Q. Please provide extracts from any business risk evidence that the company filed in the 1990s that refers to inter-fuel competition in the residential space heating market.

A. The following attachments provide extract from business risk evidence filed by Newfoundland Power in the 1990s that referred to inter-fuel competition in the residential space heating market.

Attachment A: Dr. Roger A. Morin (1991)

Attachment B: Mr. Aidan Ryan (1996)

Attachment C: Dr. Roger A. Morin (1996)

Attachment D: Mr. Karl Smith (1996)

Attachment E: Ms. Kathleen C. McShane (1998)

Attachment F: Dr. Roger A. Morin (1998)

Attachment G: Mr. Philip Hughes and Mr. Karl Smith (1998)

Dr. Roger A. Morin
(1991)

Since the last rate decision in 1989, NLP's short-term business risks have increased slightly due mainly to the economic recession, while financial risks and regulatory risks have remained largely unchanged. Relative to other Canadian utilities, NLP possesses average risks. The section below addresses the various dimensions of business, regulatory, and financial risks.

BUSINESS RISK

Q. Please elaborate on NLP's investment risks.

A. Competition in the energy industry in Newfoundland is increasing. On the one hand, customers have alternative means of filling their energy (heating) needs, namely oil. On the other hand, supplies of power from Newfoundland Hydro have become riskier due to price and regulatory uncertainty. It is becoming more difficult to forecast demand, market behavior, financing requirements, earnings, and cash flows.

In the short-run, investors are uncertain as to the final impact of the economic recession generally and the serious deterioration in Newfoundland's natural resource based economy particularly on the demand for NLP's product. The company's vulnerability is enhanced in the present recession, and is compounded by volatile fuel prices. In the longer-run, competition from fossil fuels will intensify over the next several years. The Hibernia development has not had any substantial impact on the Newfoundland economy.

Another crucial dimension of business risk is power supply risks, and they have also increased. Pricing risk refers to changes in the price of purchased power. Given the recent provincial government action of abolishing the subsidies to Newfoundland Hydro, the shortfall in revenues has to be met by rising prices charged NLP for purchased power. This reduces the competitiveness of electricity versus oil. The final impact on NLP's revenues is uncertain.

REGULATORY AND FINANCIAL RISK

With respect to regulatory risk, the Board's last rate order has been perceived by investors as fair and representative of the quality of regulation which has usually characterized this board's decisions in the past. NLP's regulatory risk is below average relative to other Canadian utilities.

With respect to financial risks, while NLP's coverage ratios and debt ratios have deteriorated slightly in recent years, but relative to other Canadian utilities, NLP's financial risks are unchanged. In other words, NLP's financial risks have risen in absolute terms, but have not changed relative to other utilities.

In short, NLP's short-term business risks have increased since the last rate decision due mainly to the economic recession, while financial risks and regulatory risks have remained largely unchanged. Relative to other Canadian utilities, NLP possesses average risks.

Mr. Aiden Ryan
(1996)

Power's customers increases, it is important that the customers understand that the rural subsidy is not a cost of providing electrical service to them. It is, in essence, a tax levied by government.

Q. Mr. Ryan, let's move on to current events. What is happening in the North American electricity business and how is this likely to impact Newfoundland Power and its customers?

A. Significant changes are developing in the North American electric utility market. Driven by global competition, new technologies and cheap natural gas, utilities are starting to compete with independent power producers and with each other to retain existing customers and attract new ones. While it is difficult to project how this type of competition will affect the Newfoundland market, the isolation of the Island electrical system from the large North American electrical grid and the lack of natural gas will probably limit its impact here. Meanwhile, electric utilities in this province are seeing a different form of competition.

Competition in Newfoundland is aimed at the space and water heating segment of utility sales as the oil companies aggressively target this market. Since the total heating market in the Province is not growing significantly and since heating sales represent over 50% of our revenue, this represents a challenge. We are responding to this challenge by working harder to give customers information on how to use electricity better and by balancing the claims of our competitors. Retaining our overall level of sales is an important factor in minimizing prices to our customers.

