Q: At the time of his pre-filed evidence, was Dr. Cannon aware of the history of Newfoundland Power's Automatic Adjustment Mechanism? Specifically, was Dr. Cannon aware that the Board had approved the use of a fixed/embedded cost rate for debt in comparison to a forecast cost rate for equity in Newfoundland Power's Automatic Adjustment Mechanism?

A: Yes, Dr. Cannon was aware of the history of Newfoundland Power's (NP's) Automatic Adjustment Mechanism (AAM) at the time he prepared his prefiled evidence. He was aware of the Board's decision in this regard and the Board's reasoning for its decision. He was also aware of the views of the Consumer Advocate and Grant Thornton with respect to the treatment of the embedded cost of debt (ECD) in NP's AAM.

In particular, Dr. Cannon took note of Grant Thornton's statement (Grant Thornton Report-NP 2003 GRA, February 4, 2003, pg. 22) that

> "In reviewing the operation of the Formula the Board should consider the significance of variations in the embedded cost of debt and whether they warrant modifications to the Formula going forward. One option the Board may consider is to modify the Formula to adjust for forecast changes in the embedded cost of debt annually."

Dr. Cannon also read the passages in Grant Thornton's Supplementary Evidence (Grant Thornton, Supplementary Evidence – NP 2003 GRA, April 4, 2003, pgs 4-5) where it is stated that

> "… we identified the changes in forecast versus actual embedded cost of debt as a second area, which deserved further consideration by the Board.
>
> The cost of debt is one component in the Company's overall cost of capital. Based on the current definition and application of the AAF the forecast cost of debt used in the AAF remains constant from year to year. However, experience has shown that, year to year, the actual embedded cost of debt varies from forecast. When the actual cost of debt is lower than the forecast cost, the Company has the opportunity to earn a higher return on equity while staying within the limits of the overall cost of capital or rate of return on rate base …
>
> One change to the AAF that would compensate for interest effects as described would involve modifying the Formula so it is adjusted annually for changes in the forecast embedded cost of debt. This change may be appropriate if significant variations in the embedded cost of debt were anticipated in future years."

Dr. Cannon also noted the Consumer Advocate's dissatisfaction with the operation of NP's AAM, in particular with its ECD fixed at the test-year value throughout the term of the AAM (Final Submission of the Consumer Advocate – NP 2003 GRA, pgs 32-40)

Dr. Cannon was also aware that in its Decision in NP 2003 GRA on pages 67 and 68, the Board recognized the potential shortcomings of using a fixed ECD set at the test-year level throughout the term of NP's AAM. Nevertheless, the Board rejected the remedy requested by the Consumer Advocate on the dual grounds that (1) it might reduce the incentive for NP to strive to lower its debt costs during the term of the AAM and (2) "it would be contrary to the purpose of having an automatic adjustment mechanism if, once a formula has been established, the Board were to use variances from forecasts of requirements to adjust various formula components as they change" (pg 68 of Decision).

The proposal that Dr. Cannon is advocating in this hearing for the treatment of the ECD in the implementation of Hydro's AAM offends neither of the two principles as set down by the Board in its NP 2003 GRA Decision.

First, use of pre-established, forecasted embedded-debt-cost values for years 2008, 2009, and 2010 in no way reduces the incentive for Hydro to seek the lowest financing costs it can secure during these years, since, all other things being equal, Hydro can still expect to over-earn its allowed return on equity if it issues new debt at rates below these used to forecast the future embedded costs of debt.

Second, using forecasted embedded average costs of Hydro's debt for 2008, 2009, and 2010 that are pre-established and approved by the Board at this hearing will not require new evidence to be submitted, reviewed, and acted upon by the Board in subsequent years when the AAM is in operation – there will be no need to *adjust various formula components as they change*, with regard to Hydro's embedded cost of debt.