, for example, Maritime Electric had a minimum requirement by legislation. And they were required to maintain a minimum of 40 percent equity.
Q. Right.
A. These are minimum targets.
Q. Okay.
A. That doesn't mean that these utilities may not, in terms of a debt ratio--pardon me?
Q. May not fluctuate a bit from that.
A. Right.
Q. Right. If we look at lines 9 through 12, if I understand BC Hydro's policy, the payment equals 85 percent provided the debt equity ratio of BC Hydro, after deducting the payment is not greater than 80/20. So, do they have a prohibition, not necessarily legislated, but a

KELLY, Q.C.:
practically adopted one that they will not pay out if the debt equity ratio would exceed 80/20?
A. That's my understanding.
Q. Okay. And if we come down to line 26, Hydro Quebec that you talked about, a minimum target equity, and dividends may not be declared in an amount which would the effect of reducing the equity ratio below 25 percent, similar mechanism?
A. Yes.
Q. And Saskatchewan Power has a target capital structure including a maximum debt ratio of 60 percent, again, similar type structure?
A. Yes, there's nothing tied to it though in terms of dividend payments, to my understanding.
Q. Now, if we look at--we looked at the piece from P.U.7 which indicated at the last hearing the rate was, the debt equity ratio was 83/17.
A. Yes, that's my recollection, yes.
Q. Right. And if we go to your evidence now at page 17, line 22, in 2004 you indicate that if the debt ratio is 86 percent, so in fact, the

debt ratio has deteriorated since 2002?
A. That's correct.
Q. And is currently below your minimal considered appropriate level?
A. That's correct.
Q. Okay. And on the same page you talk about a supportive dividend policy, if we just go back up to lines, in particular 16 through 20, page 17. And you indicate, "a reduction in the dividend pay out ratio from 75 percent of operating income as indicated in the current policy to 50 percent is required to achieve a capital structure approaching the target within a five year period". Can I just get you to elaborate on that in terms of the degree to which you consider approaching the target? How close are you contemplating here? Getting to the 80 percent?
A. I hadn't reviewed these numbers, my recollection was that it was still not quite there.
Q. Okay. Let's just have a quick look at this. Could I take you to Mr. Roberts' evidence, re-filed of August 12 at page 10. We're going to need page 10, Mr. O'Reilly, please. Should be

a table at the bottom of the page. There we go. And if we look at the table and Mr. Roberts give us here various pay out ratios that would be required to, at a 75 percent ratio, in 2008, the debt would be still 85 percent. At 50 percent it would still be 83 percent and even with 25 percent, it would only be--it would be at 81 percent, all above your minimal levels?
A. Yes.
Q. Okay. Can I take you next to CA 3 which contains Hydro's financial projection from 2003 to 2007 and if I take you to page 10 of that document. And in the part that begins there, "therefore, as provided earlier in Table 1, Hydro has set the following targets over the next five years". And if you come down to the third bullet, a 75 percent dividend pay out for Hydro dividend portion is targeted during the period 2004 to 2007, then they talk about 2003. So, based upon a 75 percent pay out ratio, we saw that it would still be 85 percent all the way out to 2008?
A. Yes.
Q. And can I just get you then to go to page 18

of your testimony at line 67 where you say, "a failure to progress towards the target will be perceived as an inability to operate as a self supporting commercial enterprise". Can I get you to comment on that, keeping in mind the fact that we have seen a deterioration from the debt equity ratio in 2002 to date and that with the current Hydro target, that we will still not be back to that 2002 ratio by 2008? And can I get you to comment on how you feel this will be perceived by the market?
A. Well, I think that we have to, sort of start, where we are. And I do believe that based on what the debt rating agencies see other crown corporations doing, that if it continues to see Hydro's debt ratio staying at the current level or deteriorating, that it will have a tendency to view this corporation as not being fully self supporting. And I think it's important for Hydro to take its proposed change in dividend payout to the shareholder and convince that it's important for them to build up the equity in the corporation.
Q. Would you agree with me that currently with Hydro's capital structure and its current

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KELLY, Q.C.:
dividend payout ratio or policy of 75 percent, that Hydro is not currently structured as an investor owned utility would be?
A. You mean in terms of a financial structure?
Q. Yes.
A. No, it's not, but at the same time, it's got a debt guarantee that permits it to operate with a considerably higher level of debt than it would otherwise. I mean, there will be investor owned companies which may not be structure to the same extent with debt as Hydro is, but has more debt than they otherwise would because they have a guarantee from the parent company. I would suggest that, for example, the company that used to be called West Kootenay Power, when it was owned by Aquilla had a parental guarantee that at some point in its history, actually had value, but that guarantee permitted that small electric utility to operate with less stats than it would otherwise required to achieve a Triple B rating on its own.
Q. That was from its parent, as opposed to from government?

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A. Yes, it was.
Q. An investor owned utility would not normally have any government guarantee?
A. Oh no, but I was just saying it could have a guarantee from a parent company.
Q. So, in Hydro's case, we've seen the abandonment of the 60/40 debt equity target, do you agree with that?
A. For the time being, yes, I think that they have decided that given the circumstances that, as I said in my testimony, it's not a practical goal, given the fact that the only source of equity capital that they have is through retained earnings.
Q. During the next four or five years they will still be below or have greater debt than the minimal required, as you've indicated as 80 percent.
A. Yes, according to their financial plan that you just showed me, that's correct.
Q. And the guarantee fee continues to be paid by Hydro to government?
A. It does.
Q. And would you be aware that there are currently no proposals by Hydro to be

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regulated on a range of rate of return with an excess earnings account? Would you have any information with respect to that?
A. I am aware of that, yes.
(11:52 a.m.)
Q. Okay. Are you aware that the rural deficit continues to be paid through the other utilities, Newfoundland Power and the Labrador Interconnected system as opposed to out of general tax revenue.
A. I am aware that there is a rural subsidy that is born by other customers.
Q. Okay. And one last area, I just wanted to touch briefly with you on or to ensure that I understand correctly, if I take you to page 21 of your evidence at line 12.
A. Yes.
Q. And this deals with, sorry, page--make sure I got the--just give me one second, page 21, line 12 to 13. The cost of long term debt to Hydro, at the time you wrote this, you indicated 6 percent, was a 75 basis point spread for approximately 6.75 percent. I take it some of that you updated this morning. And just to kind of, let me just take you to RFIs

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before I put the question to you. Can I take you first to NP 99 and this is an earlier RFI with respect to interest rate projection. And then if we go to the attached schedule--you can scroll down to the latter part of the table, Mr. O'Reilly--you see Long Canadas as a spread for Hydro of .55 percent or 55 basis points for 6.52 percent, okay. You just might want to make a note of that.
And then if I take you to NP 299 which is the update to bring that current because the data we just saw was January, February of this year. So, if you would go to the table, Mr. O'Reilly, and again, if you could go down to the latter part. The spread is .52 and the average is 5.37 for forecast 2004--could you just take us back up to the top--give you the quarters, with a rate of 5.89 percent. And I wonder, Ms. McShane, would that number for long term debt for Hydro be a more accurate number now today?
A. Sorry, I wrote the numbers down, but I was having a little trouble following exactly what they represented. So, let's--if we look at this -

KELLY, Q.C.:
Q. If you look at the table -
A. This table here, I see the number out to the right which is the .52 percent which is the spread -
Q. Spread over GOC.
A. Yes.
Q. Okay.
A. And then the -
Q. You go across the line at Long Canadas, I understand the yellow line gives us some averages, the 5.37 and .52 for the spread gives 5.89. And I'm just wondering whether that would currently be a more accurate reflection of Hydro's long term debt forecast, if needed, for 2004.
A. Yes, and in fact, I mean, you could see by looking at line 13 of my page 21 that this was an illustration based on the forecast Long Canada yield at the time plus an average historic spread of .75.
Q. Exactly. That's why I took you back to the earlier one because the earlier one is actually fairly consistent with what you got in your text. So, I don't quarrel with what

you have in your text at the time you wrote it. My question becomes, would you accept that 5.89 is a reasonable reflection today or for 2004?
A. That would be a reasonable reflection based on what current yields and spreads are.
Q. Okay. Thank you, Ms. McShane, those are my questions.
CHAIRMAN:
Q. Thank you, Mr. Kelly, Ms. McShane. Mr. Hutchings?
HUTCHINGS, Q.C.:
Q. Yes, thank you, Mr. Chairman.
CHAIRMAN:
Q. Good afternoon.
HUTCHINGS, Q.C.:
Q. Good morning, Ms. McShane.
A. Good morning, Mr. Hutchings.
Q. We have two minutes of the morning left.
CHAIRMAN:
Q. Oh, sorry.
HUTCHINGS, Q.C.:
Q. I'd like to begin by taking you to the first page actually of your pre-filed evidence and specifically line 26. You indicate there that