Mr. Erbland will provide further evidence on changes in electricity markets in the Company's service territory as well as proposals being put forward to deal with these changes.

Q. Please outline the current adequacy and reliability of the electrical supply for the Company's customers.

A. The provision of an adequate and reliable supply of electricity is Newfoundland Power's fundamental service responsibility.

Looking first at the adequacy of supply, the province of Newfoundland has an adequate supply of electrical power and energy at the present time. Under the most likely scenario currently forecast, the next large base load plant is not scheduled until early in the next decade. The timing for such a plant will be affected by the possible construction of a number of smaller generating plants by non-utility generators and by the Company. Also further reductions in load growth could move the date for a new plant even further into the future. Under the new legislation the Board will play a major role in determining how all this will unfold.

The cost of power from the next major unit is also uncertain. As it now stands production from the next large plant will have a higher cost than production from current plants and will tend to drive up rates at that time. However, if low cost natural gas becomes

Dr. Roger A. Morin
(1996)

carry fixed charge burdens which must be supported by the company's earnings before any return can be made available to the common shareholder. The greater the percentage of fixed charges to the total income of the company, the greater the financial risk. The use of fixed cost financing introduces additional variability into the pattern of net earnings over and above that already conferred by business risk, and may even introduce the possibility of default and bankruptcy in unusual cases.

Variations in operating earnings cause amplified variations in equity returns when debt financing is used. The spread in equity returns is wider in the case of debt financing, and the greater the leverage, the greater the spread and the greater the cost of common equity.

As I discuss further below, since the last rate decision in 1991, Newfoundland Power's total investment risk has not changed in any fundamental way. Relative to other Canadian utilities, Newfoundland Power continues to possess average total investment risk, with its above average business risk offset by its stronger capital structure and supportive regulatory climate.

Q. Please discuss the business risks faced by Newfoundland Power.

A. The business risks faced by the Company are high, and they have intensified since the Board's last rate decision in 1991. The province's weak economic performance over the past few years and the persistent unfavorable economic outlook will translate into an anemic demand for electricity. Earnings growth has been virtually non-existent in the past five years because of weak demand for power. This scenario is expected to persist with the provincial economy remaining weak. The weakness of the economy is traceable to the sustained weakness in the fishery sector, the termination of the Hibernia project, and federal-provincial government fiscal restraint. The Company continues to experience intense competition in the space and water heating markets from other energy sources, particularly from oil companies, which further restricts its growth prospects and increases its marketing retaliatory costs. It is becoming more difficult for investors to forecast demand, market behavior, financing requirements, earnings, and cash flows.

Investors are uncertain as to the final impact of the serious deterioration in Newfoundland's natural resource-based economy, particularly on the demand for Newfoundland Power's product. The Company's vulnerability is considerably enhanced by the dismal state of the fishing industry, and is compounded by volatile fuel prices. This volatility is somewhat mitigated by the healthier paper and mining sectors. In the longer-run, competition from fossil fuels will intensify over the next several years.

The DBRS credit rating agency recently downgraded Newfoundland Power's bonds from A (high) to A, citing Newfoundland's weak economic performance, the continued unfavorable economic outlook, and the intense level of competition in the space and water heating markets.

Mr. Karl Smith
(1996)

2. FINANCIAL POSITION

Q. Please outline the Company's financial position and comment on the significant changes over the past five years.

A. The Company's financial position is a measure of the financial health of the organization. It reflects the outcome of a series of conditions, actions and reactions, both internal and external to the organization. The Company can manage its financial health, but only within the limits set by external circumstances and events. To maintain financial strength, the Company must always be in a position to react dynamically to changing circumstances. The significant factors that impact the Company's financial position include the financial results of the business, the business environment, general economic conditions and the perception of the Company in the capital markets. The past five years have been particularly challenging ones as the Company has faced a fundamental change in its business environment. As indicated by Mr. Ryan, the business risk faced by the Company has increased during this period as the Company has begun to simultaneously experience slackening growth in overall sales and rigorous competition in heating markets. In addition, the performance of the general economy in the Company's service area has been poor and is forecast to remain so in the short-term.

