



Via Courier

26 April 2016

Ms. G. Cheryl Blundon
Board of Commissioners of Public Utilities
120 Torbay Road, P.O. Box 12040
St. John's, NL A1A 5B2

Dear Ms. Blundon:

RE: Newfoundland Power 2016-2017 General Rate Application

Please find enclosed one (1) original and eleven (11) copies of the Consumer Advocate's Final Submission.

Copies of the Final Submission have also been couriered to the parties listed below.

Electronic copies will be filed in due course.

Yours very truly,

O'DEA, EARLE

A handwritten signature in black ink, appearing to read 'Thomas Johnson', is written over the printed name.

THOMAS JOHNSON, Q.C.

TJ:jss

Enclosures

CC: Newfoundland and Labrador Hydro
Attention: Mr. Geoffrey P. Young, Senior Legal Counsel

Newfoundland Power
Attention: Peter Alteen, Q.C.

Curtis Dawe
Attention: Ian F. Kelly, Q.C.

IN THE MATTER OF

the *Public Utilities Act*, R.S.N.L. 1990,
Chapter P-47 (the "*Act*"), as amended;

AND

IN THE MATTER OF

A General Rate Application (the "*Application*")
by Newfoundland Power Inc. ("*Newfoundland Power*")
to establish customer electricity rates for 2016 and 2017.

To: The Board of Commissioners of Public Utilities (the "*Board*")

**CONSUMER ADVOCATE'S
FINAL WRITTEN SUBMISSIONS**

April 26, 2016

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Overview

For the reasons set out in this submission, a fair return on equity for Newfoundland Power is 7.50% on a capital structure of 40% equity. It is time for Newfoundland Power's capital structure to be brought into line with its Canadian utility counterparts whose equity components are in the 38%-40% range much less than Newfoundland Power's generous 45% common equity component.

It is also time for the Board to hold that Newfoundland Power's Executive Compensation arrangement is not justified and imposes an undue cost on its customers.

Finally, it is time for the Board to order that Newfoundland Power establish meaningful, incented, corporate targets for its CDM activities and results.

The Expert Witnesses – Assessment

The Consumer Advocate called 2 expert witnesses, Dr. Laurence Booth and Dr. Sean Cleary. Dr. Laurence Booth was asked to provide evidence on two issues:

1. The fair rate of return on common equity ("ROE"); and
2. The appropriate capital structure for Newfoundland Power.

Dr. Booth is an expert in finance. Dr. Booth is presently a professor of finance at the University of Toronto's Rotman School of Management where he has held the CIT Chair in Structured Finance since 1999. His C.V. contained in Appendix A of his report and his opening comments, detail his extensive qualifications to provide expert evidence in this proceeding. For example, Dr. Booth:

- holds a B.Sc (Economics), M.A. (Economics), M.B.A. (Finance), and D.B.A. (Finance);
- has published over seventy journal articles covering a range of financial issues and a number of text books including a university text on Corporate Finance that has been Americanized and sold into the U.S. market;

- has taught courses in finance and economics at the undergraduate, graduate, and doctoral levels since 1987 and has supervised Ph.D students who have gone on to teach at major universities in Canada and the U.S;
- in 2015/2016 was the President of the Mid-West Finance Association, a major regional academic finance association in the United States and for almost 21 years was chair of the finance group at the University of Toronto, Canada's largest university;
- has been an expert financial witness in over thirty utility hearings and numerous civil proceedings; and
- has appeared before most of the major utility regulatory boards in Canada.

Dr. Sean Cleary was asked to provide expert evidence on an appropriate capital structure (i.e. equity ratio) for Newfoundland Power. Dr. Cleary is presently the BMO Professor of Finance at the Smith School of Business of Queen's University. His C.V. contained in Appendix A of his report and his opening comments to the Board on April 11, 2016 details his extensive qualifications to provide expert evidence in this proceeding. For example, Dr. Cleary:

- holds a B.A. (Economics), M.B.A. and Ph.D. (Finance);
- founded the Queen's Master's in Finance program;
- holds the Chartered Financial Analyst (CFA) designation which the Economist called the "Gold Standard of Financial Designations" and has taught and prepared readings for the CFA curriculum and served on the Board of the Atlantic Canada and Toronto CFA Societies;
- authored or co-authored fourteen text books in finance;
- authored numerous papers for peer reviewed journals;
- is the editor of the finance area of the Canadian Journal of Administration Sciences;
- is the associate editor for the European Journal of Finance; and
- has testified on two occasions before the AUC on cost of capital and corporate structure related matters.

Both Dr. Booth and Dr. Cleary were clearly highly qualified to provide expert opinions and judgments to the Board. Both testified forthrightly and, in the tradition of what an expert witness is supposed to do, gave evidence and assistance to the Board on the issues before it.

1 Mr. Coyne, Newfoundland Power's expert witness, testified as regards return on equity and an
2 appropriate capital structure for Newfoundland Power. Mr. Coyne does not have the academic
3 training and credentials possessed by Dr. Booth and Dr. Cleary. Mr. Coyne commenced
4 testifying in cost of capital matters in 2008. His Master's Degree was a Master's of Science in
5 Resource Economics. His thesis studied the relationships between markets and fisheries and
6 prices in these markets. He has not carried out research for or contributed to any peer reviewed
7 academic journals in any area. Mr. Coyne has testified only for utility companies in cost of
8 capital matters. He has been retained by other Fortis affiliated utilities to provide cost of capital
9 evidence, including Fortis BC and Maritime Electric.

10
11 As regards the ROE, by reason of Dr. Booth's clearly more intensive training, knowledge and
12 experience as regarding financial markets and cost of capital estimation methodologies, where
13 there are differences to be resolved between the experts, Dr. Booth's evidence is more
14 deserving of weight. Beyond the credential gap, there are other reasons not to rely upon Mr.
15 Coyne's opinions where they conflict with Dr. Booth's. The reasons include inconsistency with
16 prior evidence in other proceedings such as:

- 17
- 18 a. recognizing the appropriateness of an incremental ROE of 41 basis points to
19 reflect the risk of generation before the Regie in 2013, but not in the present
20 matter;
 - 21 b. not screening out (nor adjusting for) utilities that own extensive generation
22 including nuclear generation in this case but excluding non-generators from his
23 proxy group when testifying on behalf of Northern States Power;
 - 24 c. presenting a mix and match of Canada and (higher) U.S. risk free rates in his
25 CAPM analysis in this proceeding, while presenting Canadian rates in his British
26 Columbia evidence prepared only two weeks earlier;
 - 27 d. in the case of Newfoundland Power (which is rated "A" by DBRS and carries an
28 A2 rating on its bonds) including companies in the proxy group with an inferior
29 BBB+ S & P rating (Newfoundland Power is not rated by S & P) while using a S &
30 P A- rating cut off in his 2013 evidence for Hydro Quebec's transmission and
31 distribution utilities; and
 - 32 e. using a beta of .59 before the Regie in 2013 and using a significantly higher beta
33 in this case.
- 34

1 These discrepancies call into question whether Mr. Coyne's evidence before the Board truly
2 represents his expert opinion or whether his true opinion is reflected in his other inconsistent
3 evidence. Whatever the conclusion, it makes placing reliance on what Mr. Coyne has stated in
4 this proceeding on these issues unreasonable.

5
6 Yet, the more profound weakness with Mr. Coyne's ROE evidence and conclusions is the
7 complete lack of independent, third party corroboration of the reasonableness of his estimates
8 and the assumptions they are based upon. There are a number of examples of this: Mr. Coyne
9 asserts that the TSX's expected return is approximately 13.50% in the face of clear evidence to
10 the contrary from respected market participants. He asserts that the market risk premium is
11 7.62% in part based on data from Duff & Philips when Duff & Philips itself has said the U.S.
12 market risk premium is 5.50%! He asserts the reasonableness of the assumption that low risk,
13 mature utilities can grow at rates at and above the GDP growth rate but has filed no evidence
14 that utilities have ever achieved the growth rate of GDP. Mr. Coyne asserts that U.S. utilities
15 generally earn their allowed returns but he has filed no evidence to substantiate this claim.

16
17 Similarly, Mr. Coyne's Capital Structure recommendations are borne out of a strictly qualitative
18 assessment that concludes for the first time in Newfoundland Power's history it has become an
19 above average risk Canadian utility. Dr. Cleary's expert quantitative assessment clearly
20 establishes that Newfoundland Power remains a typical, low risk Canadian utility, in line with his
21 qualitative assessment.

22 23 **Return on Equity Methodologies**

24
25 Mr. Coyne and Dr. Booth used different approaches to estimate the fair return for Newfoundland
26 Power.

27 28 **Mr. Coyne's Approach - Overview**

29
30 Mr. Coyne's approach relies predominately on the discounted cash flow methodology (DCF).
31 Mr. Coyne's revised Figure 1 is set out below:

Revised Figure 1: Summary of Result (including flotation costs) ¹				
	Canadian	US Electric	North American	Average

	Regulated Utilities	Utilities	Utilities	
CAPM	9.0%	9.8%	9.6%	9.5%
Constant Growth DCF	12.8%	9.8%	9.6%	10.7%
Multi Stage DCF	10.3%	9.5%	9.2%	9.7%
Average	10.7%	9.7%	9.5%	10.0%

1 Mr. Coyne places greatest weight on the results of his North American Electric Utilities proxy
 2 group. Two-thirds of Mr. Coyne's average ROE results are derived from one form or other of
 3 DCF. Mr. Coyne makes no adjustments to his results derived from the United States data to
 4 account for differences in the United States and Canadian markets or for differences between
 5 Newfoundland Power and the companies it is being compared to for the purpose of the ROE
 6 estimation. As will be discussed later in this submission the Consumer Advocate does not
 7 regard Mr. Coyne's proxy companies to be reasonable proxies for determining an appropriate
 8 return on equity. This alone will prompt the need to make adjustments as the Board recognized
 9 in Order No. P.U. 43 (2009) at p. 17, lines 31-33. In Order No. P.U. 13 (2013) the Board held
 10 that differences in the U.S. and Canadian experience justify and adjustment to the DCF results
 11 of 50 to 100 basis points. To the extent that the Board can rely at all on any of the DCF results
 12 in this case, given the demonstrated deficiencies and unsupportable assumptions at their
 13 foundation, at least 100 basis points is called for as an adjustment, as a significant adjustment
 14 must alone be made for the fact that we are comparing Newfoundland Power to vertically
 15 integrated utilities with extensive and riskier generation. To that we also must recognize the
 16 optimism of growth forecasters which McKinsey have likened to a "broken clock" for being
 17 correct twice a day.

18
 19 In P.U. 13 (2013) the Board stated that it will continue to give primary weighting to the capital
 20 asset pricing model (CAPM). The Board stated that it would also look to the results of other
 21 accepted models and other relevant evidence when determining a fair return for Newfoundland
 22 Power. The Board explicitly stated that it placed little weight on the results of the discounted
 23 cash flow model (Order No. P.U. 13 (2013) p. 31, lines 31-32). The Consumer Advocate
 24 submits that for reasons that will be set out shortly, the Board should place no weight on the
 25 results of Mr. Coyne's DCF-based estimates.

1 Dr. Booth's Approach - Overview

2
3 Dr. Booth's approach is to use a conditional CAPM-based equity risk premium approach. Dr.
4 Booth also looks to a DCF analysis to inform his judgment with respect to his ROE
5 recommendation (April 8, p. 195, line 19).

6
7 CAPM is the most common risk premium model. Dr. Booth explained the theory behind the
8 CAPM starting at page 37 of his evidence and summarized why it is so widely used:

9
10 "Why the CAPM is so widely used is because it is intuitively correct. It captures two of
11 the major "laws" of finance: the **time value** of money and the **risk value** of money...
12 ...[T]he time value of money is captured in the long Canada bond yield as the risk free
13 rate. The risk value of money is captured in the market risk premium, which anchors an
14 individual firm's risk. As long as the market risk premium is approximately correct the
15 estimate will be in the right "ball park"... CAPM measures the right thing: which is how
16 much does a security add to the risk of a diversified portfolio, which is the central idea of
17 modern portfolio theory. It also reflects the fact that modern capital markets are
18 dominated by large institutions that hold diversified portfolios."

19
20 The Alberta Utilities Commission (AUC), in a 2011 GCOC decision, described the CAPM as "a
21 well-accepted and theoretically-grounded economic model for valuing securities based on the
22 relationship between non-diversifiable risk and expected return." (Decision 2011 – 474, Decision
23 9, 2011, p. 7, para. 29). The NEB, in its 2009 Decision in RH-1-2008 stated:

24
25 "The Board is of the view that CAPM is widely accepted as a cost of equity model... In
26 the Board's view, CAPM captures the risk equity holders have to bear when holding a
27 common stock... In the Board's view, even if the DCF model is intuitive and theoretically
28 sound, challenges remain in its applicability since historical growth rates might not reflect
29 the future and analyst expectations might be different than the aggregate expectations of
30 all financial markets participants. As a result of these challenges, the Board will not rely
31 on the DCF model and will be informed by CAPM when estimating the cost of equity..."

Simple CAPM Estimates

Similar to when he last gave evidence in 2012, Dr. Booth does not believe “simple” CAPM estimates provide a fair return due to the persistently low government bond rates brought on by central bank actions around the world.

Dr. Booth’s simple CAPM estimate (at p. 42) for 2016 is 6.08% (the average of a “low end” estimate of 5.56% and a “high end” estimate of 6.61%). This is based on Dr. Booth’s market risk premium of common equities over long term Canada Bonds at 5.0-6.0%, and a relative risk adjustment (i.e. beta) of .45 to .55 which provides a going forward utility risk premium in the range of 2.25% to 3.30%. If this is added to a 2.81% consensus forecast for the average long term Canada bond yield for 2016 and a .50% flotation cost allowance this yields the low and high end CAPM estimates on which the average of 6.08% is calculated.

Mr. Coyne also provides a simple or unadjusted CAPM estimate of 6.8% as explained in reply to PUB-NP-064. In reply to PUB-NP-064, Mr. Coyne confirms that his 9.0% CAPM result for the Canadian Utility Proxy group includes adjustments made to compensate for the current market environment. Mr. Coyne’s adjustments include using a forecast (2016-2018) Canadian risk free rate, a market risk premium that combines both U.S. and Canadian market inputs including both historic and forward-looking estimates, and the adjusted beta coefficient for the Canadian and U.S. proxy companies. In order to compute his “unadjusted” CAPM, Mr. Coyne relied on the following inputs and assumptions:

- Current risk-free rate: 2.24% (30 yearlong Canada Bank yields as of 8/29/2015)
- Bloomberg Beta: .64
- Market Risk Premium: 6.3% (Historical MRP only)

Based on these assumptions, the “unadjusted” CAPM result for the Canadian Utility Proxy would be 6.8%, including 50 basis points for financial flexibility and flotation costs.

1 **Conditional CAPM (CCAPM)**

2
3 At the current point in time, Dr. Booth states that conditions in the Canadian bond market are
4 largely being driven by external factors and are still not "average" market conditions. To adjust
5 for this Dr. Booth makes two adjustments:

- 6
7 1. The first is to make the CAPM estimate conditional on the state of the markets thereby
8 converting it into a CCAPM.
9 2. The second is to adjust for the abnormally low Canada bond yields resulting from bond
10 buying programs by central banks.