Hydro's target capital structure includes a debt ratio that with the debt guarantee is at the high end of the range of reasonableness for the purposes of being a self-supporting commercial utility. Can you tell us what test is applied to determine what the range of reasonableness is in that context?
A. I don't think there's any specific test. It's clear that if you look at what the debt rating agencies view for Crown Corporations as appropriate that they're looking at a 70/30 capital structure as being typical but still, to their mind, somewhat weak relative to investor-owned companies and that when they look at companies with 80/20 capital structures that they consider those to be quite weak in terms of the ability to meet financial obligations.
Q. So is the notion of reasonableness here basically one of a comparison to similarly situated utilities?
A. That's certainly the majority of it, yes.
Q. Okay. So what are the comparables in this context for Newfoundland and Labrador Hydro?
A. Well, if we're talking about other utilities

that are government owned and guaranteed, the comparables would be BC Hydro, Manitoba Hydro, Saskatchewan Power, I know I'm missing somebody.
Q. Does Hydro Quebec fall in there?
A. Yes. And I think those are--and did I say New Brunswick Power?
Q. No.
A. Okay, New Brunswick Power, although New Brunswick Power is moving away from being guaranteed by the government.
(12:00 p.m.)
Q. They're in transition at the present time?
A. They're in transition.
Q. Yes, okay. All right. And would you agree with me that while the ownership and the existence of the debt guarantee are common factors between the companies you've named and Newfoundland and Labrador Hydro, each of them really is a very different type of operation, different size of operation and so on?
A. They certainly have differences among them, yes.
Q. Okay. I want to take you now to page 14 of your evidence, and at line 17, you're talking

HUTCHINGS, Q.C.:
again about the debt ratio target and you say "the target should not only seek to avoid impairment of the guarantors credit rating, but also should seek to provide an adequate equity cushion to avoid impairment of the shareholder's investment." Who decides the level of equity that's going to be in Newfoundland and Labrador Hydro?
A. It is presumably a decision that is made in part by management and part by the Board of Directors and in part by the shareholder.
Q. Okay. Could we bring up, please, Schedule 2 to Mr. Wells' evidence? This is a piece of correspondence, Ms. McShane, dated the 25th of March, 2003, from the President and Chief Executive Officer of Hydro to the Deputy Minister of Mines and Energy dealing with Hydro's General Rate Application and one of the things attached to it is a discussion paper on Hydro's dividends, capital structure and return on equity. Are you familiar with this document?
A. Yes, I've read the document.
Q. Okay. And I take it you're familiar with the

recommendation in the discussion paper to the effect that Hydro would like to get to an 80/20 debt equity ratio and needs to have at least a dividend policy of paying out only 50 percent of net income in order to have some hope of getting there?
A. That's my understanding of the thrust of the letter, yes.
Q. Okay. And are you aware of whether or not there's been a response to this letter?
A. My understanding was that there was an acknowledgement from the Minister, but it is my understanding that in the meantime, there's been a change in government and there has not been--the new government has not has yet dealt with these issues.
Q. Do you know when the change of government was? I mean, it's not a trick question.
A. This year.
Q. It was -
A. I don't recall the specific month.
Q. - it was a little over a month ago.
A. Was it that -
Q. I think it was a little over a month, wasn't it? Yes.

A. Oh, I was thinking it was longer ago than that.
Q. No. At the commencement of this hearing, the election had not occurred. So in terms of the real decision maker, as to the level of equity in Hydro, would you agree with me that it's really the shareholder, Government of Newfoundland and Labrador, that has the final say? There's a limited amount that Hydro, within itself, even with the approval of this Board, can do to increase the level of its own equity?
A. Well, certainly the shareholder has a significant say in what happens, and that management would make recommendations to the Board of Directors who will presumably adopt a position that they will ask the shareholder to agree to.
Q. And in this particular instance, it's quite clear that government has the authority and does, when it wants to, deplete the equity of Hydro by requiring that dividends be paid?
A. Has the shareholder, the shareholder does have the ability to withdraw dividends from a corporation, be it Hydro or be it any other

corporation.
Q. Okay. So it's fair to say that without a commitment of government, nothing that Hydro can do can preserve its level of equity, correct?
A. I would say that ultimately the shareholder does have the final say as to what happens. The situation is not dissimilar in some corporations that are owned, that are investor-owned, where there is a parent company and the parent company is the one who makes the decisions for the subsidiary.
Q. Yes. I understand that, but I mean, in the private sector with an investor-owned company, whether it's a utility or not, there will be financial consequences to depleting the equity of a company, will there not?
A. There will be, yes.
Q. Yes, okay. But in the case of Newfoundland and Labrador Hydro with its debt guarantee from government, the level of equity is not going to cause financial stress for Newfoundland and Labrador Hydro, is it?
A. For Newfoundland and Labrador Hydro?
Q. Yes.

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MS. MCSHANE:

A. The level of equity, certainly it will cause some stress if there's not enough cushion in the capital structure to finance the rate base assets.

HUTCHINGS, Q.C.:

Q. But we're operating in a system here, and it's been accepted that that's not going to change, that government has completely guaranteed the debt of Hydro in any event. So the debt is equally secure, whatever the level of equity in the company, correct?

A. The debt is secure in the sense that the government has guaranteed that it will be paid.

Q. Exactly.

A. The equity, however, is not secure.

Q. Exactly. And as you've said in your evidence, at page 14, the concern is to provide an adequate equity cushion to avoid impairment to the shareholder's investment, correct?

A. Yes.

Q. And it is the Government of Newfoundland and Labrador, the shareholder, who is determining what that amount of equity is going to be,

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correct?

A. Yes.

Q. And the government -

A. Ultimately.

Q. Yes. And the government has not responded to Hydro's request to amend its dividend policy so as to preserve or enhance the level of equity, correct?

A. Not so far, no.

Q. Okay. Would it not be reasonable then to conclude that government is satisfied with the level of equity and regards itself as having an adequate equity cushion to avoid impairment of its investment?

A. I certainly wouldn't want to draw that conclusion without having had discussions with government. They may simply have not turned their mind to this issue.

Q. Well, we can perhaps equally conclude then that it doesn't really bother them.

A. I guess--I mean, I suppose you could come to that conclusion, but it seems to me that in the first instance, you want to establish from a corporate point of view what you believe are appropriate principles, and then to seek to

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say to the shareholder, these are the principles by which we should finance our company, establish appropriate financial parameters and operate, and so, you know, I don't think that it makes sense for one to simply conclude that the shareholder has decided that he doesn't essentially care one way or the other what the equity ratio is or what the return should be.

Q. Hydro has, in fact, done exactly what you suggested. I mean, they went to government and said this is the way it should be and, you know, you should do this and this for us and we will then be appropriately structured and so on, and government has effectively, has it not, assumed the risk that their equity cushion will not be sufficient to avoid impairment of their investment? Isn't that a fair conclusion?

A. I don't understand when you say--when you say they assume the risk, do you mean without expecting any return on it?

Q. Well, what has happened is that Newfoundland and Labrador Hydro has told government what it should do in order to get things properly in

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order. Newfoundland Government has not responded to that and hence, whatever risks are inherent in not putting their house in order, Government has assumed.

A. I suppose you could conclude that without any further knowledge. I still go back to my point that it's important to establish the appropriate return on the shareholders equity based on the inherent risks that are there. You talk about them assuming the risk, you know, to some extent, when you say assume risks, there are risks that an investor should not be reasonably compensated for, because they're sort of self-imposed. In this instance, what we're trying to do is to say here is how this return should be set based on the equity investment that's there and the inherent risks to which the equity investment in this enterprise is exposed.