This has put considerable pressure on the Company in its efforts to maintain satisfactory financial results. The Company is limited in dealing with this situation through cost control. Despite the fact that the Company has done a good job in controlling costs, the overall costs of maintaining a reliable electrical system continue to increase with no corresponding increase in revenue.

Exhibit KWS-1 outlines the Company's financial results and changes in its financial position for the years 1991 - 1995.

Sales of electricity have increased by 0.7% on an average annual basis over the period while revenue from rates has increased by 1.6%. The average annual increase in the cost of purchased power over the same period has been 1.4%.

The cost of power produced by the Company, which is included in operating expenses, has declined since 1991 as a result of reductions in the labour force.

Other revenue, which is comprised mainly of joint use revenue, has decreased by 3.6% on an average annual basis. This will continue to decline in the future as Newfoundland Telephone's share of pole ownership and maintenance increases in accordance with our joint use agreement.

Other expenses have increased by 2.7% on an average annual basis. These expenses consist of operating expenses, which have increased by 2.7%; depreciation, which has increased by 4.2%; and finance charges, which have increased by 1.4%.

On an average annual basis, income before income taxes has decreased by 0.8% over the five years while net income has increased by 0.4%. The increase in net income results from a decrease in income taxes of 3.1% over the same period, mainly as a result of the significant decrease in 1995.

Payment of preferred dividends has declined on average by 28.8% per year over the five years as a consequence of the redemption of over two million preferred shares. Earnings applicable to common shareholders have increased on average by 2.1% per year over the same period.

The rate of return on common equity has decreased from 13.17% in 1991 to 12.02% in 1995 with an associated decline in the Company's cost of capital from 11.30% in 1991 to 10.63% in 1995.

The Company's interest coverage ratio has declined from 2.8 times in 1991 to 2.7 times in 1995. In each of the intervening years it was 2.9 times.

The Company's average capital structure for 1995 was 50% debt and 50% preferred and common equity. In 1991 the average capital structure consisted of 49% debt and 51% preferred and common equity.

Capital expenditures have averaged $37.2 million per year during the period. The Company has redeemed $80 million in bonds and $21 million in preferred shares over the five year period. The Company issued $118 million in bonds and $5 million in common shares. There were no issues of preferred shares during the period.

In 1994 the Company paid a special dividend on common shares of $12 million. This was paid to realign the capital structure by reducing the amount of common equity.

Q. Please comment generally on the Company's cost structure.

A. The cost structure of the Company is depicted in Exhibit KWS-2 which is a breakdown of the various components of the Company's revenue requirement in 1995.

The largest component of the Company's costs is purchased power which represents 57% of the total revenue requirement. Operating expenses are the next largest component representing 16% of total revenue. Finance charges and depreciation represent 15% of the total followed by earnings at 8% and income taxes at 4%.

The Company has some degree of control over most of its costs in the long term. However, on a short term basis, the Company can exercise the most influence on operating expenses which represent 16% of the total revenue requirement.

Q. Please review the Company's operating expenses for the last five years.

A. Operating expenses for the years 1991-1995 inclusive are presented in Exhibit KWS-3. The expenses are presented on a gross basis and totalled on a net basis, after transfers to capital

Ms. Kathleen C. McShane
(1998)

the population of Newfoundland will decline from 565,000 in 1997 to 537,000 by 2015. Newfoundland is the only province expected to experience a decline in population. Since 85% of Newfoundland Power's commercial sales are to the service sector which, in turn, is highly dependent on income and demographic trends, the threat of continued out-migration negatively impacts its business position.