11
12 The first adjustment concerns the fact that at this point in time "A" spreads are at 1.91% or 91
13 basis points more than the typical average for the business cycle, which Dr. Booth states is
14 1.0%. Consequently, Dr. Booth adds .45% for this credit market effect. Dr. Booth regards this
15 adjustment as converting the CAPM into a conditional CAPM where the CAPM holds conditional
16 upon the state of the financial markets. Dr. Booth's report (p. 45) states that while it remains
17 difficult to "disentangle the liquidity component" from the pure credit component in credit
18 spreads, since 2010 as Canadian capital markets were returning to normal, he has been
19 recommending a 50% adjustment to change in credit spreads. This adjustment has been
20 incorporated into ROE adjustment models adopted by the OEB, Regie and the BCUC.

21
22 There are two points to be made about Dr. Booth's credit spread adjustment. First, as Dr. Booth
23 testified (April 8, p. 191) research at the Bank of Canada suggests that the adjustments should
24 not be as high as 50 percent of the credit spread because their research shows that for
25 investment grade firms 63% of the spread is attributable to liquidity. Therefore, Dr. Booth's
26 approach is conservative yet as he states (April 8, p. 191, lines 21-25) "almost every board that
27 I'm aware of that's thought about an automatic adjustment mechanism has incorporated 50
28 percent adjustment to spreads, so I'd say that's reasonably acceptable." The second point is
29 that Dr. Booth's credit spread adjustments are objective. At the hearing, Dr. Booth stated during
30 cross-examination by the Board Hearing Counsel (April 8, p. 193, lines 1-17):

31
32 "Well, I'd qualify that and say that not the full 175 basis points is judgment. I think the 45
33 basis points for the credit spreads is just basically the same as the OEB, the same as
34 the Regie, the same as the BC Utilities Commission, so I would say that – I'm not

1 imposing significant judgment there. I'm just making the estimate a little bit more
2 sensitive to the business cycle. The major area of judgment is this attempt to try and
3 handle the bond buying, the implications of the bond buying program, and 130 basis
4 points now, 80 basis points three years ago, 80 basis points I was comfortable with, 130
5 I'm not comfortable with, but that is certainly the major area of judgment."
6

7 The result of CCAPM for 2016 (i.e. incorporating the .45% for the credit spread effect) is an
8 average ROE estimate of 6.54% being the average of a low end estimate of 6.01% and a high-
9 end estimate of 7.06%.

10
11 Dr. Booth regards the ROE resulting from the CCAPM as an under-estimate at this point in time
12 because capital markets are not typical as a result of massive bond buying programs by central
13 banks which have created abnormally low Canada bond yields.

14
15 As discussed in the "Risk Free Rate" section, on account of the bond buying programs, Dr.
16 Booth has added 130 basis points to the CCAPM estimate of approximately 6.54% to arrive at a
17 fair ROE of 7.83% for a benchmark utility, which is the midpoint between the low estimate (of
18 7.31%) and the high end estimate (of 8.36%). Dr. Booth points out in his report however that
19 taking into account the current yields on utility preferred shares and the difficulty in making a
20 direct transfer from preferred shared to common shares, he would tend to be conservative and
21 therefore he recommends the same 7.5% as in 2012. The Consumer Advocate would note that
22 it must also be observed that providing a floatation and financial flexibility allowance of 50 basis
23 points exceeds the 30 basis points allowed by the Regie and is higher than the allowance in the
24 United States, where for instance, in Wisconsin, no allowance is given.

25
26 **Risk Free Rate**
27

28 It is not a matter controversy that current bond yields are near historical lows and that
29 consequently adjustments are necessary to arrive at an appropriate risk for rate. Dr. Booth's
30 evidence (p. 26) is that interest rates are not, and probably will not for the foreseeable future, be
31 set by private investors. Instead, they are being set by what has been called the "global policy
32 maker".
33

1 Dr. Booth observes that the average of the March and December consensus forecasts which is
2 a proxy for the average for the year as a whole, and consistent with the application to an
3 average forward test year rate base is 2.81%.

4
5 The CAPM is an equilibrium where private investors trade off risk versus expected return. This
6 results in a premium over the risk free rate. Because the risk free rate, the government bond
7 rate, is being determined by what RBC calls the global policy maker, Dr. Booth judges it
8 necessary to determine what the correct risk free rate is in the risk return trade off which is why
9 Dr. Booth uses preferred shares as a proxy for a yield relatively less affected by central bank
10 bond buying (NP-CA-046). In its last NP GRA order, the Board accepted Dr. Booth's 80 basis
11 point adjustment to the long term Canada bond yield to reflect the unusual conditions brought
12 on by actions of global policy makers (P.U. 13 (2013) p. 23, lines 12-17). In Dr. Booth's current
13 evidence he observes that there has been an increase in the preferred share yield spread from
14 .80% in 2012 to the current 2015 average of 1.3% for an increase of .50%. There is absolutely
15 no doubt that expert judgement is required when making such an adjustment as Dr. Booth
16 explained in cross-examination by Board hearing counsel, Ms. Greene, Q.C. However, what is
17 important to note is that his judgment of what a normalized bond yield is, is shared by other
18 market participants. As Dr. Booth states (April 8, p. 193-line 18 to p. 194-line 21).

19
20 Greene, Q.C.:

21 Q. "And again you have agreed that more judgement even is required this
22 time when looking at how CAPM should be adjusted for the
23 marketplace?"

24 Dr. Booth:

25 A. "That's correct, but I'll just point out there that it's not just me saying this, I
26 mean, the Duff & Phelps report that I sent around, they've recalibrated the
27 market risk premium at 5.5 percent, which is right in the middle of my 5 to
28 6 percent range, except that it's based upon a normalized long term U.S.
29 government bond yield, and they use 4 percent, I tend to think 3.8
30 percent, but the point is they accept the normalized bond yield when they
31 do their risk premium analysis. AON Hewitt looks at a normalized long run
32 – they call it a long run target bond yield of 4.18 percent. So I think
33 everybody will recognize that the current long term bond yields are not
34 anywhere close to normal equilibrium, however you want to define it, so

1 3.8, 4, 4.1, I think it is from the AON Hewitt, that's where my judgment
2 comes in, but it's not just my judgement, it's the judgment of almost all
3 market participants."
4

5 In the Consumer Advocate's submission, the Board is once again justified in relying upon Dr.
6 Booth's expert opinion to make the "Operation Twist" adjustment of 130 basis points to arrive at
7 a risk free rate of 3.8%.
8

9 **Market Risk Premium**

10
11 Dr. Booth estimates the market risk premium (MRP) of common equities over long term bonds
12 at 5.0% to 6.0%. The Consumer Advocate submits that the evidence in the hearing
13 overwhelmingly supports the reasonableness of Dr. Booth's estimate over the estimate of Mr.
14 Coyne who states that the market risk premium is 7.62%.
15

16 First, let us turn to Dr. Booth's 5-6% MRP assessment. Dr. Booth's estimate is drawn from
17 Canadian capital market history back to 1924 (report, p. 40, line 26-27). The outcome indicated
18 an MRP of under 5%. The important thing to observe about Dr. Booth's MRP judgment is that it
19 is firmly in accordance with other independent market observers.
20

21 We must start with the view of Duff & Phelps. Dr. Booth's sur-rebuttal evidence revealed that in
22 March, 2016 Duff & Phelps released their latest estimates for the US market risk premium
23 estimate which they increased from 5% to 5.5% measured relative to a normalized yield of 4.0%
24 on 20 year US Treasury Bonds. It is not without irony that Mr. Coyne claims to be using data
25 from Duff & Phelps to support his much higher MRP of 7.6%. As Dr. Booth states (at p. 11) the
26 normalized 4.0% 20 year US Treasury Yield is also very similar to his approach and that of AON
27 Hewitt.
28

29 Dr. Booth's opinion that the MRP is 5.0% to 6.0% is also completely in line with a very recent
30 November 2015 survey (Appendix B, p. 10, Table 2) by Professor Fernandez which surveyed a
31 large sample of analysts, companies, and finance professors to estimate the MRP in various
32 markets. The survey respondents placed the Canadian MRP at a median of 6.0% and an
33 average of 5.9%, and the US MRP at a median of 5.5% and an average of 5.3%. Of particular
34 note is that the survey respondents also put the **overall** expected equity market return at about

1 8.0% in Canada and in the United States. This gives a valuable "reality check" on Mr. Coyne's
2 ROE recommendation for Newfoundland Power and buttresses the reasonableness of Dr.
3 Booth's estimate.

4
5 Dr. Booth's judgment is also supported by TD Economics. In his conclusions in Appendix B., p.
6 12-13, he referenced the 2012 TD report and stated:

7
8 *"The TD analysis placed long run Canadian equity returns at 7.00%, the same as in the*
9 *US and internationally, whereas bond returns were forecast at 3.0% for the Dex universe*
10 *bond index, that is, including corporate as well as government bonds. The implication is*
11 *for a long run market risk premium of 4.00% of equities over bonds and slightly higher*
12 *over government bonds. This is an increase compared to a similar report in March*
13 *2011, where Canadian equity returns were forecast at 7.5% and bond returns at 4.00%.*
14 *TD Economics is predicting a return to a balanced portfolio of 4.0-6.0%, which with 2%*
15 *inflation implies a real return at a maximum of 4.0%. This is the same sort of analysis*
16 *that underlies most defined benefit pension plans.*

17
18 *These particular return estimates are for long run (next decade) which would be closer to*
19 *geometric (compound) returns than arithmetic returns. An adjustment to convert them to*
20 *arithmetic returns would move the market risk premium closer to 6.0%.*

21
22 As noted, Dr. Booth's estimated expected returns can also be compared against the
23 expectations of the independent market forecaster, AON Hewitt. AON Hewitt's January 7, 2016
24 report "Capital Market Assumptions & Methodology (Canadian Version)" (CA NP 269,
25 Attachment "B" at p. 3 of 28) describes its purposes as follows:

26
27 *"This document summarizes Aon Hewitt Canada's 10-year forward-looking capital*
28 *market assumptions ("CMAs") that are to be used in the determination of strategic*
29 *portfolio allocations and related modeling or projection studies. The methodology*
30 *described herein is also the basis of longer-term 30-yr CMAs that can be used to*
31 *determine an expected long-term portfolio return for the purposes of performing an*
32 *actuarial valuation."* (underline added)

1 On the same page it states:

2
3 "The CMAs presented in this document represent Aon Hewitt Canada's best-estimate
4 view of future economic conditions and are established by a national committee
5 comprised of Investment and Risk Management practitioners. The determination of the
6 CMAs involves a thorough analysis of all available quantitative and qualitative resources
7 including, but not limited to, in-house analyses of historical returns, external analyses of
8 long-term historical returns presented in published research articles, the actual state of
9 the market and the good judgment of the national assumptions committee.
10 Additionally, the CMAs reflect the analyses and research done by Aon Hewitt investment
11 and risk management colleagues around the globe and are checked for global
12 consistency." (underlining added)

13
14 The AON Hewitt Capital Market assumptions are independent and the result of a major effort
15 made for the purpose of advising clients.

16
17 The AON results confirm Dr. Booth's market return conclusions and are consistent with the
18 previously mentioned Fernandez and TD Economics findings. AON Hewitt's 10 year Average
19 Annual Return (Arithmetic) expectation for Canadian Equities is 8.3% and for US Equities
20 (hedged) it is 8.0%.

21
22 Similar market return expectations are supported by Mercer, Newfoundland Power's pension
23 advisors, who put the expected return for equities at 8.1% (Arithmetic 9.6% - CA NP 014) and
24 bonds at 3.5%.

25
26 It is a matter of indisputable fact that the returns that Dr. Booth utilized in determining his MRP
27 and his proposed ROE are reasonable when one looks at not one, but several independent and
28 credible forecasts of future returns. In contrast, the forecast returns that Mr. Coyne used in
29 determining his MRP of 7.6% and his ROE recommendation of 9.5% for a low risk utility are a
30 significant departure from these sources and exceed the expectations of each of the
31 independent forecasters for the market as a whole.

32
33 The reasons for Mr. Coyne's gross over-estimation of the MRP are very evident: First, Mr.
34 Coyne's forward looking Canadian MRP of 9.8% and US MRP of 8.1% (which he

1 "conservatively" (p. 30, line 19) averages with historical Canadian and US MRPs of 5.6% and
2 7.0% respectively to arrive at an MRP of 7.6%, are based on optimistic constant growth DCF
3 methodology.

4
5 As Dr. Booth's sur-rebuttal evidence pointed out (p. 11-12):

6
7 *"In terms of Mr. Coyne's forward looking market risk premium estimates of 9.8% for*
8 *Canada and 8.1% for the US, he was subjected to cross examination on this before the*
9 *BCUC two weeks ago. The basic problem was that he assumed the constant growth*
10 *form of the DCF model to generate his estimates and this clearly does not hold for most*
11 *companies. The reason for this is simply that the assumed analyst growth rates in his*
12 *estimates vastly exceed any possible growth rate in the economy, resulting in internally*
13 *inconsistent estimates. I assume to head off cross examination on this inconsistency Mr.*
14 *Coyne on page 29 provides what he terms a "more conservative" estimate based on the*
15 *multi-stage DCF model, which is what he was asked to do in BC as an undertaking.*
16 *These estimates reduce the market risk premium for Canada from 9.8% to 5.39% or by*
17 *4.41% and from 8.1% to 3.96% or by 4.14% for the US.*

18
19 *These new "forward looking" market risk premium estimates have three implications.*

- 20
21
 - *First, they demonstrate the huge errors introduced by the careless use of the*
22 *constant growth DCF model. By any stretch of the imagination reducing the*
23 *market risk premium estimate by 4.41% in Canada and 4.14% in the US is a*
24 *significant error and likely greater than even the careless use of the CAPM.*
 - *Second, Mr. Coyne regards the results of his own estimates as "anomalous" and*
26 *rejects them based on his regression analysis, which in turn is based on the*
27 *same constant growth DCF estimates which are incorrect. Further this is the*
28 *same regression model that predicted a huge negative risk premium during the*
29 *financial crisis!*
 - *Third, when we partially discount the optimism of short run analyst forecasts by*
31 *using the multi-stage DCF model the forward looking DCF market risk premium is*
32 *consistent with historic estimates."*
- 33

1 Second, Mr. Coyne arrives at his historical MRPs for Canada and the United States by
2 engaging in a dubious exercise whereby he presents the risk premium over the bond income
3 returns as opposed to the risk premium over the total bond returns. The result of this exercise is
4 to inflate the historical risk premium (Undertaking No. 12).

5
6 The Consumer Advocate submits that an MRP of 5 to 6%, as estimated by Dr. Booth is borne
7 out by evidence and should be accepted by the Board.

8
9 **Beta**

10
11 In risk premium models the relative risk coefficient adjusts the overall market risk premium up or
12 down depending on whether the individual security is more or less risky than the market as a
13 whole.

14
15 Dr. Booth's analysis clearly shows that the market recognizes that Canadian utilities are lower
16 than average risk. Dr. Booth judges the relative risk of a Canadian utility to be 45-55% of that of
17 the market as a whole.