Q. One of the things you need this return for is to try to move toward an appropriate debt equity ratio, correct?

A. Well, that certainly becomes one of the byproducts. One of the things, the major thing you need the return for is because there

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MS. MCSHANE:
are dollars that are at risk that could be deployed elsewhere at a given return.
HUTCHINGS, Q.C.:
Q. Yes. I mean, one of the things you've said is that if this ratio is allowed to deteriorate further, there'd be trouble for Hydro. It'll be stopped being perceived as being self-supporting?
A. That's one of the problems, yes.
Q. Okay. But if the shareholder, the Government of Newfoundland and Labrador, is prepared to assume that risk, do we have to force this return on them anyway?
A. I guess I'm still having trouble with what you're saying about assuming the risk.
Q. You're highlighting for us some dangers associated with the current debt levels in Hydro, correct?
A. Yes.
Q. And there are risks associated with those high debt levels?
A. That's correct.
Q. Government of Newfoundland and Labrador is aware of those risks?

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A. They may be.
Q. Yes, and I mean, they've had representations from Hydro saying we should do X, Y and Z in order to better our debt ratio and reduce those risks, correct?
A. Yes, in order to provide a better basis for being self supporting.
Q. Okay. And if government wanted to minimize those risks, there are things they could do about it, correct?
A. There are things that they could do, yes. They could agree to the change in the dividend policy.
Q. Yes. And they haven't done anything?
A. Not so far, no.
(12:15 p.m.)
Q. Okay. That's fine. At line 22 of page 17 of your evidence, you're talking about the 86 percent debt and you indicate that "there's no evidence that the higher debt ratio will negatively impact on the debt rating of the province in the near-term." You go on then to note two items in this connection. The first is that the debt rating agencies are concerned with Hydro's financial parameters on a

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consolidated basis and that those consolidated ratios have been under 70 since 1996. I take it you're suggesting that as a result of the better consolidated debt ratios, the 86 percent debt on a regulatory basis is less of a concern? Is that fair?
A. I agree that the debt rating agencies clearly do look at the corporation on a consolidated level and on a consolidated level, they would be less concerned.
Q. Okay. The second item you note there is, as I understand your evidence, is the only instance that you're aware of where a debt rating agency has noted the negative impact of a Crown corporation's high debt level on the debt rating of the province, and that relates to New Brunswick, which had allowed its--or been thrust--had it thrust upon it that its common equity ratio was down to one percent?
A. That's correct.
Q. Okay. And you're not aware of any negative results from the debt rating agencies other than this one instance? Is that correct?
A. Of all the debt reports that I've read, I've not read any that have suggested that the

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financial wherewithal of the Crown Corporation has caused a problem with the rating per se.
Q. If we look at the notion of debt being self supporting, so long as the company can pay its debt and pay its interest payments and cover its operating expenses, then its debt is self supporting, correct?
A. In that narrow context, yes. I've seen other regulators suggest that that's not the case. For example, there was a case of Ontario Hydro back in the mid 80s when Ontario Hydro, all its debt was guaranteed by the Province and even though they were covering their costs, the regulator argued that they weren't self supporting because they had to depend on the guarantee of the province in order to operate at the level of debt that they had. So it really depends on how broadly you interpret the term "self supporting." But in the narrow context, yes, they're self supporting.
Q. Was Ontario Hydro paying a debt guarantee fee at that time?
A. I don't recall if they were or not.
Q. Okay. But I mean, in the context of Newfoundland and Labrador Hydro, which is

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HUTCHINGS, Q.C.:
paying a guarantee fee, it's supporting itself by paying that fee?
A. No, I don't think that that follows necessarily. I agree with you that by paying the fee that it is compensating the Government, the shareholder, the Government in this case, for taking on the risk of the debt, but I don't necessarily think you have to pay a fee to meet the standard of self supporting as it was being defined by the Ontario Energy Board.
Q. So your position is if you're--whether or not you're paying a guarantee fee, if you have the guarantee, then it can be regarded as self supporting, if you're in fact meeting your own debt obligations and not relying on the guarantee to that extent?
A. Sorry, could you repeat that?
Q. Yes, okay. That tended to wander off a bit. To the extent that you're not leaning on the guarantee by requiring that the guarantor make any payments, you're self supporting?
A. Yes. I would say in that--that's the context, the narrow context that I had in mind when I

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talked about being self supporting.
Q. Yes, okay. I just wanted to refer finally on this point to page 18 of your evidence and you say there that "a failure to progress toward the target will be perceived as an inability to operate as a self supporting commercial enterprise." I take it that the debt of Hydro today is perceived as being self supporting?
A. Yes, I would say that today it is self supporting in the sense that the Corporation hasn't had any need to be backstopped.
Q. Yes.
A. So in that context, yes.
Q. Yes. And that has been the case from the inception of Newfoundland and Labrador Hydro, correct?
A. I'm not aware of any situations where there has been a backstop, but that doesn't mean there haven't been.
Q. Okay. Are you aware of any credit agency or debt rating agency report that has ever referred to Newfoundland and Labrador Hydro's debt as being anything other than self supporting?
A. I am not.

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Q. No, okay.
A. But again, let's remember that they are doing this on a consolidated basis, where the consolidated ratios are stronger than the utility only ratios.
Q. Okay. So the impression I take from your statement at line 6 there on page 18 is that unless there is movement, we will be perceived as deteriorating? Am I taking your position correctly?
A. Unless there's movement, will be perceived as deteriorating?
Q. You say "a failure to progress will be perceived as an inability."
A. Yes, I would say that in a sense that would be--well, it would be viewed negatively. I don't know that it would be viewed as deteriorating. It would be viewed as standing still and not progressing.
Q. Okay.
A. And therefore I think that would have a negative impact from the point of view of the debt rating agencies.
Q. Okay. Although so far as you're aware, the history of Newfoundland Hydro up to date has

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not revealed any negative consequences as a result of its high debt levels?
A. They have not, as I've indicated to you earlier, had to be backstopped to my knowledge by the Province.
Q. Or had negative comments from the debt rating agencies, relative to the Province's debt, Province's rating?
A. Not in the context that occurred in New Brunswick.
Q. No, okay.
A. But there have been comments about the weakness of the capital structure ratios.
Q. Okay. Ms. McShane, I want to suggest to you that the task we're undertaking here is something of an artificial type of exercise, in the sense that we're trying to determine a rate of return, appropriate rate of return on basically shares that don't exist for an investor who can't buy them, even if they didn't exist. I mean, is that an accurate picture of what we're doing here?
A. Shares that don't--there's equity that exists.
Q. Yes. But there are no shares. There are no -
A. There is--no.

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HUTCHINGS, Q.C.:
Q. - certificates out there trading?
A. That's correct. There are no shares that are traded. Now what was the rest of it?
Q. Well, we're looking at a return to an investor who doesn't exist because he can't acquire the shares. I mean, there are no investors other than government in Newfoundland and Labrador Hydro.
A. That's true. Government is the sole investor and by logical extension, then the owners are the taxpayers.
Q. Yes. So I guess it's a question of how far we have to take the fiction and how much fact we insert into it. I think you acknowledge in your evidence obviously that one of the differences that has to be taken into account is that Newfoundland and Labrador Hydro doesn't pay income tax?
A. True.
Q. Do you take into account the fact that the Government of Newfoundland and Labrador, as shareholder, doesn't pay income tax?
A. True.
Q. Okay. But do you take that into account in

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determining the proper rate of return?
A. No.
Q. Why not?
A. Because I do not take that into account for any shareholder. For example, you would expect the same rate of return if you, for example, operating in Alberta. The same rates of return are allowed to the investor-owned utilities as to the government-owned utilities. I mean, you never know what the tax position is of the ultimate shareholder and to try to make that differentiation is -
Q. But in this case, we do, don't we? We do know what the tax position of the shareholder is?
A. Yes, but I guess my point is that the return is not reduced to other corporations to take effective--account of the fact that the taxation, for example, is different on the equity than it is on the debt.
Q. No, I understand that in a situation where there will be a mix of shareholders, all of whom will take best advantage of their own tax situations, but for this Board regulating this utility, we know exactly who the only shareholder is and we know exactly what that