Q. How have the economic trends impacted Newfoundland Power's sales?

A. Sales growth has slowed substantially. Customer growth slowed from 2.1% during 1987-1992 to 1.3% in 1992-1997. Energy sales growth dropped from 4.0% in 1987-1992 to 0.7% during 1992-1997. Lack of growth potential raises the probability of the company being unable to meet increasing expenses (e.g., taxes) without increasing rates. As rates rise, competitive pressures build. This lack of growth was a key factor cited by DBRS when it downgraded the company's First Mortgage Bonds from A(high) to A in 1996.

Q. Does Newfoundland Power face any competition in its service area?

A. Yes, it competes with oil for space and water heating. In contrast to many electric utilities, a significant proportion (54%) of the company's sales are for space heating. Recent declines in fuel oil prices make oil a more competitive option.

Q. Please describe Newfoundland Power's circumstances with respect to its power supply.

A. Newfoundland Power purchases approximately 90% of its power from Newfoundland & Labrador Hydro and generates the remaining 10% itself. The fact that it purchases the bulk of its power means that its fixed costs are relatively low compared to electric utilities which are vertically integrated. However, its variable costs are high, which can have negative competitive ramifications. In addition, because the company purchases the preponderance of its supply, management has little control over 75% of its operating

Dr. Roger A. Morin
(1998)

Business Risk

The business risks faced by the company relative to other utilities remain high, despite the improvement in the provincial economy since the last rate case. The structural parameters of the province's economy remain fundamentally unchanged: a relatively weak regional economy, high unemployment and stagnant population growth. The company's high relative business risk continues to be driven by its small size relative to other A-rated utilities and a weak regional economy in the long-term.

The Newfoundland economy experienced minimal growth in 1997 and is expected to do better in 1998. In the medium term, significant development of natural resources will result in higher than average economic growth. Offshore oil projects (Hibernia, Terra Nova) and metal mining developments (Voisey) are expected to generate significant growth over the next few years.

In the longer term however, the economic impact of these projects will diminish considerably upon completion, and population emigration is expected to resume and lower demand.

The company continues to be vulnerable to competition in the space and water heating markets from other energy sources, particularly from oil companies. Not only does this restrict its potential growth prospects, but the company's vulnerability is compounded by volatile fuel prices.

On a broader industry basis, the North-American energy market is becoming highly competitive. The traditional role of electric utilities has changed drastically due to growing competition (wholesale and retail wheeling, customer choice, unbundling). Competition is present in numerous segments of the energy markets as regulatory barriers are removed, for example unbundled facility elements and equal access to networks. Evolving regulatory public policy encourages a competitive bulk wholesale power market by requiring utilities to provide wheeling and connection services. This policy has spilled over into the Canadian markets.

Mr. Philip Hughes and Mr. Karl Smith
(1998)

Q. What is the significance of sales competition to the long-term growth of Newfoundland Power?

A. Over one-half of the Company's total energy sales are to competitive end uses such as space and water heating. In the short term, the Company could absorb losses in these markets. However, in the longer term, the loss of these markets would significantly impact revenue flows and the Company's ability to meet its financial obligations. The most recent rating reports from both CBRS and DBRS continue to note competition in these markets as an issue.

Q. What are the principal expense risks of the Company?

A. The major risks associated with Newfoundland Power's expenses are purchased power from a single supplier, the evolution of the Company's business from an expansion mode to an operating and maintenance mode, and the Company's increasing effective tax rate. We will elaborate on each in turn.

Newfoundland Power obtains over 90% of its energy from a single supplier, Newfoundland & Labrador Hydro. The cost of purchased power represents about 56% of the price to the customer. Newfoundland Power has no control over these costs.

In 1995, this Board approved a change to the Company's accounting for general expense capitalized ("GEC") from a full cost method to an incremental method. This change reflected the evolution of the business from an expansion mode to an operating and