18
19 Mr. Coyne, on the other hand, uses "adjusted betas" and states that the average beta for his US
20 Proxy Group is .73, while the average beta for the Canadian Proxy Group is lower at .64, with
21 the average beta for the North American Group being .72. Mr. Coyne's report states that "*Both*
22 *Value Line and Bloomberg report adjusted betas to compensate for the tendency of beta to*
23 *revert towards the market average of 1.0 over time.*" (Coyne Report, p. 28, lines 5-6). Mr.
24 Coyne's report continues:

25
26 *"There are two primary reasons to adjust raw betas. First numerous empirical studies*
27 *have provided evidence that an individual company beta is more likely than not to move*
28 *toward the market average of 1.0 over time. Second, adjusting beta serves a statistical*
29 *purpose. Because betas are statistically estimated and have associated error terms,*
30 *betas that are greater than 1.0 tend to have positive estimated errors and thus tend to*
31 *overestimate further returns. Betas that are below the market average of 1.0 tend to*
32 *have negative error terms and underestimate further returns. Consequently, it is*
33 *necessary to adjust forecasted betas toward 1.0 in an effort to improve forecasts.*"
34 (emphasis added) (Coyne Report, p. 28, lines 9-16).

1
2 Mr. Coyne's use of adjusted betas has been explicitly rejected by the A.U.C. As noted in Dr.
3 Booth's sur-rebuttal evidence (p. 12) and as acknowledged by Mr. Coyne (Transcript, April 4, p.
4 31) the A.U.C. stated as follows in the 2009 A.U.C. Generic Cost of Capital Order at paragraph
5 251:

6
7 *"The Commission is persuaded by the empirical analysis of Drs. Kryzanowski and*
8 *Roberts that there is insufficient evidence to support the use of adjusted betas for*
9 *Canadian utilities if the purpose of the adjustment is to adjust the beta towards one and*
10 *therefore, beta should not be adjusted towards one. Therefore, the Commission rejects*
11 *Mr. Coyne's beta results as unreasonably high, because he adjusted his beta estimates*
12 *on the assumption that they would revert to 1.00. In other words, his analysis assumes*
13 *that, in time, utilities would be as risky as the market as a whole."*
14

15 Dr. Booth's sur-rebuttal evidence observes (p. 12, lines 25-29):
16

17 *"Apart from the fact that the AUC specifically rejected Mr. Coyne's evidence, I am not*
18 *aware of any Canadian regulator that has accepted betas adjusted toward 1.0. Mr.*
19 *Coyne references the 2009 OEB technical conference and that the Board took no 'issue*
20 *with Concentric's adjusted betas.' However, not specifically rejecting estimates is not*
21 *the same thing as accepting them. Further, the OEB decision was not the result of a*
22 *litigated hearing with information requests and cross examination, so a larger number of*
23 *issues went unexamined including this inappropriate adjustment."*
24

25 Mr. Coyne's report leaves the impression that Value Line and Bloomberg only report adjusted
26 betas. In fact, Bloomberg also reports unadjusted or raw betas. Mr. Coyne was requested by
27 the Consumer Advocate to undertake to provide the raw betas for his proxy groups, which Mr.
28 Coyne provided in Undertaking No. 17. A comparison of the differences between the "raw
29 betas" and the "adjusted betas" can be seen on Undertaking No. 19 – Attachment A, p. 2 of 2.
30 Here one can observe that for the US Proxy Group the adjusted beta used by Mr. Coyne was
31 .73 versus a raw beta of .54 and an Industry Index beta of .51. For the Canadian Proxy Group,
32 Mr. Coyne's adjusted betas are .64 versus a raw beta of .46 and an Industry Index beta of .54.
33 Finally, for the North American Group, Mr. Coyne's adjusted beta was .72 versus a raw beta of
34 .53 and an Industry Index beta of .49.

1
2 Given Mr. Coyne's reliance on adjusted betas, the same cannot be accepted as reasonable or
3 reliable. Dr. Booth's evidence is that regression estimates of utility risk for the last five year
4 period ending in 2014 show a beta estimate at .45 (Appendix D, p. 5). Dr. Booth observes that
5 as interest rates increase back to normal levels he expects utility betas to increase as they trade
6 less on their bond values and more as regular equities. Dr. Booth expects some tendency for
7 their betas to revert back to their long run average level: for the market as a whole this is 1.0.,
8 but for regulated utilities this is about .45-.55 (Appendix D, p. 6).

9
10 Before leaving the topic of beta, given the prevalent use of US proxy groups in Canadian utility
11 rate hearings, it must be observed that the evidence is quite clear in this proceeding that the
12 betas for US utility holding companies are higher than those of Canadian utilities. Unfortunately,
13 we cannot observe what the beta for a stable, non-volatile and consistent earner like
14 Newfoundland Power would be. However, we can observe that as noted above that the raw
15 betas for the Canadian Proxy Group are at .46 versus .54 for the US Proxy Group. We
16 observed from Mr. Coyne's recent evidence in British Columbia for Fortis BC Energy Inc. that
17 his US Proxy Group had a raw beta of .62 versus a raw beta of .47 for the Canadian Proxy
18 Group. The beta when adjusted to industry average was .57 for the US Proxy Group and again
19 lower at .49 for the Canadian Proxy Group (CA NP 152, Attachment "A", at p. 240 of 247). Dr.
20 Booth's report (at Appendix "C", p. 7, lines 17-26) sets out further data as to the high utility betas
21 in the US versus in Canada. Dr. Booth concludes (Appendix "C", p. 7, line 26 to p. 8, line 2):

22
23 "The data indicates clear differences in risk perception of Canadian UHCs relative to US
24 electric companies and a less clear difference for the US gas companies."

25
26 Mr. Coyne was asked whether he had any data that would indicate that Canadian utilities do not
27 persistently have lower betas than US utilities. He stated referring to his reports for
28 Newfoundland Power and Fortis BC (Transcript, April 6th, p. 55, lines 20-22):

29
30 *"Well, they certainly are in these two cases. I don't know about consistently over time.*
31 *Perhaps they are."*
32

33 Dr. Booth's beta estimate is also consistent with the view of Barron's which states in a May
34 2015 article that the U.S. utility sector "has only about half the market's volatility" (Information

No. 26). The Consumer Advocate submits that Dr. Booth's beta estimate of .45 to .55 is reasonable.

Mr. Coyne's "Constant Growth DCF" Estimates

In Mr. Coyne's "Summary of Results" (including flotation costs) the Constant Growth DCF methodology produced the highest ROE estimates (U-15 Revised Figure 1). These estimates ranged from 9.6% for the North American Electric Utilities to 12.3% for the Canadian Regulated Utilities. Mr. Coyne used the Constant Growth DCF methodology to estimate the market risk premium. [Transcript, April 4th, p. 154]

The predictable result of using "out-sized" constant growth estimates is to arrive at an "out-sized" market risk premium. The Board will recall during the hearing that Mr. Coyne's constant growth DCF produced a 13.46% required return on the TSX – a truly eye popping figure that is clearly not grounded in reality. Mr. Coyne could only offer that the required return of the Canadian market *"implied by the stock prices, divided yields and estimates built into those forecasts. . . tells us this is what investors are expecting today based on those assumptions."* [Transcript, April 5th, p. 104] On cross-examination, Mr. Coyne was asked whether he could point to any independent third party source that would support such a high required return. Not surprisingly, Mr. Coyne stated, *"I cannot, no."* [Transcript, April 5th, p. 105]

It is for good reason that this Board stated in P.U. 13 (2013) (p. 27 – lines 28 to 31) as follows:

"The Board does not believe that much weight should be given to the experts' recommendations in relation to either the historic or forward-looking equity risk premium models as these are largely based on inadequate Canadian data, unadjusted United States data and analysts' growth forecasts using the constant growth model." (emphasis added)

At page 31 of P.U. 13 (2013) the board explicitly stated that it *"does not accept the use of analysts' forecasts using the constant growth model. . ."* [Lines 27-28]. The Board should completely disregard the constant growth estimates put forward in this case by Mr. Coyne. The same goes for Mr. Coyne's multi-stage DCF estimate, which we turn to next.

1 **Mr. Coyne's Multi-Stage DCF Estimates**

2
3 In Mr. Coyne's "Summary of Results", the Multi-Stage DCF produced the second highest ROE
4 estimates at 9.7%. These estimates ranged from 9.2% for the North American Electric Utilities
5 to 10.3% for the Canadian proxy group.

6
7 In Mr. Coyne's Multi-Stage DCF Analysis the US Proxy Group is assumed to grow at an
8 average rate of 5.32% for the first 5 years, tapering from 5.06% to 4.68% over years 6 to 10 and
9 growing thereafter at the US GDP rate of 4.55% in perpetuity (Exhibit JMC-4, p. 1 of 3). This
10 analysis yields a mean ROE of 9.45% including .50% for flotation costs. For the Canadian
11 Proxy Group, the companies grow at 8.05% for the first 5 years, tapering from 7.35% to 4.62%
12 over years 6 to 10 and thereafter growing at the assumed Canadian GDP rate of 3.94% in
13 perpetuity (Exhibit JMC-4, p. 2 of 3). This analysis yields a mean ROE of 9.45% including
14 flotation. Finally, for the North American Proxy Group, Mr. Coyne has the average growth rate
15 at 5.28% for the first 5 years, tapering from 5.14% to 4.56% over years 6 to 10 and growing
16 thereafter at an assumed GDP rate of 4.41% in perpetuity. This analysis yields a mean ROE of
17 9.24% including flotation.

18
19 As was pointed out during Mr. Coyne's cross-examination, these Multi-Stage DCF analyses all
20 assume that the utilities' growth will exceed GDP for the first ten years by a sizable margin and
21 then go on in perpetuity at the rate of estimated GDP growth. These are not reasonable
22 assumptions and are certainly not assumptions that are borne out by the evidence in this
23 proceeding. During cross-examination, the Consumer Advocate asked Mr. Coyne if he had any
24 evidence that electric utilities have on average grown at the rate of GDP in either Canada or the
25 United States. Mr. Coyne replied, "*No, I have not provided that evidence.*" [Transcript, April 6th,
26 p. 131, lines 5 to 24]

27
28 Notably, the A.U.C in its March 2015 generic cost of capital decision stated (CA-NP-169,
29 Attachment A, para. 190,191)

30
31 190... However, the Commission is also mindful that, as both experts acknowledged, the
32 GDP growth rate may be an ambitious target for long-run earnings growth in respect of
33 low risk, mature, utilities.

1 191... After considering the characteristics of the various DCF-based ROE estimation
2 models employed by the participating expert witnesses, the Commission finds that
3 reasonable DCF estimates for the Alberta Utilities are in the range of 7.0 per cent to 9.0
4 per cent and that this range is consistent with an expected average equity market return
5 between 8.0 per cent and 9.0 per cent. In arriving at this conclusion, the Commission
6 noted that Ms. McShane's DCF results for her U.S. utility sample, for which the growth
7 rates were very close to the forecast GDP growth rate, were in the range 8.5 per cent to
8 9.0 per cent. However, the Commission considers growth rates that are close to the
9 forecast GDP growth rate to be overly optimistic for regulated utilities. [footnotes omitted
10 and emphasis added]
11

12 Mr. Coyne testified that this was the model adopted by FERC and the one that's most broadly
13 used when you're adopting a multi-stage approach. [Transcript, April 6th, p. 131] Notably,
14 FERC's Order which was put to Dr. Booth on cross-examination (Information No. 32) states at
15 paragraph 43 that participants to that proceeding will be given an opportunity to present
16 evidence concerning the appropriate long-term growth projection to be used for public utilities
17 under the FERC's two-step DCF methodology.
18

19 A 2015 Oliver Wyman report put to Mr. Coyne on cross-examination (Information No. 21)
20 estimated that utility earnings will grow on average 3.3 percent annually during the next 15
21 years, far lower than the rate of growth used in Mr. Coyne's analysis [Transcript, April 6, p. 133]
22

23 The Consumer Advocate submits that Mr. Coyne's multi-stage DCF analysis cannot be relied
24 upon by the Board as it too suffers from optimistic growth rate assumptions and leads to an
25 exaggerated ROE at the expense of customers. The Multi-Stage DCF model is very difficult to
26 place any weight upon. As Dr. Booth said on this point during cross-examination by Ms. Green,
27 Q.C.: [Transcript, April 18, p. 204-205]
28

29 "Well, here's an interesting question. If the Board thinks that the short run five year
30 growth rates are biased, and as a result it puts greater weight on multi period, then you
31 look at it and you say, well, if you think the first five years are overoptimistic, and then
32 you taper to the long run growth rate and the GDP as saying that the next five years are
33 overoptimistic, straight off the bat it's saying that the first ten years of a multi-stage DCF
34 analysis are optimistic. So you get into bind. If you reject constant growth, you also reject

1 the first ten years of a multistage model, and then there's no evidence whatsoever that
2 utilities grow at a growth rate of GDP. The AUC mentioned this, and, in fact, if I picked
3 up the tabs from the FERC, the FERC recognizes it as well."

4
5 **Mr. Coyne's Proxy Group Selection**

6
7 Mr. Coyne's report's contention is that the proxy companies *used in his ROE analysis possess a*
8 *set of business and financial characteristics that are similar to Newfoundland Power's regulated*
9 *electric utility operations, and these provide a reasonable basis for the derivation and*
10 *assessment of ROE and capital structure estimates."*

11
12 On cross, Mr. Coyne stated that the return should be comparable to the one that one could earn
13 on like risk "*so that really grounds our analysis around trying to find those that are like risk, and*
14 *so we wouldn't want to use the universe of utilities. . . so the idea is to narrow it down to those*
15 *that look most like the target company for the purposes of cost of capital analysis."* [Transcript,
16 April 7, p. 2]

17
18 This Board stated in Reasons for Decision Order No. P.U. 43 (2009) as follows:

19
20 "*The Board believes that in this type of analysis, it is not enough that the chosen*
21 *comparables are the best available. If this data is to be relied on it must be shown to be*
22 *a reasonable proxy or that reasonable adjustments can be made to account for*
23 *differences."* [p. 17, lines 3-5]

24
25 **Regulated vs. Unregulated Operations/Assets**

26
27 Newfoundland Power is a "poles and wires", transmission and distribution utility. It has a very
28 small amount of generation. Its assets are 100 percent regulated. In contrast, each of the
29 companies that populate the proxy group of Mr. Coyne is a utility holding company. The utility
30 holding companies are not comprised of 100 percent regulated assets, nor are their earnings
31 derived from 100 percent regulated earnings as is the case with Newfoundland Power.

32
33 In the case of the Canadian utility Proxy Group, because there are so few publically traded
34 regulated Canadian electric and gas utilities, the only screening criteria was that the company

1 possess an investment grade credit rating (Coyne Report, p. 15, lines 21-22). Mr. Coyne
2 admitted that his Canadian Proxy Group companies were not close matches for Newfoundland
3 Power (Transcript, April 6th, p. 179, lines 7-12). Canadian Utilities Limited and Emera, both of
4 which are also included in Mr. Coyne's North American Proxy Group have major differences
5 from Newfoundland Power. The former is an international, global entity and the latter's major
6 subsidiary, Nova Scotia Power, is a vertically integrated utility with large generation capacity.