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shareholder's -
A. Correct.
Q. - tax position is, correct?
A. Yes.
Q. But it's your position that we should ignore that fact?
A. Yes. Let me give you another example. This is also an example in Alberta. We know that--this is AltaLink, which is an electric utility which bought the--try and remember now. It bought the transmission assets of TransAlta, and AltaLink is a limited partnership and it is owned by the Ontario Teachers Pension Fund and two other investors, one is a US investor, and my brain is getting old and I can't remember who the third one is at the moment.
Q. We'll take your word for that there's a third one.
A. There's a third one. So when the Alberta Board determined what the return should be, it did take into account the fact that one of the owners was not taxable by allowing a lower tax allowance, because it knew that the Ontario Teachers Pension Fund or assumed that the Ontario Teachers Pension Fund didn't have to

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pay taxes, but it didn't give the Ontario Teachers Pension Fund a different return than it gave the other investors.
Q. Because the Ontario Teachers Pension Fund could decide tomorrow to sell their stake to you?
A. I don't know that that was the--that certainly wasn't the rationale that was given.
Q. But I mean, these are tradeable units of ownership, are they not?
A. They could be sold, yes.
Q. Yes, okay. So I think we have a little different situation. If we did adjust the rate of return allowed to Government on the basis that it didn't have to pay the tax, would that result in a lower rate of return, a lower margin and hence a lower revenue requirement for Newfoundland and Labrador Hydro?
A. I guess that if you could make the distinction between what the return to the typical investor would be versus the province, I mean, you could make some assumption, but the thing is that we don't make those adjustments for other investors.

(12:30 p.m.)
HUTCHINGS, Q.C.:
Q. No, I understand your position and that you don't think we should do it. Okay.
A. Well, and the point is -
Q. What I'm asking you is that if we did it, would it reduce the revenue requirement?
A. If you did it, it would--if you made an adjustment because you could tell what the relative return would be to other types of shareholders, because that is really the only basis on which you can do it, right?
Q. Yes.
A. I mean, you'd have to say well, the typical investor in some other utility would be taxed at this and this rate on this part of their return, the dividend part. That would be 50 percent of the return. And so you would have to make some assumptions about what the effective after-tax return is.
Q. Yes.
A. Okay. But it becomes almost impossible to do that because -
Q. Yes, I'm not asking you to give us a number.
A. Okay.

Q. I'm just asking you -
A. Well, in -
Q. - qualitatively, will the revenue requirement be lower?
A. In principle, if you could assume that the effective return to another investor in a similar risk enterprise would be lower because of their taxability and you applied that back to Hydro's return, then obviously the after-tax return would be lower.
Q. Yes, okay. So if I got a dividend out of Hydro, I'd pay tax on it.
A. No.
Q. At a certain percentage.
A. No, you wouldn't, not necessarily.
Q. It would not be income to me?
A. It would if you actually had it in your personal portfolio.
Q. If I -
A. What if you -
Q. - if I was a taxable individual.
A. Right, if you put it in your RRSP, it would not be.
Q. Yes, okay.
A. And if you had invested -

Q. There are ways--yes, there are ways of managing tax, but -
A. Absolutely.
Q. - all other things being equal, I pay tax on my income.
A. I try to pay as little as possible, but yes, I would agree with you that there is dividend income that is taxable. There have been at least one study that's been done that shows that a very high percentage of investment income in this country and in the U.S. as well, is not taxable.
Q. I want to talk now a bit about the business and financial risk of Newfoundland and Labrador Hydro. You indicate at page 2 of your evidence that, at line 4, that a fair return on equity for Hydro at its forecast and target capital structure ratios is no less than that applicable to an average risk business, plus financial, Canadian electric utility. And I believe in answering questions this morning you indicated that you understood Hydro's rationale for looking at the 9.75 percent rate of return, as opposed to your recommended rate in the context that this was

a determination by the Board of the appropriate level for Newfoundland Power and you would equate the risk of Newfoundland Power and Newfoundland Hydro, is that fair?
A. Total risk, yes.
Q. Total risk, yes, okay. So clearly, if the Board determined that the business risk, total risk associated with Newfoundland and Labrador Hydro were less than that associated with Newfoundland Power, presumably a lesser rate of return would result?
A. I think that would probably -
Q. It's another tautology, I think.
A. - follow, yes.
Q. Okay, all right. At page 9, you discuss the business risk of Hydro. At lines 23 and 24, you're saying that "Hydro's market demand risks effectively mirror those of Newfoundland Power, with the added risks associated with its dependence on a small number of large Industrial Customers, the obligation to serve a declining world population." In terms of the fact that Hydro has different customer classes, has Industrial customers, as well as large utility customer, would it not generally

HUTCHINGS, Q.C.:
be accepted that a diversity of customers would tend to reduce the business risk of a utility?
A. It depends on the degree of diversity. Typically if a company is reliant on a small number of large Industrial customers, that does not necessarily add to the diversity, in the same was as, for example, a company like, I'm going to use a gas company because I happen to know this one fairly well, that's got, like 30 percent of its revenues from a large number of Industrial customers across a large number of different industries, so the customer base is very balanced, as among industries, as among a number of Industrial and large commercial customers.
Q. No, I understand that, I just--and maybe I'm reading this over simplistically, but I was getting the impression from what you said, that you have Newfoundland Power with a certain risk and then because Newfoundland Hydro also has Industrial customers, you add that on and it's additional risk, as opposed to looking at the whole thing and saying,

well, there's some degree of diversity here, so that's another type of risk, as opposed to an additional risk?
A. Well I guess I was looking at it sort of as an additional risk because there are very discreet number of large Industrial customers that are significant contributors to the revenues of Newfoundland and Labrador Hydro. And when I said that the risk of Hydro mirror those of Newfoundland Power, I didn't necessarily mean they were in that context they were identical, but simply because ultimately the customers that are being served are those of Newfoundland Power, then the customer profile that Newfoundland Power has, reflects, you know, back on Hydro.
Q. Okay. If we move on then, you deal next with the general economic situation of the Province and so on, and there are, obviously, some positives in terms of large projects and some negatives in terms of out migration and so on. Do you regard the general economic outlook as being positive or negative for Hydro in the sense of more positive going forward than it has been in the past or more negative going

forward than it has been in the past?
A. I'd say generally speaking that, depending on what we consider to be the past, that it's more positive than, let's say, ten years ago.
Q. Okay, no that's perfectly fair. You go on then to talk about the supply and operating characteristics, top of page 11 you note "geographically dispersed, but relatively sparsely populated service area." I take it the concern there would be the risk of having a group of high cost customers on the system to be served?
A. That's correct. That's part of it.
Q. All right, and are you aware of the statutory regime whereby Hydro recovers the costs of the rural subsidy?
A. I understand how the rural subsidy works, yes.
Q. So those costs are guaranteed to Hydro, basically?
A. I understand that there is a deficit that is included in the rates of other customers.
Q. And has been required to be -
A. Paid by other customers.
Q. - paid by other customers and that's a part of the system. Okay, the next risk you talk

about is at line 10, you talk a key supply risk relates to the hydrological conditions, and I think you immediately then talk about the Rate Stabilization Plan and you understand how Hydro is made whole in respect of those issues.
A. I understand how the RSP works, yes.
Q. Yes, and that includes an interest rate or a return on amounts due to them, so that they are fully made whole, both in terms of actual amounts and the time differences?
A. I understand that the amounts that have to be financed attract the cost of financing.
Q. Okay. The point you mention here, you say, "cash flows are sensitive to actual water levels and fuel costs." What sort of risk does that create for Hydro, given the fact that it is in fact a publicly owned and government guaranteed entity?
A. It means that there is a higher probability that they may have to be back stopped.
Q. But, I mean, for a private company or an individual, obviously if cash flows are sensitive, that would mean you wouldn't be able to pay your bills when they became due.