7 8 Generation vs. Poles and Wires

9
10 In fact, in the case of the US Utility Holding Companies, all but Eversource have significant
11 generation: Allele-1985 MW, Duke-49,600 MW, Great Plains Energy-6660 MW, OGE-6845
12 MW, Pinnacle West-6400 MW, and Westar-7200 MW. A number of these companies also own
13 and operate nuclear generation facilities. It is difficult to conceive of Newfoundland Power with
14 its Petty Harbour hydro plant being considered a close match to these utilities. [Transcript, April
15 4th, pp. 100 to 116]

16
17 It is well recognized, including by Mr. Coyne, that electrical generation exposes a utility to more
18 risk than transmission and distribution. This is recognized by both DBRS and Moody's. Mr.
19 Coyne makes no adjustment for this fact which is simply unreasonable and inconsistent with his
20 own evidence before the Régie where his 2013 evidence was that the incremental ROE
21 required to offset the increased operating risk of regulated generation is approximately 41 basis
22 points. [Transcript, April 4th, p. 86, lines 13-24; CA NP 154, p. 53]

23
24 During cross-examination, Mr. Coyne was also referred to his May 29, 2015 evidence on behalf
25 of Northern States Power. For Northern States Power, a company with 830 MWs of generation,
26 Mr. Coyne screened out companies whose owned generation did not comprise greater than
27 25% of the MWH sales to ultimate customers (Transcript, April 4th, p. 124). In Wisconsin, Mr.
28 Coyne considers the risk of generation to be a factor that investors consider in making their
29 investment decisions in utility companies (Transcript, April 4th, p. 127). 6 of the 7 US companies
30 (Transcript, April 4th, p. 131) that are in Newfoundland Power's Proxy Group were also used in
31 Wisconsin but Newfoundland Power, if it were publically listed, would not have passed the
32 generation screen in Wisconsin because it lacks the risk associated with owned generation.

1 Mr. Coyne's explanation for not applying an adjustment to account for the proxy group's
2 generation compared to Newfoundland Power was that *"we examined Newfoundland Power's*
3 *overall risk profile and we find that from an investor standpoint, they have credit ratings, they're*
4 *comparable to Newfoundland Power, so they're not being diminished in their credit rating as a*
5 *result in that business. If they were significantly disadvantaged as a result of being generators*
6 *we might see that show up in their credit rating. So we don't see that here."* [Transcript, April
7 4th, p. 117, line 18 - p. 118, line 3]. This is not a credible explanation. If it were, Mr. Coyne
8 would have had no need to screen out non-generators in his Wisconsin evidence for NSPW –
9 he could have merely ensured that the credit ratings were comparable.

11 Earnings Volatility

13 While downplaying the significance of the risk factor of generation present in his proxy groups
14 relative to Newfoundland Power, Mr. Coyne fails to consider the important factor of "earnings
15 volatility" of Newfoundland Power versus the proxy group companies, a clear case where
16 Newfoundland Power is at less risk than the firms in the proxy groups. The Board noted in P.U.
17 43 (2009) that "earnings volatility" was a significant difference between Newfoundland Power
18 and the proxy group companies (p. 17, line 8). Nor does Mr. Coyne address or consider the
19 relative ability of Newfoundland Power to earn its allowed return versus the proxy group's
20 performance. Ms. Perry testified that she believed that whether a firm achieves its allowed
21 return *"would be important to an equity investor"* (Transcript, March 29th, p. 143). Ms. Perry
22 then admitted, *"No, I have not had conversations with Mr. Coyne about whether or not U.S.*
23 *utilities or his sample companies earn their allowed returns"* (Transcript, March 29th, p. 142). In
24 fact, neither Ms. Perry nor Mr. Smith ever talked to Mr. Coyne prior to his providing his reports in
25 this matter.

27 Mr. Coyne testified that the Quebec regulator, the Régie, had requested that it be provided with
28 data as to whether the proxy group's utilities were able to earn their allowed returns, noting that
29 the Régie had indicated this was a *"constraint for them in terms of being able to utilize U.S. data*
30 *and U.S. proxy groups."* Mr. Coyne testified that he did not provide such data in this case as the
31 Board did not ask for it (April 4th, 2016, p. 206), though he admitted that it was important
32 whether the US operating companies in his proxy group were actually able to earn their allowed
33 returns (April 4th, p. 207, line 11). Mr. Coyne stated (April 4th, p. 207, lines 11-23):

1 *"Well, it is important in what I looked at beyond—and again, I mentioned the problems in*
2 *the accounting data—it is important and the way I looked at it is I looked at the*
3 *regulatory provisions that they had down to the tariff level in place that allowed them to*
4 *manage their costs so that they would be able to earn their allowed returns. So, we*
5 *looked at a more fundamental way because you're trying to look—this would tell you*
6 *what they are able to do historically, but it doesn't tell you what they're going to be able*
7 *to do on a going forward basis."*

8
9 The ability to earn the return is where as Dr. Booth stated, *"the rubber hits the road". The ability*
10 *of the utility to earn its ROE reflects the sum impact of everything that a utility is subject to short*
11 *run business risks, financial risks. . ."* (Transcript, April 7th, p. 103, lines 15-22). Newfoundland
12 Power has earned its allowed return for over two straight decades.

13
14 Mr. Coyne admitted that he has not filed evidence that establishes that North American utilities
15 earn their allowed returns (April 4th, p. 193, lines 9-10). Mr. Coyne asserted that he had *"done*
16 *other examinations on this issue and what I find is that on average, both Canada and U.S.*
17 *utilities earn their allowed returns."* He stated that the last time he had looked at the matter was
18 in the 2013 Hydro Quebec hearing (April 4th, p. 199). In point of fact, the chart filed in Quebec
19 comparing allowed versus actual returns for a small number of US operating companies showed
20 that in 4 of the 11 years, from 2000 to 2011, the operating utilities failed to earn the allowed
21 return on average (Transcript, April 5th, p. 5, line 3-8). Mr. Coyne admitted that he had not
22 researched more broadly how US utilities perform in relation to actual versus allowed returns
23 (Transcript, April 4th, p. 202, lines 12-17).

24
25 Of course, in this case we are comparing Newfoundland Power to utility holding companies. Dr.
26 Booth's report (at p. 67-68) and Schedule 8 clearly demonstrates that Newfoundland Power's
27 ROEs are much more stable than the proxy group firms whose earnings are quite susceptible to
28 significant variation. On cross examination, Mr. Coyne was presented with the allowed versus
29 actual returns of his US proxy group companies as reported by AUS. [April 5th, p. 6]

30
31 This data which showed that several of the US proxy companies were not earning the allowed
32 return was disputed by Mr. Coyne. However, Mr. Coyne declined to file data that indicated that
33 his proxy group companies actually earned their allowed returns. [April 5th, pp. 24-25]

1 During cross examination, Mr. Coyne was also provided with a 2015 report by Oliver Wyman
2 (Information No. 21) which reported that the average US utility does not earn its allowed return
3 on equity and citing that in 2014, the average return on equity was 8.1% (April 5th, p. 28). Mr.
4 Coyne stated that he was not sure how Oliver Wyman had reached that conclusion but again
5 declined to point to a report or paper by a third party source to re-but Oliver Wyman's findings
6 and suggested that the Board should prefer the research he had filed in Quebec (April 5th, pp.
7 29-30; p. 32).

8
9 Newfoundland Power has put forward, through its expert witness, companies that it maintains it
10 is comparable to. Its CFO and its expert have confirmed that the issue of a company's ability to
11 earn its allowed return is important to an equity investor. For Newfoundland Power, its track
12 record of achieving its ROE speaks for itself. There is no evidence whatsoever that US utilities,
13 much less the proxy group companies earn their allowed return on a regular basis. This is
14 where the rubber hits the road. This lack of evidence draws into serious question the
15 comparability of US and, for that matter, Canadian utility holding companies with Newfoundland
16 Power.

17 18 **Other Differences**

19
20 On a number of other features, Newfoundland Power, is less risky than the proxy companies
21 used by Mr. Coyne. These features are:

- 22
- 23 • Regulatory Lag and Test Year
- 24 • Customer Mix
- 25 • Capital Cost Recovery
- 26 • Volume/Demand Risk
- 27

28 **Regulatory Lag and Test Year**

29
30 Newfoundland Power is certainly less risky than the US proxy companies on the issue of
31 Regulatory Lag and Test Year. Fortis Inc. states in its MD&A's Corporate Overview section that
32 if a historical test year is used there may be regulatory lag between when costs are incurred and
33 when they are reflected in rates (Transcript, March 29th, pp. 139-140; Information No. 5 – p. 2).
34 The vast majority of the US proxy group's operating utilities are on historic test years, unlike the

1 Canadian experience where forecast test years are the norm. Mr. Coyne stated that most
2 utilities would probably prefer a forecast test year (Transcript, April 4th, p. 164, line 4). As
3 regards rate case lag, Newfoundland Power, at 6 months, is the lowest and is well below the
4 majority of US operating utilities as is clear in Exhibit JMC-5, Schedule 5 of Appendix A.
5 Timeliness of decisions has been cited as one of the reasons why the Board is regarded as one
6 of the more supportive regulators in Canada by Moody's.

7 8 **Customer Mix**

9
10 Newfoundland Power's customer mix is less risky than the proxy group companies.
11 Newfoundland Power's customer base, being comprised solely of residential and commercial
12 customers, is cited as a strength of its business profile (DBRS Report of August 21, 2015, p. 2).
13 From a customer mix perspective, Mr. Coyne agreed that residential customers are less cyclical
14 and from that standpoint are preferable (Transcript, April 4th, p. 185). Mr. Coyne's report
15 provides data on the proxy group companies' customer mix which clearly show that most of the
16 companies are more exposed to industrial and non-residential customers than is Newfoundland
17 Power. This risk factor which is in favour of Newfoundland Power *vis-à-vis* the other
18 companies, was not considered by Mr. Coyne as part of his overall risk assessment of
19 Newfoundland Power.

20 21 **Capital Cost Recovery**

22
23 Newfoundland Power obtains pre-approval of the Board in respect of its annual capital
24 expenditures, which neither Emera nor Canadian Utilities Ltd.'s utilities enjoy. Indeed, out of the
25 17 operating utilities of the US Proxy Group, only 4 have a pre-approval regime. Mr. Coyne
26 admitted that a pre-approval regime is the least risk regime in terms of imprudence findings after
27 the fact (Transcript, April 4th, p. 154, lines 15-16). Moody's states that the Board's review and
28 approval of Newfoundland Power's capital spending plans and long-term debt issuances
29 "significantly reduce the risk of cost disallowances and support the company's ability to recover
30 costs." (Moody's Report of February 5, 2016, p. 3). Disallowances are a direct risk to utility
31 shareholders, a risk that has been minimized in this jurisdiction compared to the jurisdictions of
32 proxy group companies of Mr. Coyne.

Volume/Demand Risk

Newfoundland Power has a weather normalization account. None of the 17 operating utilities (owned by the US Proxy Group firms) in the US has this mechanism (Exhibit JMC-5, Schedule 2). 7 of the 17 have no protection whatsoever from volume/demand variances. Nova Scotia Power has only partial decoupling and no weather normalization protection. Its partial decoupling only concerns the load 1 or 2 of its large industrial customers (Transcript, April 4th, p. 172, lines 10-11). It would be unrealistic to not consider Newfoundland Power as being better protected than a number of the US companies, as well as Emera and Canadian Utilities Limited (which has no volume/demand risk mitigation).

Capital Structure

Overview

In Order No. P.U. 13 (2013) the Board found that there was little substantive evidence demonstrating that the appropriate common equity ratio for Newfoundland Power is 40% and found that a change on the common equity ratio had not been justified (Order No. P.U. 13 (2013). At the same time, the Board clearly recognized that it had been some time since Newfoundland Power's capital structure had been comprehensively reviewed and the Board ordered Newfoundland Power to file a comprehensive report in relation to its capital structure in its next general rate application. To that end, Mr. Coyne and his colleague, Mr. Trogonoski (who did not testify), prepared a report on Capital Structure and the Consumer Advocate retained Drs. Booth and Cleary to provide their expert opinions to the Board on an appropriate capital structure for Newfoundland Power.

First, it is necessary to put Newfoundland Power's longstanding 45% common equity component into a proper perspective for the purposes of the Board's assessment of an appropriate common equity ratio for Newfoundland Power. At the outset, the fact that Newfoundland Power has had a deemed common equity ratio for the last 25 years does not mean that it enjoys a presumption of being reasonable and appropriate in this proceeding, particularly in the light of the fact that it has not been comprehensively reviewed for many years.

1 In this assessment, it must be recognized that Newfoundland Power's deemed 45% common
2 equity component is materially higher than those of other Canadian utilities. Dr. Cleary's report
3 (Table 10) shows that the median common equity ratio of electric distributors is 40% and it is
4 lower again for gas distributors at 35%. Newfoundland Power's sister utility, Fortis Alberta, has
5 a common equity ratio of 40% on which its allowed ROE is 8.30% compared to Newfoundland
6 Power's present ROE of 8.80%. Even Fortis's Maritime Electric on PEI, which is generally
7 regarded as higher risk than average T&D companies, has 41.90% common equity. In a similar
8 vein, Mr. Coyne's Figure 1 at p. 6 shows that Newfoundland Power has 45% common equity
9 compared to an average of just 39.1% for the 5 investor owned utilities he compares
10 Newfoundland Power to, including Maritime Electric.

11 12 **Financial Risk**

13
14 In assessing Newfoundland Power's overall risk as a utility, we turn first to its "financial risk".
15 Newfoundland Power's expert has posited that with its 45% common equity ratio,
16 Newfoundland Power has "comparable financial" risk as other investor-owned utilities in
17 Canada. In referring to financial risk, Mr. Coyne observes at p. 2 that, "*Financial risk primarily*
18 *relates to the risk associated with the way in which a company has financed its business, as*
19 *evidenced by the relative percentages of debt and equity in the capital structure.*" Mr. Coyne
20 defines "Financial Risk" as follows (Appendix A, p. 3):

21
22 *"Financial risk exists to the extent a company incurs debt obligations in financing its*
23 *operations. These fixed obligations increase the level of income which must be*
24 *generated to cover interest payments before common stakeholders receive any return,*
25 *and they are considered by both debt and equity investors in addition to business risks."*
26

27 In P.U. 19 (2003) at page 31, the Board accepted the following definitions by Dr. Morin:

28
29 *"Refers to the additional variability of earnings induced by the employment of fixed cost*
30 *financing, that is, debt and capital stock."*
31

32 and by Drs. Winters and Waters:

33
34 *"Risks that arise through the corporations' financing and capital structure."*

1
2 Using Mr. Coyne's definition, it is clear that Newfoundland Power incurs less debt obligations in
3 financing its operations than all other transmission and distribution utilities in Canada.

4
5 Dr. Cleary has concluded that in fact Newfoundland Power, with its 45% common equity
6 component, has **lower** financial risk than both Canadian electric distributors which have a
7 median common equity ratio of 40% and Canadian gas distributors which have a median
8 common equity ratio of 38%. At the same time, Newfoundland Power has had an allowed ROE
9 from 2011 to 2015 that is slightly above both the average and median ROEs for both Canadian
10 gas and electric utilities. [Report of Dr. Cleary, p. 28, line 11; p. 29, lines 2 to 9]

11
12 Newfoundland Power's expert, Mr. Coyne, has erred in his conclusions regarding Newfoundland
13 Power's financial risk.

14
15 1) Mr. Coyne has erroneously concluded that Newfoundland Power with its 45%
16 common equity component has **comparable** financial risk as other investor-
17 owned electric utilities in Canada.

18
19 2) Mr. Coyne has also erred in his conclusion that Newfoundland Power's credit
20 rating of "Baa1" from Moody's which Mr. Coyne asserts is "equivalent to BBB+
21 from S&P" is one notch lower than the Canadian proxy group average of A-.

22
23 3) Mr. Coyne has also erred in his assertion that Newfoundland Power's credit
24 metrics are weaker than average for the Canadian proxy group companies in
25 terms of cash flow interest coverage and cash flow to debt. These incorrect
26 assertions are made at p. 9-10 of Mr. Coyne's Capital Structure evidence.

27
28 Let us turn to Mr. Coyne's incorrect assertion that Newfoundland Power's Moody's issuer credit
29 rating of Baa1 "is one notch lower than Canadian Proxy Group S&P of A-". This conclusion is
30 wrong on a number of fronts. First, Newfoundland Power does not have a rating from S&P but it
31 does have a DBRS rating of A while Valener and Enbridge each have lower DBRS credit ratings
32 of BBB+ and BBB (High) respectively. Canadian Utilities also has an A DBRS rating like
33 Newfoundland Power. Emera is not rated by DBRS (Undertaking No. 21). Demonstrably,
34 Newfoundland Power does not have a lower credit rating than the Canadian Proxy Group firms,

1 as Mr. Coyne asserts. In fact, it has a higher one on average. Second, Mr. Coyne's assertion
2 that Newfoundland Power's Moody's issuer rating of Baa1 is one notch lower than the Canadian
3 Proxy Group only of A- is premised on his unsubstantiated assertion that a Moody's issuer
4 rating of Baa1 is "equivalent to BBB+" from S&P. There is no independent evidence in support
5 of that assertion on the record. Dr. Cleary observed that it was his view that if Newfoundland
6 Power had an S&P rating, it would probably be A- or A (Transcript, April 11th, pp. 36-37). The
7 third problem with Mr. Coyne's assertion is that he ignores the fact that Moody's rates the first
8 mortgage bonds of Newfoundland Power as A2. As Ms. Perry explained, Moody's "*provides a*
9 *double notch upgrade because our debt is secured into our trust deed.*" (Transcript, March 29th,
10 p. 156, lines 19-22). Ms. Perry explained that secured debt provides more security to lenders
11 than unsecured debt as the assets of the company are put up as security. Holders of
12 unsecured debt would rank behind holders of secured debt (Transcript, March 29th, p. 137, lines
13 14-25; p. 158, lines 1-8).

14
15 Dr. Booth explained that Newfoundland Power's Moody's A2 rating is the rating that is "used to
16 access the capital markets." (Transcript, April 7th, p. 119, lines 19-25; p. 120, line 104). This
17 was not challenged on cross examination. In fact, as referenced by Dr. Booth in his evidence
18 (p. 94), Fortis itself in its third quarter 2015 report refers to Newfoundland Power's bond rating
19 as "A" from DBRS and "A2" for Moody's. No Fortis subsidiary has a higher bond rating than
20 Newfoundland Power, in fact, as Dr. Booth stated.

21
22 Finally, Mr. Coyne also erred in stating that Newfoundland Power's credit metrics are weaker
23 than average for the Canadian Proxy Group companies in terms of cash flow interest coverage
24 and cash flow to debt. Frankly, even if this were true it would add little to the discussion as to
25 whether Newfoundland Power is an overall average risk Canadian utility because these are
26 utility holding companies that are not close matches to Newfoundland Power and Valener and
27 Enbridge are not primarily engaged in the provision of electricity (Transcript, April 6th, p. 174).
28 Removing Valener, the remaining firms in the Canadian Proxy Group had an average of 13.37%
29 cash flow to debt, and Newfoundland Power's was much superior at 17.5%. Furthermore, with
30 Valener excluded, the remaining firms' debt to EBITDA ratio was 5.54 versus Newfoundland
31 Power's much stronger 3.30 (Transcript, April 6th, pp. 174-178).

32
33 Furthermore, Newfoundland Power's credit ratings are not only strongly relative to the Canadian
34 Proxy Group firms and strongly relative to other Fortis affiliates, its DBRS rating and interest

1 coverage is amongst the strongest in Canada amongst utilities, according to DBRS. During the
2 hearing, Ms. Perry was cross examined concerning a comparative analysis of utilities' credit
3 metrics, allowed ROE and equity thickness filed before the BCUC (Information No. 6) by Fortis
4 BC Energy Inc. on October 2, 2015. The source of the data utilized in Fortis BC Energy's
5 analysis was DBRS Research. What is absolutely clear is that Newfoundland Power enjoys
6 materially superior interest coverage than both electric distribution transmission companies as
7 well as natural gas distribution and transportation firms. In fact, Newfoundland Power's interest
8 coverage exceeded all 10 of the 11 utilities surveyed by Fortis BC Energy over the 2012-2014
9 period. In fact, the 11th firm, Hydro One Inc. which is rated A (high) by DBRS equaled
10 Newfoundland Power in 2013 and was itself bested by Newfoundland Power in 2014 in interest
11 coverage. Newfoundland Power also was shown to have the highest equity ratio of any of the
12 firms while having a ROE that was about average for the electric distribution group surveyed.
13

14 It is quite clear that Mr. Coyne's conclusions with regard to Newfoundland Power's financial risk
15 do not withstand scrutiny and are wrong. In fact, Newfoundland Power has clearly been
16 demonstrated to have less financial risk than other investor owned utilities in Canada. The
17 Consumer Advocate submits that if this Board were to conclude that Newfoundland Power has
18 comparable financial risk with other investor owned utilities, the Board would need to identify the
19 evidence that supports this conclusion. We submit that the Board will find itself unable to do so.
20

21 **Business Risk**

22

23 Mr. Coyne provides the following definition of "Business Risk":
24

25 *"Business risk for a regulated utility results from variability in cash flows and earnings*
26 *that impact the ability of the utility to recover its costs including the fair return on, and of,*
27 *its capital in a timely manner. Concentric includes operating risk and regulatory risk*
28 *under the broad definition of business risk."*
29

30 **Mr. Coyne's Qualitative Assessment**

31

32 Mr. Coyne compares the business risk of Newfoundland Power to 5 other Canadian investor-
33 owned utilities in order to assess whether Newfoundland Power continues to be an average risk
34 Canadian utility. The 5 investor owned utilities are: ATCO Electric, Fortis Alberta, Fortis BC

1 Electric, Maritime Electric and Nova Scotia Power. In assessing the business risk of
2 Newfoundland Power relative to these utilities, Mr. Coyne considered the following factors:

- 3
- 4 1) power supply risk and electricity prices;
- 5 2) macro-economic and demographic conditions;
- 6 3) volume/demand risk;
- 7 4) competition from alternative funds;
- 8 5) regulatory environment; and
- 9 6) capital and operating cost recovery.
- 10

11 An examination of Mr. Coyne's comments on these various factors (pages 18-24 of Appendix A)
12 reveals that Mr. Coyne's analysis is qualitative in nature, not quantitative. Accordingly, Mr.
13 Coyne's conclusion as to the relative risk of Newfoundland Power on the listed factors
14 essentially comes down to Mr. Coyne's judgment. To illustrate, as regards operating cost
15 recovery, Mr. Coyne compares the utilities' operating cost recovery mechanisms such as
16 pension/ OPEB expense, storm costs, DSM and cites Newfoundland Power's lack of a storm
17 deferral account and thereafter cites weather and storm related risk as a factor contributing to
18 his assessment that Newfoundland Power's business risk has increased compared to the
19 Canadian investor-owned electric utilities since the last GRA. While Newfoundland Power does
20 not have a storm-related deferral account it has other accounts which other utilities lack such as
21 Pension/OPEB's expense. What is the value of a OPEBs and Pension account compared to a
22 DSM account? Is the lack of a storm deferral account offset by the fact that NL is regarded as
23 having a more supportive regulatory regime than in Nova Scotia and Alberta according to Mr.
24 Coyne's evidence? This indicates the problems inherent in the qualitative analysis of Mr.
25 Coyne.

26

27 Likewise, Mr. Coyne cites the Province's macro-economic and demographic trends as a factor
28 contributing to his assessment that Newfoundland Power's business risk has increased relative
29 to the Canadian investor-owned electric utilities since the last GRA. (P. 24 of Appendix A, lines
30 19-20). However, there is no evidence as to what the macro-economic and demographic trends
31 were in 2012 relative to this GRA in PEI, Nova Scotia, B.C., Alberta and NL – being the 5
32 provinces where the comparator utilities operate.

1 We observe that in Newfoundland Power's Revised Application (Vol II, Tab 5, p.17) the
2 Conference Board of Canada 2016 forecast puts NL's household disposable income per capita
3 over 2015 to 2017 higher than PEI's (by \$5,000 to \$6,000), Nova Scotia's (by \$4,000 to \$5,000),
4 Ontario's (by \$2,000 to \$3,000), New Brunswick's (by \$4,000 to \$6,000), Quebec's (by \$6,000
5 to \$7,000) and Manitoba's (by \$4,000 to \$5,000). The point here is that it is incredibly difficult to
6 draw reliable conclusions as to the relative risk of Newfoundland Power as compared to the 5
7 investor-owned utilities that Mr. Coyne analyzes by reference to a purely qualitative
8 assessment.

9
10 As Dr. Cleary stated:

11
12 "...being a finance guy, if there's a way that you can justify things instead of just waving
13 your hands and saying, 'This is more risk' and 'This is less risk', it's always nice if you
14 can jump to [the] punch line [if] you will, because all of those factors that have been
15 discussed here that affect business risk...you put them all together and the impact
16 should be on business risk or the operating earnings." (April 11, p. 25, lines 7 to 17)

17
18 Mr. Coyne did not compare the volatility of earnings of Newfoundland Power to other Canadian
19 utilities (April 6, p. 172, lines 12-14), whilst clearly acknowledging that operating risk shows up in
20 earnings as the following exchange shows: (p. 175, lines 1-10)

21
22 Q. "But these are the companies that you're asserting Newfoundland
23 Power is now above average risk in relation to, correct?"

24 Mr. Coyne::

25 A. "From an operating risk standpoint, yes."

26 Johnson, Q.C.:

27 Q. "Operating risk shows up in earnings, does it not?"

28 Mr. Coyne:

29 A. "Yes."

30
31 **Dr. Cleary's Approach**

32
33 Dr. Cleary's approach therefore is to provide the Board with a quantitative assessment to
34 support his qualitative opinions that Newfoundland Power remains a typical low risk Canadian

1 utility. Such an assessment is necessary and indeed logical given that business risk by
2 definition concerns variability in cash flow and earnings.

3
4 The purpose of Dr. Cleary's analysis (as explained in PUB CA 025 and in his surrebuttal
5 evidence at p. 9) was to provide quantitative evidence to evaluate Mr. Coyne's claims that
6 Newfoundland Power had higher business risk than both his Canadian proxy group and his U.S.
7 proxy group. Figure 7 and Table 8 of Dr. Cleary's report objectively demonstrates that
8 Newfoundland Power has much less volatility in its EBIT (Earnings Before Interest) than the
9 U.S. firms in Mr. Coyne's proxy group and also less volatility than the operating companies of
10 the Canadian companies that Mr. Coyne included in his Canadian proxy group. The figures
11 presented by Dr. Cleary do not lie and were not challenged by Newfoundland Power during the
12 hearing.

13
14 Dr. Cleary also explained that the measure of CV (EBIT/Sales) on which Newfoundland Power
15 bests the Canadian firms and the U.S. firms is not subject to growth in EBIT due to rate base
16 growth (April 11, p. 29, lines 15-25). Dr. Cleary testified that EBIT volatility is a standard
17 measure of business risk in finance textbooks, accounting textbooks as well as the Chartered
18 Financial Analysts curriculum. (April 11, p. 136, lines 1-5). Clearly, such standard measures of
19 business risk are relevant and non-judgmental evidence of the level of Newfoundland Power's
20 business risk relative to other firms. It would be illogical to think otherwise. It is in fact precisely
21 the type of information that regulatory boards should be considering in assessing utility claims
22 as to their risk profile in relation to others. It is not surprising that the Regie, as testified by Mr.
23 Coyne, sought quantitative data as to the ability of U.S. utilities to actually earn their allowed
24 returns. Notably, in his analysis Mr. Coyne used the co-efficient of variations in ROE. (April 11,
25 p. 138, Lines 3-4).

26
27 Dr. Cleary also testified that the difference in betas between the US and Canadian utilities is
28 consistent with the fact that US utilities faces higher business risk than Canadian utilities. Dr.
29 Cleary explained (Transcript, April 11, pp. 33-34):

30
31 *"So, the other thing that I did want to mention is there's a lot of discussion about betas*
32 *last week and I did discuss betas in my evidence. It's also consistent if you look at—I*
33 *don't think there was any debate that the U.S. utilities had higher betas. It was whether it*
34 *be .5 or .6 was the discussion and whether U.S. was .6 and Canada was .5, for*

1 *example. Well, let's just say that's the truth. I think Mr. Coyne's evidence is .67 and .6,*
2 *but if you looked at it and you said, okay, if they have the same business risk, then they*
3 *should both have a beta of .5. Let's say .5 is the number you start with. Now, if one utility*
4 *has more financial risk than the other, ie. Higher leverage, then we would expect its beta*
5 *to be .6. I'm just pulling these numbers out for illustrative purposes and the other one*
6 *would stay at .5, it has lower financial risk. But on the other hand we know that the U.S.*
7 *utilities have less leverage, yet their betas are .7 versus .6 or .6 versus .5. It clearly*
8 *shows that the U.S. utilities in this sample have higher business risk because they have*
9 *lower financial risk, yet they have higher betas. So, that's consistent with my analysis.*
10 *And it's consistent with all the discussions that have been going on about the*
11 *comparison of these two."*

13 **The Current Economy and Future Supply Costs**

15 Mr. Coyne has put forward two reasons for asserting that Newfoundland Power has high
16 business risk today than at the time of its last GRA in 2012, namely:

- 18 1) Deterioration in provincial economy; and
- 19 2) Increased supply costs upon interconnection.

21 **The Current Economy**

23 It is clearly the case that the provincial economy in common with the economies of other oil
24 producing provinces in Canada has been hit by the sharp drop in oil prices. It is not in dispute
25 that the provincial economy is weaker now than three years ago. However, it is also true that
26 Newfoundland Power has faced challenging economic conditions in the province contributors in
27 the past such as during the post-moratorium period and periods of recession.