MS. MCSHANE:
A. That's right.
HUTCHINGS, Q.C.:
Q. That's the concern about cash flows, so that's not a real concern for Newfoundland and Labrador Hydro, is it?
A. It's, I guess, less of a concern than it might otherwise be.
Q. And these would really have to be enormous amounts of money for that to create a problem for Newfoundland and Labrador Hydro, wouldn't they?
A. I guess I don't quite understand what you mean by a "problem". It can create considerable volatility in cash flows; it doesn't necessarily mean that you're at the very edge where you have to go to the shareholder, but it can cause volatility in -
Q. But in a highly leveraged privately owned non-government guarantee company, that could actually put the company into bankruptcy, couldn't it?
A. Yes, it could.
Q. Okay, and that's not going to happen for Newfoundland and Labrador Hydro, is it?

A. No, but it probably wouldn't happen in any public utility either because there is the ability to go to the regulator.
Q. Another item you mention here at line 21, talking about other supply risk issues and talk about the impact of deviations from forecast to thermal efficiencies. Do you know what the history has been of the forecast of thermal efficiencies, whether in fact Hydro has out performed their forecasts or under performed their forecasts?
A. Not specifically, no.
Q. Okay. Would you agree with me that this risk can be minimized by Hydro doing good or conservative forecasts of their thermal efficiencies?
A. Well, I would--if the regulatory process works for thermal efficiencies the way it should work for other forecasts, the forecast should be set at what the best estimate of the thermal efficiency is, just like volumes are forecasted what the best forecast of volumes are. So, you can make that argument about any type of input to the revenue requirement that if you could, you know, set your volumes at

conservative levels, if you could set your costs at higher levels than you were going to incur, then you mitigate your risk. But my assumption would be that the thermal efficiency for the plant would be set on the best estimate of how the plant would operate.
Q. All I'm saying is that this is, in fact, a manageable risk and if well managed, will not likely result in any losses for Hydro, would you agree with that?
A. Not any more so than any other -
Q. Manageable risk.
A. - manageable risk. I mean, there will be probabilities that you will be above and below and from a risk perspective, what you'd be concerned about, as an investor, is the downside.
Q. Yeah, but I mean, it's not an uncontrollable risk, such as fuel prices, if you have no way of recovering additional fuel costs, that's a risk that's really beyond your control?
A. Oh, I don't disagree with that and that's typically why, when you look at how regulation has preceded throughout Canada, that the types of risk that are recognized that firms can't

control are the types of risks that are covered by, deferral accounts on gas costs or purchase power cost and costs of that nature.
Q. Do you have any idea how much money is at risk for Hydro in respect of kilowatt hour per barrel more or less on their forecast efficiencies?
A. Not off the top of my head.
(12:45 p.m.)
Q. No, okay. The next item you mention in terms of the risks, is the potential cost implications of older plant. What plant are you specifically referring to there or is it all of the plant?
A. It wasn't any specific plant that I had in mind.
Q. Okay, I mean, do you know the relative age of Hydro's hydraulic facilities, for instance, in comparison to other facilities in Canada?
A. Not off the top of my head, no.
Q. Okay, are you aware that there are operating plants in Canada that are probably as much as 100 years old?
A. Pardon, what?
Q. That are as much as a 100 years old?

MS. MCSHANE:
A. Hydraulic plants?
HUTCHINGS, Q.C.:
Q. Uh-hm.
A. Yes.
Q. Okay. And you're aware that the major hydraulic plants in Newfoundland started to be built in the 1960's?
A. I wasn't specifically aware of that, no.
Q. Okay. You come down then to regulatory risks--well, no, the next item you mention here is environmental standards and that essentially in this context comes down to a regulatory risk, doesn't it, whether or not the regulator will permit sufficient funds to be paid to look after those expenses?
A. Allow the cost to be passed through. Actually, I thought you were going to mention the article in the paper this morning that said "Martin Cool on Kyoto".
Q. No, I'll leave Mr. Martin and Kyoto off to one side. Kyoto is Mr. Browne's issue.
BROWNE, Q.C.:
Q. Better get our money now.
HUTCHINGS, Q.C.:

Q. But would you agree with me that as a government owned utility, especially given the ability of government to give direction to this Board as to how it regulates Hydro, that Hydro's regulatory risk is pretty small?
A. Sorry, could you repeat the first part of that?
Q. Given that Newfoundland and Labrador Hydro is a government owned utility and given that the government has authority to give direction to this Board with respect to its regulation, that the, comparatively speaking, Hydro's regulatory risk is fairly small?
A. Well if you asked Hydro, one, that question, I think they'd probably say that that wasn't the case, so I don't think that you can conclude that the regulatory risk is small simply because the shareholder is the Province. I think the Province has, as I indicated in my testimony, they have two concerns. They have the concerns of their constituents and they have the concerns of their Crown Corporations and there will be dilemmas as between the two. And I think that given that they have to answer to their constituents, that there's no

reason to conclude that Hydro doesn't face a, you know, a similar level of regulatory risk to any other utility.
Q. Would you agree with me that Hydro, in facing a particular regulatory problem, has another way to go that wouldn't be available to Newfoundland Power, and that is to say to its shareholder, this is really a problem for us, can you give appropriate direction to the Board to solve our problem?
A. I mean, I guess that that's always a possibility that they can do that and then, you know, the shareholder has to decide whether this is something that is reasonable to seek the Board to implement, but you know, as I said before, it's--the shareholder and the Province have to look at their two roles independently and keep in mind that ultimately they are accountable to the citizens of the Province.
Q. I take it you would agree with me that there is little in the way of competitive risk for Newfoundland and Labrador Hydro?
A. I would say at the present time the competitive risks are very limited. I said

that in my testimony.
Q. Okay. You've included in your evidence at Schedule VIII a listing of some Canadian utilities, betas for regulated Canadian utilities. For what purposes do you use these particular utilities in your evidence?
A. I use them as one input to determining what an appropriate relative risk adjustment is in the context of the Equity Risk Premium Test.
Q. Okay, are these intended to be operations that are comparable to Newfoundland and Labrador Hydro?
A. As close as one can get based on the market data that are available.
Q. Okay. Do you know what the current state of regulation of the electricity market in Alberta is?
A. I do.
Q. Can you let us know what that is?
A. Let's see, there has been a separation of the distribution, transmission and generation functions. The transmission and distribution are subject to regulation. The retail function is being removed from the distribution. Sometimes it's being provided

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MS. MCSHANE:
as a regulated rate option by the utility. Some customers are receiving that service from an alternative provider. The existing generation of the utilities is now contracted for the long-term through purchase power arrangements.
HUTCHINGS, Q.C.:
Q. Is it--am I correct in assuming that TransAlta has now sold its transmission business and doesn't have any regulated utility operations?
A. That's correct, sold the last of it in 2002.
Q. And this Alberta situation would also affect Canadian utilities, I presume?
A. Yes.
Q. Yes, okay, so those are two of the comparables that are now operating more in a deregulated environment than a regulated one?
A. Well TransAlta is certainly, Canadian utilities--I think we have to be pretty careful about if we say they're operating in a deregulated environment. Yes, their existing generation is subject to long-term purchase power agreements, but it's still akin to being a long-term cost of service contract.

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Canadian Utilities also has significant natural gas distribution operations which are regulated. The transmission is highly regulated and the distribution is highly regulated. So just to give you an example, when you talk about, you know, transmission, transmission in Alberta, the transmission function of CU Inc., which is the sub that holds the utility operations, determines what its--essentially determines what its revenue requirement is for the test year, goes before the regulator, and they decide on what that revenue requirement is, goes to the independent system operator, hands him a bill and gets a cheque. So you can say that there is, you know, deregulation on certain aspects, but there are clearly significant aspects that are very highly regulated and very much subject to a relative high degree of security on the revenues.
Q. Yes. I understand what you're saying, but would you agree with me that generally speaking, utilities that are operating in this environment of restructuring and deregulation and potential competition are generally facing

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a higher risk than a fully regulated utility?
A. To some extent, that's correct. They would face higher business risk. If you look at Canadian Utilities, which is sort of an interesting example because it has very diverse regulated operations which contribute to it being viewed as a relatively low risk company and, in fact, has one of the highest debt ratings as among utilities in this country, and it's still rated in the A plus area, and to some extent, has offset, you know, increase in business risk by increasing its common equity ratio. So you have to be sort of careful about saying well, it's not a comparable because they face somewhat higher business risks, when they've offset that higher business risk with a higher common equity ratio.
Q. Okay. Just moving on now to talk about another form of risk. One of the items that you mention, page 7 of your evidence, is that the more variable are the revenues and the less variable are the costs, the higher the business risks, and you say that, I think, in the context of businesses generally, but that