29 Dr. Booth put the present circumstances into perspective: (Apr. 18, p. 121 line 22 to p. 122 line
30 14)

- 32 A. "Well when you look at these issues, Mr. Kelly, you have to look at it in the context of
33 is there anything unusual about this, and going back over the last 25 years for the
34 province, we've had periods of very good economic growth; we've had periods of not

1 very good economic growth. We've had periods of bad winter storms; we've had
2 periods where we had mild winter storms. We've had, I would suspect most of the
3 underlying risks that affect the utility, so I don't look at an individual factor, I just look
4 at, well, what is the upshot of these, what does it really mean in terms of the
5 performance of the utility, which is why I look at the ability of the utility to earn its
6 allowed ROE."

7
8 The undisputed fact is that Newfoundland Power has consistently earned its allowed ROE
9 during the past two decades and Dr. Cleary's evidence clearly shows that Newfoundland
10 Power's earnings have grown consistently every year since 1995 (Figure 6) and that its revenue
11 growth has been much less volatile and more resilient than NL's real GDP growth rates.
12 (Figures 5). Dr. Cleary's report states (p. 19, lines 13-19),

13
14 "While the forecast economic decline is not a positive development,
15 fortunately for NP it is less affected than companies operating in cyclical
16 industries such as real estate or consumer durables. Further, given its
17 low-risk business model accompanied with strong regulatory support,
18 there is no obvious reason that a weak economy represents a
19 significant increase in permanent business risk for NP. Indeed, the
20 historical record confirms that NP has weathered previous economic
21 "storms" and managed to maintain growth in sales and operating income,
22 and earn ROEs at or above the allowed ROEs."

23
24 Utilities are always exposed to forecast risk as the ability of a utility to recover its prudently
25 incurred costs and earn a return depends on the ability to achieve the forecast used in the rate
26 setting process. (March 29, p. 120, lines 11-23) Mr. Henderson confirmed that there was no
27 reason to believe that the Company's ability to forecast load going forward would be any less
28 reliable than it was in the past (April 12, p. 114, line 12).

29
30 Newfoundland Power's position that the weakened economy has contributed to it now being an
31 "above average risk" Canadian utility would certainly create a contradiction as to how
32 Newfoundland Power viewed its business risk profile when the NL economy was more robust
33 and sales were growing well above the usual trend. During these periods as seen in its GRA

1 applications in 2007, 2009 and 2012 (Information No. 1, 2 and 3) the company did not maintain
2 that the then prevailing more positive economic circumstances had reduced its business risk.

3 4 **Future Supply Costs**

5
6 Next, we turn to the position that Newfoundland Power has become an above average risk
7 Canadian utility on account of its being exposed to an increase in the price of electricity supply
8 after the interconnection.

9
10 Dr. Booth's evidence in respect of business risks is that there are short run and long run risks.
11 Short run risk is the ability to earn the allowed ROE and reflects the return on capital. Long run
12 risk is the return of capital and reflects the ability of the utility to recover its investment in plant
13 and equipment; that is, capital recovery risk. (Booth evidence p. 72, lines 2-5; April 7, p. 102,
14 lines 18-24). Mr. Coyne made it clear that he is not contending that the risk faced by
15 Newfoundland Power is one of recovery of its prudently incurred costs. He was explicit on this
16 point and testified that he does not anticipate the Board walking away from the regulatory
17 compact. (April 7, p. 58 lines 15-25; p. 59 lines 1-21; p. 61 line 20, line 21-25; p. 62, lines 1-25;
18 p. 63, line 1). Dr. Booth is in full agreement.

19
20 Rather, Mr. Coyne's contention is instead that Newfoundland Power's earnings will be at greater
21 risk. The risk identified was that due to increased power supply costs, customers will find a way
22 to consume other fuels "which means between rate cases if your demand is shrinking and you
23 customer count is held flat, you typically have a harder time recovering your allowed return".
24 (April 7, p. 59, lines 9-13).

25
26 In this GRA we are setting rates for 2016-2018 in all likelihood. The power supply costs will not
27 be changing due to the interconnection during this period of time. To elevate Newfoundland
28 Power's risk profile from average to above average risk in this proceeding is clearly not justified.
29 Indeed, Newfoundland Power's risk profile was not previously changed when in the 1990s
30 electricity was actually experiencing a 40% cost disadvantage to furnace oil used for home
31 heating and Newfoundland Power continued to earn its allowed ROE and saw minimal numbers
32 of customers switch (CANP 042) to furnace oil and other fuel sources. Switching from electric
33 heating to oil-based heating involves a significant capital expenditure in the range of \$25,000 to
34 20,000, depending upon the configuration adopted (CANP 041).

1
2 Mr. Coyne's assessment of Newfoundland Power being characterized as an "above average
3 risk" Canadian utility was due to the combination of weaker economic conditions in the province
4 and power supply costs risks due to future interconnection. The reasons for his assessments in
5 both of these regards has been undermined and cannot form the basis for such a finding.
6

7 **The Influence of Mr. Coyne's "Above Average Risk" Assessment**

8

9 While Mr. Coyne stated that his "above average risk" assessment did not directly influence his
10 recommendation on the ROE, he stated that it did influence his recommendation with respect to
11 the capital structure, as the following exchange clearly demonstrates: (April 17, p. 68 line 22-
12 25, p. 69 line 1-14)
13

14 Greene, Q.C.:

15 Q. "Did it influence your recommendation with respect to the capital
16 structure?"

17 Mr. Coyne:

18 A. "Well I took it into account because that accounts for the comparable
19 financial risk, so it is the capital structure that enables the company with
20 its risk profile to be comparable to its Canadian peers, and I think given its
21 business risk combined, the capital structure added up with its credit
22 metrics in the business risk make it only somewhat above average."

23 Greene, Q.C.:

24 Q. "So I take from that answer, it did influence your recommendation on
25 maintaining the 45 percent common equity?"

26 Mr. Coyne:

27 A. "Yes, very much, yeah, explicitly."
28

29 Mr. Coyne also makes it clear that his 45% recommendation is borne out of a "worry" of his that
30 Newfoundland Power's equity ratio is lower than its "U.S. peers". Mr. Coyne states that
31 Newfoundland Power's 45% equity:
32

33 "is 5% below its U.S. Peers, and that's true even for the pure T&D companies that we
34 looked at. So it has a —given its risk profile, vis-à-vis those companies, I think it's

1 appropriate to have it at the high end of the Canadian competition or comparators, but I
2 still worry about still being 5% below its U.S. peers. There's a history in Canada of
3 Canadian regulators allowing lower capital equity ratios than the U.S. peers, so I take
4 that into account. That's why I am not recommending a 5% increase to look like the U.S.
5 proxy companies, but I think you have to acknowledge that gap. So that's why I
6 recommend 45 stay in place." (April 7, p. 70 line 1 to 20)

7
8 Basing a recommendation of 45% equity in any way upon a "worry" that Newfoundland Power's
9 common equity component is low relative to U.S. utilities is patently unreasonable. There is no
10 regulatory precedent for a Canadian regulator to determine an appropriate capital structure
11 based upon the level of common equity permitted in the U.S. for utilities. Furthermore,
12 Newfoundland Power's previous long time expert is on the record as stating that the universe of
13 U.S. utilities has higher business risk than the typical Canadian utility which is a wires and pipes
14 utility. (April 4, p. 211; Information No. 18, p. 2 of 5). Notably, Mr. Coyne testified that he made
15 no judgment as to whether the universe of U.S. utilities has more or less risk than his proxy
16 group. (April 4, p.217 line 18-21) and testified that he was not looking for companies that were
17 low risk *per se* (April 7, p.6 line 18). Newfoundland Power has an A bond rating from DBRS and
18 an A2 bond rating from Moody's. Only 4% of U.S. investor owned utilities have an "A" bond
19 rating and only 23% have an A- rating. 32% have a "BBB+ rating, while 42% have a BBB rating
20 or lower. (CANP 126, Attachment A, p. 1 of 1)

21 22 **Credit Metrics Considerations**

23
24 Newfoundland Power does not require a 45% of common equity structure in order to maintain
25 credit and raise capital. Dr. Cleary's report at Table 15 sets out the credit metric estimates
26 using a 40% equity ratio with ROEs at 7.50%, 8.00%, 8.30% and 8.50%. Dr. Cleary's report
27 confirms that if the equity ratio was reduced to 40% Newfoundland Powers credit metrics for
28 2016 and 2017 remain firmly in the Baa issuer range for Moody's and in the mid to high A range
29 for DBRS under all of the ROE scenarios

30
31 At the request of the Board Hearing counsel, Newfoundland Power produced (Undertaking No.
32 4) *pro forma* 2017 metrics for pre-tax interest coverage, cash flow interest coverage and cash
33 flow to debt coverage for a range of equity ratios between 40% and 45% and a range of allowed
34 ROEs between 8.3% and 9.5%. Under all scenarios, the metrics presented are within the range

1 of an A credit rating according to Moody's criteria. The metrics provided also assume that
2 Newfoundland Power pays out a \$55,000,000 dividend to reduce its equity component from
3 45% to 40% (March 31, p. 20, lines 3-6). However, Ms. Perry erroneously stated that in respect
4 of the cash flow to debt coverage metrics that Moody's "actually have indicated that to maintain
5 the credit that we have today, that they expect us to be at the high end of the range, between 15
6 and 17." (Table 3 of Undertaking No. 4 reports that at 40% equity and an 8.30% ROE, the
7 coverage is 15%) Ms. Perry's statement is not accurate. Moody's does not condition the
8 maintenance of Newfoundland Power's credit rating to the cash flow to debt ratio being in the
9 high end of the range of 15% to 17%. Moody's 12-18 month forward view as of February 2,
10 2016 is for the ratio to be between 15%-17% (Exhibit 4, p. 4) and Moody's has stated that a
11 downgrade is unlikely in the near term but that a downgrade would be likely if combined with a
12 meaningful reduction in the level of regulatory support, there was a sustained deterioration in
13 NPI's financial metrics "such as" cash flow to debt falling into the low teens.

14
15 Ms. Perry also addressed the 2017 *pro forma* earnings test interest coverage calculation which
16 is required for Newfoundland Power to issue First Mortgage Bonds in 2017 for a range of equity
17 ratios between 45% and 40% and a range of allowed ROEs between 8.3% and 9.5%. Ms. Perry
18 stated that any coverage metric around 2.10 would cause her to be uncomfortable, whereas the
19 coverage required was 2.0. Ms. Perry stated that if the debt cost for the new issuance in 2016
20 went up by one percent (from 5% to 6% - p. 16, line 23) and at the same time Newfoundland
21 Power's earned ROE varied by 40 basis points (p. 7, line 25), this would cause a .10 drop in the
22 bond interest coverage. Given Newfoundland Power's track record of earning its return, this
23 analysis bears little resemblance to reality. The upshot of Ms. Perry's testimony is that to satisfy
24 her comfort level, the Board would need to award Newfoundland Power a rather generous ROE
25 and common equity component as follows:

- 26
27
- 9.50% ROE on 42%-45% common equity;
 - 28 • 9.00% ROE on 44%-45% common equity;
 - 29 • 8.80% ROE on 44%-45% common equity;
 - 30 • 8.50% ROE on 45% common equity.
- 31

32 As regards Newfoundland Power's presentation of its Earnings Test Interest Coverage in
33 Undertaking No. 4, the Consumer Advocate sought clarification from Newfoundland Power to
34 show how the *pro forma* interest coverage based on a 8.00% ROE and 40% equity component

1 was calculated. Newfoundland Power's response in Undertaking U-7 (in footnote 2) shows that
2 the calculations were based on a 75,000,000 sinking fund bond issue at a rate of 5.50%.
3 However, Ms. Perry previously testified (March 30, p. 45, line 10) that the new issuance was
4 estimated to be at 5% and that the 5% cost was the rate assumption built into the company's
5 metrics reported in Exhibit 5 of its Application. Accordingly, the tables in Undertaking 4 are not
6 based on an assumption that is consistent with the testimony of Newfoundland Power's CFO,
7 Ms. Perry, nor the assumption used in the exhibits.

8
9 More importantly, despite the Consumer Advocate's correspondence to Newfoundland Power of
10 April 14, 2016, seeking information aimed at clarifying why Newfoundland Power's interest
11 coverage calculations based on an allowed 8.30% ROE on a 40% equity ratio in Undertaking
12 No. 7 do not appear to be consistent with an 8.3% ROE, the reply of Newfoundland Power of
13 April 18, 2016 is unresponsive to certain detailed and specific data requests. Newfoundland
14 Power has judged the data to be "unduly burdensome, and [are] not necessary for a satisfactory
15 understanding of the matters under consideration" by the Board in the GRA. This is
16 unacceptable as Newfoundland Power is relying upon interest coverage calculations to help
17 ground its request for an ROE and 45% equity component. The response of Newfoundland
18 Power to the Consumer Advocate's letter of April 14, 2016 is insufficient to make conclusions
19 regarding Newfoundland Power's interest coverage ratio calculations. Newfoundland Power's
20 interest coverage calculations as Dr. Cleary has testified are not in accordance with either his
21 ratio calculation (which, at no time was disputed or challenged by Newfoundland Power) or
22 those of DBRS, its own bond rating agency. Interestingly, Newfoundland Power states in its
23 April 18, 2016 letter that the calculation of the interest coverage ratio is based on "Standard and
24 Poor's Ratings Services methodology" and not DBRS methodology, despite the fact that that
25 Newfoundland Power is not rated by Standard and Poors. Newfoundland Power also
26 acknowledges that differences in metric calculations by credit rating are "inevitable".

27
28 The fact that the metrics related to "cash flows" (i.e., CF/Debt coverage and CF interest
29 coverage) are similar to those calculated by Dr. Cleary speaks volumes – since cash flows don't
30 lie. On the other hand, many assumptions can be made to alter income – either at the bottom
31 level (i.e., net income available to common shareholders) or at the operating income level (i.e.,
32 earnings before interest and taxes or EBIT). The fact that Newfoundland Power does not
33 adequately reconcile their EBIT with the net income available to common shareholders shows
34 this point to be true. In fact, in Attachment B of NP's April 18, 2016 response, NP refer to "net

earnings” of \$80,199 in row 1, then further down NP refers to “net earnings” of \$35,048, –
begging the question “ which is it?”

Newfoundland Power suggests the differences are due to differences in accounting decisions made for regulatory purposes, versus those for financial reporting purposes. This may well be the case – unfortunately, Newfoundland Power does not provide sufficient details to show this to be the case. When we have a situation where a utility’s bond rating agency DBRS, let alone Dr. Cleary, is calculating interest coverage levels higher than those presented by the utility, there is a clear need for transparency. We recommend that the Board’s financial consultants Grant Thornton review the data Newfoundland Power provides to external parties for calculation of ratios, as well as the ratios it provides to the Board. There needs to be consistency and the ratios should be calculated as they are by debt rating agencies used by the utility. This does not appear to be an issue with Newfoundland Power’s cash flow metrics, since accounting “decisions” do not impact cash flows as much as they can income measures.

In this discussion about Newfoundland Power’s credit metrics, it is important to keep in mind that the Board as it has stated previously does not regulate interest coverage but rather looks to credit metrics as an indication of the extent to which a return will assure financial integrity as required by the fair return standard. Indeed as noted by the Board in Order No P.U. 43 (2009) (page 24, lines 1-25) in Order No. P.U. 32 (2007) the Board approved a cost of capital proposed by the parties in a settlement that resulted in forecast credit metrics that were marginally below the bottom of the range recommended by Moody’s.

Other Credit Considerations

It is necessary of course to look beyond the credit metrics because credit metrics alone are not the only determinants of a credit rating. In the case of Moody’s, 40% of the rating is related to “Financial Strength” being comprised of the specific metrics used by Moody’s. 60% of the rating is related to other factors:

Factor 1: Regulatory Framework (25%)

- a) Legislative and Judicial Underpinning of the Regulatory Framework
- b) Consistency and Predictability of Regulation

- Factor 2: Ability to Recover Costs and Earn Returns (25%)
- a) Timelines of Recovery of Operating and Capital Costs
 - b) Sufficiency of Rates and Returns
- Factor 3: Diversification (10%)
- a) Market Position
 - b) Generation and Fuel Diversity

During her direct testimony, Ms. Perry stated that Newfoundland Power's 45% equity ratio is viewed as a "primary indicator of overall regulatory support for the company's credit worthiness". Moody's, in fact, does not state that the 45% common equity ratio is a "primary indicator" of overall regulatory support as Ms. Perry suggests. Moody's explicitly states that it considers the "PUB's regulation of NPI to be credit supportive **primarily because** of a track record of reasonably timely and balanced decisions that enable NPI to generate stable and predictable cash flows and earns its allowed ROE." There is no merit to any suggestion that a reduction of Newfoundland Power's equity component would hinder the utility from having stable and predictable cash flows and to earn its allowed ROE. There is no evidence or suggestion that the Board's decisions are about to become less timely and **less** balanced. Nor is there validity to a suggestion that the Board's adjusting the company's equity component to be in line with other Canadian utilities would constitute a "meaningful reduction" in the level of regulatory support (which, if combined with a "sustained deterioration" in financial metrics) could lead to a downgrade by Moody's.

During the Hearing, Ms. Perry agreed that factors in a rating grid do not constitute all of the factors that go into a rating." (March 30, p. 102) and agrees that as its Fortis BC sister company stated in its recent filing, consideration of issues such as liquidity, management quality, ownership and governance all play a part. Newfoundland Power's core liquidity comes from its \$100 million credit facility which has a no material adverse change clause (March 30, p. 103). There is no reason to believe that Newfoundland Power does not compare favorably to the Canadian utilities on other considerations, including management quality, ownership and governance.

Claims that the board's reduction of Newfoundland Power's equity component will cause a re-evaluation of regulatory support must be put into perspective as such arguments are not just

1 made here. In the Fortis BC Energy Inc. filing of October, 2015 (in which Mr. Coyne also gave
2 evidence) the company sought an increase in the equity component of its capital structure from
3 38.5% to 40% (Info. No. 6, p. 17, lines 23-24) because of it high risks relative to the majority of
4 proxy companies (p. 17, lines 31 – p. 18, line 3). Fortis BC Energy Inc.'s submission was that
5 "Reductions in either allowed ROE or equity thickness will not only weaken financial metrics, it
6 may also lead credit rating agencies to reconsider *the qualitative evaluation of regulatory*
7 *support* and stability of financial metrics, putting pressure on FEI's ratings."

8 9 **The Fortis Context**

10
11 The fact is that Newfoundland Power's executives, and indeed utility executives generally, are
12 never going to recommend a reduction of equity in the capital structure. Officers have a fiduciary
13 duty to the corporation with the principal objective of enhancing shareholder value. As Dr.
14 Booth's report states:

15
16 "This imposes on the directors a fiduciary responsibility to the company's shareholders
17 and not their customers. In NP's case this means Fortis Inc. In this context utilities
18 claiming to be facing more risk to support either high or more common equity are acting
19 like the managers of any their private corporation, which is to say acting in the best
20 interest of their shareholders." (Booth report, p. 91, lines 17-20)

21
22 Dr. Booth's evidence is that for utilities owned within a holding company, like Fortis inc., "the
23 parent has an incentive to finance the utility with as much equity as possible, so that the tax
24 advantages to financing with debt are shifted to the parent." (Booth report, p. 92 – lines 10-12).
25 Dr. Booth's description of the incentive that is at play was not challenged by Newfoundland
26 Power. It is the parent company's shareholders that get the tax advantages to debt financing
27 and not the utility rate-payers. This is called the "double leverage" problem. As described by Dr.
28 Booth, Fortis clearly states that its target equity ratio is 45% comprising both common and
29 preferred shares, when in 2014 its common shares were only 35%. Dr. Booth states "Fortis also
30 states that it buys regulated utilities with a mixture of common and preferred shares, as well as
31 debt. This is a clear admission of double leverage or that the utilities themselves have an
32 inefficient capital structure" (Booth report, p. 93, lines 2-4)

Conclusions and Options on Capital Structure

Both the evidence of Drs. Booth and Cleary buttressed by the quantitative analysis of Dr. Cleary show that Newfoundland Power continues to have low business risk, similar or slightly lower than that of similar Canadian utilities. The report of Dr. Cleary (Section 3.3.1 and 3.3.2) demonstrates that Newfoundland Power currently has less financial risk than other Canadian utilities based on an examination of allowable ROEs and equity ratios and of existing credit metrics. Furthermore, Dr. Cleary's examination indicates that Newfoundland Power would maintain solid metrics if the equity ratios were reduced to 40% and if the allowed ROE was also reduced. Indeed, even using the company's manner of presenting the credit metrics (pending a requested further review by Grant Thornton), Mr. Coyne agreed during the Board hearing counsel's cross-examination that there is some flexibility in the metrics at various capital structures, and even at lower capital structures without there being a negative impact on Newfoundland Power's financial integrity (April 7, p.78, lines 11-15).

The Board has options as to how to move Newfoundland Power to a more appropriate equity ratio for rate making purposes. It can order that a percentage of common shares be replaced with lower cost debt or it can deem preferred shares as done in Quebec by the Regie in the case of Gaz Metro as recommended by Dr. Booth. To go the deeming route, Dr. Booth recommends (p. 97) that as an interim measure and until the next hearing, the Board asks Newfoundland Power to provide the average preferred share yields on Fortis Inc.'s preferred shares issued during December 2015 and deem this cost for its common equity for the test year. Dr. Booth recommends that the Board indicate that this is a first step towards the replacement of 5% common shares with long term debt at the next hearing. At the next hearing the Board can consider whether there is any electricity price shock and whether it continues with the replacement.

Executive and Director Compensation

Overview

The Consumer Advocate has four (4) concerns with the method used by Newfoundland Power to determine the amount of executive compensation that it has included in its revenue requirement.

- 1
- 2 1. The peer group that it has traditionally used to serve as a comparator for the overall level
- 3 of executive compensation is not reflective of the level of compensation needed to
- 4 attract and retain competent executives and directors at the present time.
- 5
- 6 2. The adjustments since the last GRA that have been made to the level of STI-related
- 7 compensation that is included in the revenue requirement has increased executive
- 8 compensation by an amount that is out-of-step with current economic conditions in
- 9 Newfoundland and Labrador.
- 10
- 11 3. The weighting given to "earnings" within the Short Term Investment Plan (STI) results in
- 12 a disproportionate amount of the company's STI that is included in its revenue
- 13 requirement being directed to the benefit of shareholders at the expense of ratepayers.
- 14
- 15 4. The inclusion of "regulatory performance" as a discretionary factor in the STI is
- 16 inconsistent with the established practice in other Canadian jurisdictions (Information No.
- 17 11) and further skews the proportion of STI that is based on factors that benefit
- 18 shareholders at the expense of ratepayers inappropriately.
- 19

20 **The Peer Group used is not Appropriate**

21

22 Newfoundland Power's executive and director compensation is established on the basis of a so-

23 called peer group that clearly does not consist of peers.

24

- 25 • Newfoundland Power is an electric utility. The peers to Newfoundland Power executives
- 26 should clearly include the executives in other Canadian utilities. The selected Hay
- 27 comparator excludes other utilities.
- 28 • Newfoundland Power is a company operating in the Atlantic Canada region. The peers
- 29 to Newfoundland Power executives should clearly include the executives in other
- 30 companies operating in the Atlantic Canadian region. The selected Hay comparator
- 31 excludes comparable companies in the Atlantic Canada.
- 32

33 While it is conceivable that at some time in the distant past, when this current comparator group

34 was originally adopted by Newfoundland Power this comparator group might have been

1 appropriate – although there is no evidence that the selection of the comparator was based on
2 an analysis of different available peer groups to determine which was most appropriate, it is
3 clear that the only rationale for continuing to use this peer group is because it is the way they
4 have always done it. Doing anything the same old way does not meet any reasonable standard
5 for the **company's burden of proof** in demonstrating that the costs it seeks to pass through to
6 ratepayers have been prudently incurred.

7
8 Newfoundland Power uses the broad Canadian Commercial Industrial markets to determine
9 comparable compensation levels. This group is not refined by location, industry, or size but is
10 comprised entirely of private companies that are clients of Hay Group (April 1, p. 95:11). A list of
11 Atlantic Canada companies provided by Hay Group (Undertaking – U-10) shows that of the 278
12 companies in the broad Canadian Commercial Industrial market peer group used by NP, only 9
13 (3.2%) are located in Atlantic Canada. Mr. Aboud, from Hay Group, asserts without providing
14 **any analytic support** that this is the most appropriate comparator group for Newfoundland
15 Power.

16
17 Mr. Aboud uses the example of Siemens Canada, a Toronto-based company that is 5 times the
18 size of Newfoundland Power. Mr. About states: "There's absolutely no reason that you wouldn't,
19 shouldn't recruit an executive from Siemens Canada" (April 1, 25:22-24). Mr. Aboud might be
20 correct, but this logic for what should be included in the peer group implies that it is appropriate
21 to exclude other utilities and other Canadian companies operating in the Atlantic Canada
22 because Newfoundland Power should not be recruiting from utilities or other Atlantic Canada
23 companies. The logic supporting the choice of peer group is transparently flawed.

24
25 This perspective clearly does not line up with Newfoundland Power's recruitment history. Each
26 of Newfoundland Power's executives attended university in Newfoundland and were promoted
27 from within Fortis Inc. Of the eleven directors, Newfoundland Power could point to only two that
28 were hired from outside the company (Undertaking - U-9) - both of whom were already located
29 in St. John's. In using the broad Canadian market as a peer group, Newfoundland Power is
30 failing to recognize its history of hiring from within the Atlantic Canadian utilities market.

31
32 Mr. Smith stated "...Hay puts together the group for us in terms of what they feel is the
33 comparable group..." and went on to say "Hay recommends to the company that the broad
34 Canadian Industrial group [as] the recommendation and Hay goes and finds the companies that

fit that group.” (March 30, p. 149:1-518). Newfoundland Power’s board of directors must then approve the recommendation. Neither Newfoundland Power nor Hay Group has been able to produce any analysis that supports Hay’s recommendation to use the broad Canadian Commercial industrial market. This is out of step with other regional electric utilities. Both NS Power and NB Power have a focus on regional companies and utilities (Information No. 14). While the Board has accepted this group in that past, that is not enough to support its continuing use. Given the exclusion of the very companies that common sense would suggest are most comparable to Newfoundland Power, it is the Consumer Advocate’s view that this policy cannot withstand scrutiny in the absence of any analysis of the alternatives.

The evidence on the record suggests that by excluding what would seem to be the most obvious comparators results in an inflated comparator median salary. According to the Hay Group itself, the median salary in the broad Commercial Industrial executive and non-executive market is 32.5% higher than the Atlantic Canada Industrial executive and non-executive market in 2012 (CA-NP-199, Attachment B, page 13). In using the broad Canadian Commercial Industrial market without supportive analysis, Newfoundland Power is effectively expecting ratepayers to pay a 32.5% premium on its executives and directors without justification other than the observation that they have always done it that way. Even if it was acceptable in the past, the evidence shows that it is not currently appropriate.

Total base salaries for NP’s executives and directors in 2016 are forecasted to be \$2,986,900. Using the 32.5% figure derived from salary discrepancies in Hay’s report, total salaries would be \$2,253,421.

	2016 Salary	2016 Salary Adjusted for Atlantic Region	Difference
Executives	\$1,170,000	\$882,688	\$287,312
Directors	\$1,816,900	\$1,370,732	\$446,168
Total	\$2,986,900	\$2,253,421	\$733,479

The executives and directors, having salaries set according to the Canada-wide market, will cumulatively receive \$733,479 more than they would if properly identified as part of the Atlantic Canada market. In addition, all incentives tied to base salary are inflated by 32.5%.

1 Mr. Aboud, referring to table 3 in the most recent Hay Report (NP Rebuttal Evidence, Section 3,
2 Page 8) suggests ratepayers are benefiting from the exclusion of LTI in rates:

3
4 The ratepayer is paying 31.7 percent below market. So in terms of the ratepayer
5 implication, the ratepayer not being obligated to cover the LTI or short-term incentive
6 over 100 percent of target and short-term incentive, the ratepayer is paying 31 percent
7 below market, 26 percent below, 15 percent below, 11 percent below. So in total if I add
8 up those four percentages, the ratepayer is paying 22 percent below market for the
9 Newfoundland Power four executives. (April 1, 15:6-17)

10
11 His contention that Newfoundland ratepayers are paying below market on executive
12 compensation is not supported by the evidence. The market in which Mr. Aboud is referring is
13 the broad Canadian Commercial Industrial market. As previously explained, this market pays
14 executives a great deal above the Atlantic Canada market.

15
16 Excluding LTI from revenue requirement is already standard practice and should not be
17 accepted as a justification for continued use of a market that has not been justified with
18 analysis.

19
20 The Consumer Advocate submits that Newfoundland Power has failed to demonstrate that the
21 forecast costs to compensate its executives and directors that it is seeking to include in its
22 revenue requirement have been prudently incurred. The company has not met its burden of
23 proof in this regard therefore the full amount of compensation that it is seeking to include in its
24 revenue requirement should be reduced to a level for which the prudence has been
25 demonstrated. It is the view of the Consumer Advocate a prudent level of compensation would
26 be no higher than the level paid for comparable positions in Atlantic Canada.

27 28 **STI Changes**

29
30 CA-NP-322 outlines the salary policy for the four executive members of Newfoundland Power
31 as well as the eleven senior managers. Since the 2013 GRA, there has been another change to
32 the STI plan. As outlined in (Information No.12 – reproduced below), target STI as a percentage
33 of salary has increased for 3 of the 4 executives.

Executive	Hay Points	Target STI as % of Salary		2016 Salary	2016 Recoverable STI		Additional Recoverable STI	
		Former Policy	New Policy		Former Policy	New Policy	%	Total
Gary Smith	2128	40%	50%	\$360,000	\$144,000	\$180,000	25%	\$36,000
Gary Murray	1628	40%	40%	\$250,000	\$100,000	\$100,000	-	-
Jocelyn Perry	1560	35%	40%	\$280,000	\$98,000	\$112,000	14.3%	\$14,000
Peter Alteen	1560	35%	40%	\$280,000	\$98,000	\$112,000	14.3%	\$14,000
Total	-	-	-	\$1,170,000	\$440,000	\$504,000	14.5%	\$64,000

1 The policy change lead to a 14.5% increase in recoverable STI. This is addition to increases to
2 base salaries and corresponding proportional increases to STI.