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would be true for utilities, wouldn't it?
A. Yes, I've made that statement. That's true.
Q. So revenue volatility is definitely a risk for a public utility?
A. Yes.
Q. Okay. Is there any measure by which we can tell when revenue volatility becomes a real problem that the utility should be concerned about? I mean, is it a certain percentage of its revenues or its net income or what--is there any test that we can apply to that?
A. I've not seen a test applied to the volatility in revenues. The one measure of volatility that one can look at that I'm aware of is the volatility in operating income, which allows you to compare across companies.
Q. Yes, okay. So if a certain portion of the company's income, I mean, was subject to significant volatility, 10, 15, 20, 25 percent swing, shall we say, possible in the net income of a company, would that be regarded as a significant risk?
A. Yes. If you lined up utilities and looked at how much the operating income could vary as among those utilities, the ones with the most

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MS. MCSHANE:
potential volatility would be viewed on that issue as riskier.
HUTCHINGS, Q.C.:
Q. Would you agree with me that in respect of almost all of the electric utilities certainly in Canada and probably in North America, they bear the risk of their sales or loads not being as forecast?
A. I would say that there is a general propensity for that to be the case, as among electric utilities. Some of the pipelines certainly are covered for revenue or load variations. For example, Trans Canada Pipelines has been. Nova Gas Transmission. But the utilities--and again, it depends. If we're talking about transmission in Alberta, there is no load variability.
Q. I understand that. Mr. Greneman told us that he was not aware of any utility other than Newfoundland and Labrador Hydro that had this sort of load variation provision that we have in the RSP here. Are you aware of any such provision?
A. I think that's right, and I think I did answer

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an RFI on that.
(1:00 p.m.)
Q. Okay. Are you aware of the magnitude of the adjustments associated with the load variation provision for Newfoundland and Labrador Hydro?
A. The load as opposed to the other element?
Q. Yes.
A. No, I did not specifically look at the elements of the RSP.
Q. I think on the basis of the material that's before us now, Newfoundland and Labrador Hydro is seeking a return, a margin on its operations in 2004 of something in the range of 15 million dollars. Does that sound about right to you?
A. That number sounds about right, yes.
Q. Okay. Would you be surprised to find that in the year 2002, the load variation provision of the RSP dealt with a variation in the amount of 5.5 million?
A. I would take that, subject to check.
Q. Okay. Would you say that that's a significant portion of the income of Newfoundland and Labrador Hydro?
A. Yes, but don't forget that the income of

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Newfoundland and Labrador Hydro has only been being determined on 12 percent of equity too, so, you know, the five million has to be kind of looked at in context. If you had a regular 55/45 percent capital structure, that'd be a totally different story.
Q. But for any utility to have a third of its income at risk and to, by reason of regulatory fiat under the RSP have that risk removed is a significant reduction in risk, isn't it?
A. But again, I think you have to look at it in the context of the capital structure that's in place.
Q. Okay. In Schedule 16 of your evidence, you have a group of US natural gas distribution companies, and I take it these also are intended to be comparables for Newfoundland and Labrador Hydro, are they?
A. Yes.
Q. Okay. Among the companies that are listed here, do you see any whose risk characteristics are currently unstable?
A. Not that I'm specifically aware of. The only one that I'm aware of that might be considered to be facing some problems at present would be

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NICOR.
Q. Okay. And NICOR has made a major restatement of its earnings over the past number of years?
A. I think that they did, yes.
Q. Okay. When was this particular schedule put together in terms of the timing?
A. It would have been together in March of 2003.
Q. Okay. And were you aware of what changes had occurred in the beta for NICOR over the previous nine to twelve months prior to March of 2003?
A. It's gone up.
Q. Significantly?
A. I think perhaps on the order of .2, .25, but I'd have to check to make sure.
Q. Okay. Perhaps you can check that, if you would, and just let us know later on? I won't need to pursue it with you further, but I'd just like to know what the beta was, say, in June of 2002 as compared to March of 2003.
Mr. Fitzgerald asked you some questions this morning about your DCF analysis and I think you confirmed for him that the basis of your analysis was analysts' forecasts and that was one of the principal inputs into your

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HUTCHINGS, Q.C.:
analysis? Is that correct?
A. Yes.
Q. These analysts that we speak of, I understand that their work is compiled by the agencies you refer to, but the analysts themselves, would these be working for like investment banks and things like that?
A. Yes.
Q. Okay. Can you explain for us what optimism bias is?
A. Optimism bias is when the analysts overestimate the earnings forecast due to excessive optimism about the potential of the companies.
Q. Did you make any adjustment for that phenomenon in doing your calculations on the DCF analysis?
A. No, I did not. First of all, I did look at--oh, let me back up and say that one of the reasons that's been given for optimism on the part of the analysts is because they're being paid to be optimistic. So one has to at least look to see whether forecast by independent research operations are systematically

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different from those that might be optimistic because they have a pecuniary reason to be. And indeed, I've looked at the value line forecast, which are produced by an independent research firm, and I found no systematic difference as between the value line forecast and the consensus analysts' forecast.
The second thing that particularly in the case of utilities that's useful to test the reasonableness of the forecast is to look at how they compare to longer term growth in the economy over time. Because in the long-term you would expect that mature industry should be expected to grow at approximately the rate of growth in the economy as a whole. And those comparisons have indicated that the forecasts that are being produced for low-risk utilities are in line with those forecast, long-term forecasts for the economy as a whole. So that gives me some comfort that these particular forecasts are reasonable.
The third thing that I have looked at, particularly with respect to the sample of gas distributors that you were talking about which whose growth rates I follow all the time and

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use in the context of my discounted cash flow related risk premium test, you can go and look at how the resulting DCF costs compare to the returns that are being allowed by regulators who are using the--who have been using the discounted cash flow test over time to see whether if--whether that numbers that you would derive quarter by quarter using the analysts forecasts are offside what regulators are allowing. And my analysis has indicated the DCF numbers over time that I've used are lower than what the allowed returns for these companies have been. So on those basis, you know, I think that using the analysts forecasts in this context is not unreasonable.
Q. Are you aware of the $1.4 billion settlement in an action against U.S. investment banks in New York?
A. I am.
Q. Recently?
A. Generally, yes.
Q. And would you agree that one of the items at issue there were--was the notion that some of these investment analysts were, in fact, overstating their forecasts for the purposing

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of assisting their employers and so on?
A. I understand what was going on is that they were making recommendations that they shouldn't have made.
Q. Yeah.
A. And let's understand something, though. That when you're talking about--let's say, I'll pick a company. Lucent Technologies is probably somewhat well known. But take some of these smaller technologies. The investor is depending on the analyst to explain to him what this company is doing. So to a great extent the investor is at the whim of the analyst. I mean, that's not true with utilities.
Q. Pardon me?
A. That's not true with utilities. I mean -
Q. No. I -
A. - the utility business is a well-understood business. And if analysts were systematically overstating the outlook for these companies, investors would know that.
Q. Okay. Are you aware whether or not any of the analysts forecasts that were compiled by the services you referred to were involved with