3 This STI target is based on achievement of 100% of corporate and individual targets. Pursuant
4 to PU 19 (2003), any target reached in excess of 100% by the executive or managers does not
5 form an obligation on rate payers. Amounts in excess of 100% of target are deemed to be non-
6 regulated and therefore the cost of same is borne by shareholders and not customers.

7 The Consumer Advocate recognizes that it is not the role of interveners or even the Board to
8 dictate Newfoundland Power's compensation policies. It is, however, appropriate for the Board
9 to only allow in the company's revenue requirement and rates a level of compensation that is
10 demonstrably prudent. In the Consumer Advocate's submissions it is neither prudent nor
11 reasonable to expect Newfoundland Power's customers in this province to pay higher rates in
12 order to support a 14.5% increase in the target STI payout to executives. This would be highly
13 questionable at the best of times. For the current economic situation, it is simply
14 unconscionable.

Net Income

The STI corporate targets and results for 2015 are outlined in PUB-NP-079 and reproduced below.

Short Term Incentive Plan Corporate Targets and Result for 2015

Category	Measure	Target (100%)	Weight	Result
Reliability	Outage Duration Index (SAIDI)	2.3	15%	2.36
Customer Satisfaction	% Customer Satisfaction	84.70%	15%	86.10%
Safety	Injury Frequency Rate	0.69	20%	0.176
Regulatory	Regulatory Performance	Subjective	15%	140%
Financial	Controllable Operating Cost/Customer	\$232	10%	\$220
	Earnings	\$37.7m	25%	\$38.8m

The largest component, earnings, comprises 25% of the STI plan. In the 2013 GRA, the Consumer Advocate pointed to regulatory precedents in other jurisdictions to demonstrate that STI related to earnings were being excluded from revenue requirements:

The Consumer Advocate submits that the revenue requirement for 2013 and 2014 should not include expenses in relation to the portion of the short term incentive plan for executives and managers that relates to achieving earnings targets. He argues that the achievement of these targets is for the primary benefit of shareholders and not rate payers. In support of his position, the Consumer Advocate provides regulatory precedent from the Public Utilities Board of Northwest Territories, Alberta Energy Utilities Board, and the Ontario Energy Board, and he submits that Newfoundland Power's earnings base compensation targets are not truly distinguishable from these regulatory precedents, and urges the Board not to allow their inclusion of expenses in relation to this portion of the Short Term Incentive plan in revenue requirement for the test years". (GRA 2013 Decision – p.52, 34-43)

1 Newfoundland Power argued that including financial performance as a component of STI is
2 common in British Columbia, Alberta, and Prince Edward Island. The Board ultimately decided
3 in 2013 to leave earnings as a recoverable component of STI. Since that decision, British
4 Columbia's Utilities Commission has reversed its policy:

5
6 The Panel has concerns as to whether all of the components of FBC's corporate and
7 individual performance objectives or scorecard provide value to the ratepayer. The Panel
8 notes that the corporate financial objective with the highest weighting, at 30 percent, is
9 regulated earnings. While there is no disagreement as to the importance of a utility being
10 healthy and financially sound financially, the Panel is not persuaded that exceeding its
11 approved ROE is in the interest of ratepayers. For these reasons, the Panel is not
12 persuaded there is sufficient evidence to support the need for the STIP to be fully funded
13 by the ratepayer. The Commission Panel finds that 30 percent of the STIP costs are on
14 the account of the shareholder. Therefore, the Panel directs FBC to recover only 70
15 percent of the STIP from the ratepayer and reduce its O&M Base accordingly. (FortisBC
16 2014-18 PRB Decision, p. 202-203)

17
18 Alberta's Utilities Commission clarified its position in ATCO Electric's 2013-2014 Tariff
19 Application:

20
21 The Commission reiterates its findings from Decision 2011-450 that a net income
22 component greater than 10 per cent might result in an inherent conflict between
23 shareholder interests and customers. If ATCO Electric wishes to include a net income
24 component for specific individuals higher than 10 per cent of their VPP compensation,
25 those costs are to be borne by shareholders. (ATCO 2013-2014 Tariff Application p.
26 215)

27
28 The Consumer Advocate agrees with British Columbia and Alberta's utility commissions that
29 earnings should not be a recoverable component of the STI plan. The ratepayer's best interests
30 are at odds with the executive earnings incentives and should not be paying this incentive
31 through rates. It is clear that excluding the earnings component of STI has become typical
32 among Canadian utilities.

1 **Regulatory Performance**

2
3 Regulatory performance accounts for 15% of the STI plan. It is explained in PUB-NP-081:

4
5 The corporate performance measure Regulatory Performance is intended to reflect the
6 criticality of timely, efficient acquisition of regulatory approvals to Newfoundland Power's
7 overall performance. This performance measure does not lend itself well to statistical or
8 simple cost based analysis. As a result, it is evaluated on a subjective basis.

9
10 This component is not common among Canadian utilities. Furthermore, it is completely
11 discretionary, which is uncommon for any component of STI amongst Canadian utilities. The
12 following exchange between the Consumer Advocate and Mr. Smith points to a connection
13 between the ROE obtained by Newfoundland Power's executives and Regulatory Performance
14 incentives:

15 Mr. Johnson:

16 Q. So can you tell me how much your bonus would be if the Board were to
17 approve 9.5 percent ROE versus, say, approving 7.5 percent?

18 Mr. Smith:

19 A. In the regulatory area?

20 Mr. Johnson:

21 Q. Yeah.

22 Mr. Smith:

23 A. I certainly can't speak to the decision that my Board will make, but they will
24 assess the overall decision of the Board.

25 Mr. Johnson:

26 Q. And they would view that 9.5 is considerably more success, correct?

27 Mr. Smith:

28 A. They would view the decision of the Board to make sure we can maintain our
29 financial integrity as a success. (March 31, 55:19-56:12)

30
31 It is clear that, like net income, the incentives associated with this unusual component of STI are
32 more aligned with shareholders than with ratepayers.

By including regulatory performance and earnings in the required revenue, ratepayers are covering the costs of these incentives for executives to improve or maintain financial integrity with a higher ROE. Mr. Smith agreed that a higher ROE results in higher rates for customers (March 31, p. 28:21-25). Therefore, the Consumer Advocate submits that the short term incentive components related to regulatory performance earnings should be excluded from the revenue requirement. As a consequence, 40% of the amount of the compensation corresponding to these STI targets should be removed from the revenue requirement.

The following table compares Newfoundland Power's proposal, the Consumer Advocate's proposal, and a scenario with Newfoundland Power's proposed salaries with adjustments to exclude regulatory performance and earnings from recoverable STI.

Executives & Directors		Newfoundland Power's Proposal	NP Salaries with adjusted STI	Consumer Advocate's Proposal
Total Salaries		\$2,986,900	\$2,986,900	\$2,253,421
Total STI		\$776,535	\$465,921	\$351,507
Reliability	15%	\$116,480	\$116,480	\$87,877
Customer Satisfaction	15%	\$116,480	\$116,480	\$87,877
Safety	20%	\$155,307	\$155,307	\$117,169
Regulatory Performance	15%	\$116,480		-
Costs	10%	\$77,654	\$77,654	\$58,584
Earnings	25%	\$194,134		-
Total Compensation		\$3,763,435	\$3,452,821	\$2,604,928

Factoring in the salary adjustment that accounts for bringing salaries in line with the Atlantic Canada median and removing the components of STI that solely benefit shareholders, total executive and director compensation totals \$2,604,928. This amount is 31.8% lower than the amount Newfoundland Power is seeking to currently recover in rates. These adjustments bring compensation more in line with competitive regional salaries and common industry practices.

Conservation and Demand Management

The Need for Targets

Newfoundland Power sets corporate performance targets for reliability, safety, earnings, controllable costs and other areas but has no such targets in place that specifically drive performance on achieving results in relation to conservation and demand management. This is a fundamental failure of not only Newfoundland Power's but also Newfoundland and Labrador's corporate approach in this area. The Consumer Advocate firmly believes that targets for participation and demand and energy savings should be set in conjunction with the Board on an annual basis, with the results published annually.

Mini Split Heat Pumps (MSHP)

The Conservation and Demand Management Plan includes the development of an Educational Initiative to promote mini split heat pumps. The Plan is set to commence in 2016. (Application, Volume II, Section 2, p 2-14, lines 11-12)

The objective of the Mini Split Heat Pump Educational Initiative is to encourage customers to choose high efficient mini split heat pumps installed by qualified contractors. Financing will be made available to support the uptake of high efficiency units.

Financing is planned to be limited to MSHPs with an estimate of Heating Seasonal Performance Factor (HSPF) of 9.6 or higher. The company states that this aligns with the minimum HSPF required for certification of units meeting the Energy Star Most Efficient 2015 designation. To qualify for financing, the installation must be performed by a contractor that has the necessary permits and certification to perform electrical and refrigeration work in the province.

Only very modest spending is planned for this initiative, averaging approximately \$100,000.00 per year over each of the next 5 years. [Schedule C, p. 13 of 24]

Newfoundland Power indicates that an incentive could not be offered for this program because it does not pass the economic analysis.

1 The Consumer Advocate is concerned by the low level of spending and effort directed toward
2 this educational initiative. Research carried out by Newfoundland Power as reported in its Mini
3 Split Heat Pump Research Report indicates that the residential MSHP market appears to be
4 developing in urban centers. As at the end of 2015 the company reports that less than 4,000 of
5 Newfoundland Power's customers had a MSHP installed in their home. The report also
6 confirms that the sizing and location of the systems are important to ensure maximum efficiency
7 is achieved. (Information No. 40, p.2, footnote 4) Sizing and location of MSHPs is important.
8 The report states, "If the system is oversized relative to the size of the space or located in an
9 area such as a hallway, short cycling may result, reducing system efficiency". (p.6) As the
10 report points out, "Some MSHP are capable of producing savings at very low temperatures
11 while other systems stop providing savings at much warmer temperatures" (p.5)

12
13 The report observes that suppliers and installers indicate that not all MSHP brands and products
14 are equal with respect to efficiency, quality and price. Some models are capable of maintaining
15 high efficiency at outside temperatures as low as -20°C, which other models can produce very
16 little heat at -10°C (p.9)

17
18 The report finds that in the St. John's area, a high efficiency MSHP is capable of providing
19 energy savings 100% of the time during the heating season under normal temperature
20 conditions, and 99.3% under extreme conditions. By comparison, in the same area, a lower
21 efficiency system can provide savings for 96.3% of the heating system under normal
22 temperatures, but as low as 61.1% under extreme temperatures. The report also observes that
23 in addition to the less efficient systems underperforming on energy savings, "...higher system
24 peaks could be expected from the installation in colder areas of the province and from less
25 efficient systems, particularly if the system continues to operate when energy input exceeds
26 energy output." (p.27)

27
28 Indications of growing interest and growing potential for Mini Splits could lead to increasing
29 installations of MSHPs that are not efficient and which could contribute to a higher system peak.
30 Therefore, there are real risks that without a properly funded and resourced educational
31 initiative, we could end up with a situation where installations which will be in place for decades
32 are not optimal. Frankly, it is difficult to conceive that spending only \$100,000 per year on the
33 Mini Split Heat Pump Educational Initiative will be sufficient to educate and guide consumer
34 choices in a timely fashion. The amount of spending should reflect the amount of risk involved

1 with customers choosing inefficient technology and installation procedures for the island's future
2 energy consumption and demand.

3
4 Incentives In Aid of the Educational Initiative
5

6 Newfoundland Power states that an incentive for MSHPs could not be offered because it did not
7 pass the economic analysis. Mr. Henderson testified, "Mini splits do not currently meet the
8 requirement of utility economic testing. That means from a system perspective, the cost of mini
9 splits could not be recovered from the system savings." (April 12, p. 49, line 1-2)

10
11 Mr. Henderson stated that the potential study estimated the current cost of conserved energy or
12 CCE of mini splits at about eight to ten cents per kilowatt hour. This represents a levelized cost
13 per kilowatt hour of energy saved over the life of a mini split. The mini split CCE is roughly
14 equivalent to current marginal costs of energy at Holyrood which is about ten cents. However, it
15 is double the current estimates of four to five cents per kilowatt hour for marginal cost of energy
16 following interconnection to the North America grid. So from a total cost perspective mini splits
17 will not be an economical viable conservation measure following interconnection. (April 12,
18 2016, p. 40-41)

19
20 Newfoundland Power's MSHP Report states that analysis of weather conditions and metering
21 data suggest that MSHP's "will likely contribute to high electrical demand at time of system
22 peak." Newfoundland Power reports that based on data from monitoring of homes with MSHP
23 over the 2014-2015 winter season, load for the MSHP homes was higher than that for electric
24 baseboard heated homes at times during system peak periods. However, Mr. Henderson
25 acknowledged that the study had limitations and did not regard the work carried out as
26 authoritatively concluding that MSHPs are not of value from a system peak perspective. (April
27 12, p. 58, lines 16-21). In the NL Conservation Demand Management Potential Study of
28 January 2015 by ICF International (Information No. 36) the authors state (at Section 8.6) that in
29 the study most of the heat pump measures are assumed not to produce any peak demand
30 savings because during the winter peak period the heat pumps and mini splits are expected to
31 revert back to electric resistance heating. However, the authors point out that this is a
32 conservative assumption for the Island Interconnected region. They note that although the peak
33 demand occurs on the coldest winter days in a climate such as that of St. John's, the

1 temperature is typically not very extreme on those peak days; therefore many heat pumps will
2 continue to work in heat pump mode and not revert to electric resistance.

3
4 Nova Scotia Power has embarked on a study of both central and ductless heat pumps (mini
5 splits) to determine amongst the other things, the impact to the average household contribution
6 to peak of installing a ductless mini split or a central heat pump in a home with existing electric
7 baseboard heating. (April 12, p. 94, lines 4-24; undertaking No. 22)

8
9 New Brunswick is a winter peaking province and NB Power's \$500.00 rebate program's goal is
10 stated to "encourage homeowners to install heat pumps which are best suited to New
11 Brunswick's climate and over winter peaking electricity system." (Information No. 39; April 12,
12 p. 75-76). Mr. Henderson observed that in New Brunswick it was Newfoundland Powers
13 understanding that this technology was passing total resources cost tests (April 12, p. 77, lines
14 7-8) to homeowner. However, he did not know whether peak reduction was the reason they are
15 able to justify it. (p.77, line 13-15)

16
17 The Consumer Advocate submits that Newfoundland Power should be ordered to file an update
18 to its MSHP Report incorporating data as regards the peak reduction benefits, if any, found in
19 New Brunswick and to track and report on this progress and results of Nova Scotia Power's
20 study, subject to that utility's cooperation. In the meantime, given the current marginal cost of
21 energy pending first power from the interconnection and the recognized need to educate the
22 public about the installation of suitable, efficient MSHP technology, a rebate in support of the
23 educational initiative's goals should be implemented for MSHPs.

24
25 **ALL OF WHICH IS RESPECTFULLY SUBMITTED THIS 26th day of April, 2016.**



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