HUTCHINGS, Q.C.:
any of the investment banks that were involved in this action?
A. I'd be surprised if they weren't. I mean, these are the major, the major investment banking firms that are providing the forecasts to this consensus. But that's not to say that the analysts in particular doing the utility analysis are the analysts or the people recommending the stocks -
Q. No, I -
A. - in the suit that you're talking about.
Q. I understand what you're saying. I just need to deal with a couple of other points quickly. You suggest at page 47 to page 48 of your evidence that we need to add 50 basis points to compensate for financing and market pressure costs, unanticipated market conditions, and the recognition of the fairness principle. I take it we're agreed that Hydro does not actually issue equity and therefore doesn't face any issuance costs?
A. They do not face any out-of-pocket issuance costs, no.
Q. Or no issue of market pressure in respect of

their equity issues because there aren't any, obviously?
A. There would be no actual market pressure because they do not issue shares.
Q. Okay. Hydro's exposure, of course, is only in the debt markets, correct?
A. Its direct explicit exposure to the capital markets is in the debt markets.
Q. Okay. Would you agree with me that the debt markets are substantially less volatile than the equity markets?
A. Generally speaking.
Q. Okay. And for Hydro there is no such thing as a market-to-book value for its equity?
A. No, because there is no market value. Just as there are no market-to-book values for a significant number of the stand-alone investor owned utilities because they're owned by some other company who has a market-to-book ratio that reflects their consolidated operations.
Q. Okay. So what exactly then is this 50 basis points intended to compensate Hydro for?
A. It is a notional adjustment to allow, in principal, the market value, which I agree doesn't actually exist, to be in excess of

book value. And effectively what this does is recognize that in the context of regulation on original cost that there is a return that's being determined in a capital market that base its returns on market value, but applies that to a book value. And there should be some notional ability to maintain a market value above book value, and that should apply equally to an investment of a public company as to a private company.
Q. I think we're paying nonexistent costs to a nonexistent shareholder to buy nonexistent shares, but I'll leave that for argument, Ms. McShane. Just going back to the capital structure issue. I think we agreed earlier that Hydro obviously doesn't pay any taxes. And would you agree with me that an implication of that is that there are less benefits to Hydro of debt than there would be for an investor owned utility?
A. Yes, I said that in my testimony.
Q. Okay. Would you agree with me that Hydro's current capital structure is not optimal in the sense that it is heavily weighted toward debt?

A. Well, yes, that would be my view that it's not optimal. I also discussed in the testimony that it's a lot less simple to determine what optimality is when you don't pay taxes because of the lack of benefit to be gained from the income--from the deductibility of interest expense.
Q. Yeah. But with a company that has a high degree of leverage such as Hydro has, the equity investors required return will be higher, correct?
A. Than if it were 60/40, you mean?
Q. Yeah.
A. Yes.
Q. Okay. Thank you, Ms. McShane. Mr. Chair, those are all my questions.
(1:15 p.m.)
CHAIRMAN:
Q. Thank you, Mr. Hutchings, Ms. McShane. Good afternoon, Mr. Kennedy. Do you have a long -
MR. KENNEDY:
Q. I have a few questions. I was just thinking that subject to the other counsel, I'm assuming that counsel for Hydro might have some redirect -

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GREENE, Q.C.:
Q. I have no--at this point I have no rebuttal.
MR. KENNEDY:
Q. So do the--I can try to plough ahead here now, Chair. I might be able to finish in ten minutes, or we could break and come back in the morning if you feel that that's more appropriate?
CHAIRMAN:
Q. Well, I think if you could--do you have any questions at this point? No? Well, if you could plough through in ten minutes or so with no redirect and limited questions, I might have a couple, depending on yours, I think we might be able to conclude 1:30 or shortly thereafter so.
MR. KENNEDY:
Q. Okay. That's fine, Chair.
CHAIRMAN:
Q. I'd prefer to do that, if that's okay.
MR. KENNEDY:
Q. Ms. McShane, I said I only have a couple of questions. At the very beginning of your direct testimony you made some comments on questioning by counsel for Hydro concerning

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the testimony of Dr. Waverman?
A. Yes, I did.
Q. And I just wanted to make sure I had your comments correct. Sometimes I find what you hear is what you hope you heard, rather than what the person said. And if I gather correctly, you made two points in regards to Dr. Waverman's testimony. One was just pointing out his distinction that there was no common stock equity that Hydro had?
A. Yes.
Q. And the other one was that the only capital that Hydro raises is debt?
A. In the capital markets is debt, correct.
Q. Okay. And I thought I heard you speak to the first one. I was just wondering, were you in actual fact speaking to both of those points when you then followed on with your comments about from your perspective there's no substantive difference between your position and Dr. Waverman's or those points don't make a substantial difference?
A. Oh, sorry, no. If that's what you understood me to say, then I either mis-spoke or -
Q. I misheard.

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A. What I was -
Q. Just as I suspected.
A. What I was suggesting was that his first comment was--or my first comment with respect to what I understood his rational to be was that one of the reasons that Hydro's shareholder equity only should attract the cost of debt is because it was shareholder equity, not common stock equity. And the point I was trying to make was that I did not see a substantive difference between those two concepts that would lead to the conclusion that one requires an equity return but the other only requires a debt return.
Q. Okay. At page 47 of your pre-filed testimony, right at the bottom, Ms. McShane, line 30, you indicate, "As a Crown Corporation Newfoundland Hydro does not raise capital in the public equity markets. Therefore, it would not incur out-of-pocket equity financing in market pressure costs." And this is in your section regarding financing flexibility which was the line of questions that counsel for the Industrial Customers just asked you. So I gather correctly, though, do I, that in sofar

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as the point made by Dr. Waverman that Newfoundland Hydro doesn't raise capital in the equity markets, its only source of raising capital is from debt, that you agree with that point?
A. No. It has a source of equity from retained earnings. I agree that they don't raise equity in the public equity markets. And my understanding was that he was using that rational, the fact that they don't raise equity in the equity markets to conclude that the return on the retained earnings that are there should be the cost of debt.
Q. Sure, I understand. And I think we can get to the point where we at least note where the point of departure is between yourself and Dr. Waverman. But, just that line then at page 47 at line 30, you say "As a Crown Corporation Newfoundland Hydro does not raise capital in the public equity markets." It's not a matter of it doesn't raise equity in the equity markets, it doesn't raise capital in the public equity market. So if it doesn't raise capital in the public equity markets, where does it raise its capital, where does Hydro

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MR. KENNEDY:
obtain its capital?
A. Okay. I think we may be mis-communicating. It raises debt capital in the debt market. It does not have access to the public equity market. To date its only source of equity is through retained earnings.
Q. Right, okay. So you ostensibly agree, then, with the fact that Hydro has no common stock equity?
A. It doesn't have common stock equity as he's defined it. It does not have--the regulated utility does not have common stock equity shares that publicly trade.
Q. Right. Now, at page 13 of your report, and this is in just a section that you're discussing the business risk of Hydro and this is at the tail-end of that section.
A. Yes.
Q. And right there at line 1 you go, "Although there is no bright line between the province as shareholder and as author of public and social policy, to the extent feasible that distinction must be drawn. As shareholder and representative of the taxpayers of the

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province, the province should have a reasonable expectation of being provided the opportunity to earn a fair return on its equity investment." All right. So I just wanted to see if you first agreed with in regards to the line that begins on--or the sentence that begins on line 2, "As shareholder", and you go, "As representative of the taxpayers of the province". The government as shareholder of Hydro would actually be representative of the citizens of the Province of Newfoundland and Labrador and not just the taxpayers of the province?
A. True.
Q. Okay.
A. And I guess I was looking at the main -
Q. Most are paying taxes -
A. - owners. Yes, most are--typically one does look at the ultimate ownership of a Crown Corporation being the taxpayers, but the citizens would be equally applicable.
Q. Sure. So at page 5 of Dr. Waverman's report, Ms. McShane. And I take it you've--I think you've already said that--obviously if you've commented on Dr. Waverman's report, you've

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read it. And this is just in the summary of conclusions sections of Dr. Waverman's report, and you'll see up there at line 1 Dr. Waverman writes that "Hydro is a Crown Corporation and has no common stock equity". And so, we've agreed with that point, have we, that Hydro has no common stock equity?
A. Not the way he's defined it, no.
Q. Right.
A. It has shareholders' equity. He agrees it has shareholders' equity.
Q. Yes, yes. And towards the bottom then at line 17 or 16 where he goes, "Hydro has no common stock equity and as a political subdivision of the Province of Newfoundland, the province's citizens are its ultimate owners." So subject to your caveat there about the definition of common stock equity, you'd agree with the fact that the province's citizens are the ultimate owners of Newfoundland and Labrador Hydro?
A. Sorry, could you read me that sentence again?
Q. Okay.
A. Line 16.
GREENE, Q.C.:
Q. It's different, you read something different

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than is on screen, Mr. Kennedy.
A. Yes.
HUTCHINGS, Q.C.:
Q. And different than the hard copy that we have.
MR. KENNEDY:
Q. Oh, beg your pardon.
GREENE, Q.C.:
Q. Different than the hard copy that we have, as well.
MR. KENNEDY:
Q. I must have it--oh, okay. What happened there? Okay. That's fine. We can just read the one on the screen, Ms. McShane. "Hydro has no common stock equity and the province's citizens are its ultimate owners." So subject to your caveat there about the definition of common stock equity, you're agreeing that the province's citizens are the ultimate owners of Hydro?
A. I do.
Q. Okay. Then Dr. Waverman states that compensating those owners simply means raising through regulated rates funds sufficient to maintain operations and satisfy, one, the interest obligations on the outstanding

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MR. KENNEDY:
guaranteed debt. Would you agree with that? That is a cost that needs to be compensated for?
A. I do, I agree with that.
Q. And two, the opportunity costs of the province's citizens. Just accepting for a moment the statement inside the parenthesis, would you agree with that broad, broad statement, that the two things we need to compensate Hydro for is the, number one, the interest obligations on the outstanding guaranteed debt, and two, the opportunity costs of the province's citizen's for the shareholders' equity portion of the capital structure?
A. Yes, I can agree with the second part as long as we understand that the, to me the opportunity cost is related to the potential alternative use that those funds could be put to and the risk to which they're associated.
Q. Right. So, if I can gather correctly, the point of departure between yourself and Dr. Waverman is that the opportunity costs that's being referred to here in point number two,

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the cost to be compensated to Hydro, that Dr. Waverman is suggesting that it's represented by the marginal cost of provincial guaranteed debt and in your case you are of the opinion that that opportunity cost which needs to be compensated is what an investor in a similar investor owned utility would expect to receive?
A. No, I don't think that you need--that you can go to that second step without going first to the step that they need to be compensated for what they--what the closest alternative return they could have gotten in an investment of similar risk. And then that would, to my mind, would be similar to an investor owned utility. But you can't, you can't go to the step of the investor owned utility without making the first stop, being that you've got these dollars of retained earnings at risk and there is an alternative investment opportunity associated with them and what is the closest alternative there is and what's the return on that.
Q. Would you agree with the general proposition that the ultimate question is the

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determination of what Hydro's costs of capital are?
A. I agree that you're trying to determine what the cost of capital is to Hydro where the cost of the retained earnings is represented by the opportunity cost which should reflect what those funds could--alternative uses for those funds.
(1:30 p.m.)
Q. Okay. That was sort of two statements you made, though, right? So I just -
A. Possibly.
Q. And I guess following your own advise there to break down the issues so that we don't blur a couple in one sentence, you do agree that the initial question is what is the cost of capital to Hydro, and then the next question is, well, how do we calculate what the cost of capital is to Hydro?
A. Fair.
Q. And that we both recognize that it's an issue of the opportunity costs to the equity portion of the capital structure of Hydro which is at issue and that while you were suggesting that that opportunity cost is what an investor--

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what would be the, as you said, next step down in--or up in risk that that investor would be exposed to in a similarly situated enterprise, that that's what the opportunity cost is from your perspective?
A. Is that the opportunity cost should be what the next alternative of--would earn, which is subject to similar risks.
Q. And so that would be, just to put it into concrete terms, what the citizens of the Province of Newfoundland and Labrador's opportunity cost is?
A. Well, see, that's where I have a problem with--because that's so broad. There is no such thing as the opportunity cost of the citizens of Newfoundland and Labrador. There is an opportunity cost associated with the specific investment.
Q. That's all the questions I have, Chair. Thank you, Ms. McShane.
A. Thank you.

CHAIRMAN:
Q. Thank you, Mr. Kennedy. Your plough works reasonably well.

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GREENE, Q.C.:
Q. Still no rebuttal, no.
CHAIRMAN:
Q. Still no rebuttal. Questions? I have just a couple of questions, Ms. McShane. And my plough is not nearly deep as Mr. Kennedy's, so I'll be very brief, I can assure you. Nine months ago or so, or I guess a year ago this Board certainly decided on the return for Newfoundland Power. And I guess looking at the methodologies here that I've read through in the evidence, methodologies really haven't changed substantially. Certainly I think you made the comment, I believe it was to Mr. Hutchings, and it's in your testimony, that you equate the total risk of Newfoundland Power, Newfoundland Hydro. What over the last year, in your estimation, are some of the key factors that have changed and that this Board would consider, should consider in relation to this matter and whether we should change our mind in relation to the 9.75, I guess, given that the historic data is--the historic data, just to focus the issue?
A. Well, perhaps to put this in some kind of

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context, my recollection was the decision for Newfoundland Power came out after this evidence was filed. And given the discussions that were had at the Newfoundland Power hearing, I don't know that there are any significant changes that have occurred since that time. I know that we discussed, for example, the S & P report at the time of the Newfoundland Power case when Standard and Poor's had expressed its concern about the low levels of returns and capitals--the common equity ratios for investor owned utilities. And there has been some additional support in that direction from DBRS. I think that there are indications that the utility risk premium has remained somewhat higher than it might have been a number of years ago due to spreads that we've observed between utility bonds and long Canada yields. But, there are no material changes that I'm aware of that have occurred since the time that decision was rendered.
Q. Okay. Thank you. Just one other question that I have. You commented on the fact that if indeed the debt equity ratio doesn't

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improve, it's 83/17, I believe, if it doesn't improve, that there's a tendency for Hydro to be viewed, I guess, by the capital markets as being not fully self-supporting. And you also referred, I think it was again in discussion with Mr. Hutchings the standard of self-supporting that you have, you're looking as defined by the Ontario Energy Board. And I think you did indicate, not necessarily that definition, but a narrow definition that you were using for self-supporting. Unfortunately, I missed that. I'll get it in the transcript, I'm sure, but could you clarify what you mean by self-supporting?
A. When I used the term "self-supporting" in this evidence, I was using it in a relatively narrow sense that there had been no need for Hydro to rely on the, either the shareholder or the debt guarantor for, as a back stop, because it had been able to meet its operating and maintenance expenses and its financial obligations without looking to the shareholder or the debt guarantor.
Q. Okay. And there were two other impacts that I had heard if that, indeed, debt equity ratio

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doesn't improve, one is that it may both reflect on, I guess, government in one instance and the shareholder in another, being one and the same, but impair the guarantor's credit rating and the adequacy, I guess, of the equity cushion to avoid impairment to the shareholders' investment. Are there any other negative impacts that you're aware of from if, indeed, the debt equity ratio doesn't improve to an 80/20 or beyond?
A. No. I mean, as long as there is a debt guarantee in place, those are the only real world impacts of which I'm aware.
Q. Thank you, very much. Are there any questions, matter--business matter arising.
MR. FITZGERALD:
Q. Just one question, Chair, arising.
CHAIRMAN:
Q. Sure.
MR. FITZGERALD:
Q. Out of your question. Ms. McShane, the Chairman asked you what elements or factors may have changed in the nine months since the previous decision of the Board in relation to Newfoundland Power. And I think you did

MR. FITZGERALD:
confirm this morning that one of the factors, I guess, when you're calculating the weighted average, the cost of capital, that has changed, or at least that the Board considers when they're considering that aspect of the case, and that is the drop in the yield from-- for Canada 30-year bonds, there has been a drop since the beginning of the year. Is that correct?
A. Oh, sorry, yes. I mean, if you're looking at the 5.6 percent that the Board used in its decision for Newfoundland Power and what the yield is today, the yield today is lower than the 5.6 percent.
Q. Thank you, Mr. Chairman. Those are the questions.
CHAIRMAN:
Q. Thank you, Mr. Fitzgerald? Any other? No. Thank you, very much Ms. McShane. Thank you for your patience everybody. We will reconvene at 9:00 tomorrow morning with Dr. Kalymon.
Adjourned.

CERTIFICATE

I, Judy Moss Lauzon, hereby certify that the foregoing is a true and correct transcript in the matter of Newfoundland and Labrador Hydro's 2003 General Rate Application for approval of, among other things, its rates commencing January, 2004 heard on the 3rd day of December, A.D., 2003 before the Board of Commissioners of Public Utilities, Prince Charles Building, St. John's, Newfoundland and Labrador and was transcribed by me to the best of my ability by means of a sound apparatus.
Dated at St. John's, Newfoundland and Labrador this 3rd day of December, A.D., 2003
Judy Moss Lauzon