(9:08 a.m.)
CHAIRMAN:
Q. So I don't think there are any preliminary matters, are there?
MS. GLYNN:
Q. Newfoundland Power has filed the remainder of the undertakings and they have been circulated. I don't think there were any comments to make on the undertakings? No, so that would be it, Mr. Chair.
CHAIRMAN:
Q. So Mr. Johnson I believe now proceed to your witness.
JOHNSON, Q.C.:
Q. Yes, that's right. Good morning, Mr. Chairman, Commissioners. Seated in the witness stand is my next witness, Sean Cleary. Mr. Cleary is prepared to take an oath on the Bible, Mr. Chairman.
DR. SEAN CLEARY (SWORN) EXAMINATION-IN-CHIEF BY THOMAS JOHNSON, Q.C.
CHAIRMAN:
Q. You are now sworn, sir. Mr. Johnson?
JOHNSON, Q.C.:
Q. Thank you. Dr. Cleary, I guess the Board

doesn't know you because you haven't appeared here before. So I'm going to ask you some questions in relation to your background. Dr. Cleary, you are the Bank of Montreal professor of Finance at the Smith School of Business at Queen's University, correct?
DR. CLEARY:
A. That's correct.
JOHNSON, Q.C.:
Q. And you have a Ph.D. in Finance from the University of Toronto which you received in 1998?
DR. CLEARY:
A. That's correct.
JOHNSON, Q.C.:
Q. And before completing your Ph.D., you earned an MBA from St. Mary's University and a Bachelor of Arts in Economics from Acadia University?
DR. CLEARY:
A. Also correct.
JOHNSON, Q.C.:
Q. And in addition to your current position as professor of Finance at Queen's University,

you were from 2008 to 2014 the founder and director of the Master's in Finance Program at Queen's University?
DR. CLEARY:
A. That's also correct.
JOHNSON, Q.C.:
Q. Following the completion of your Ph.D. in 1998, you were an assistant professor in Finance at St. Mary's University?
DR. CLEARY:
A. Yes.
JOHNSON, Q.C.:
Q. And following that, you were an associate professor in Finance and then a full professor in Finance at St. Mary's between 2002 and 2007, correct?
DR. CLEARY:
A. That's correct, almost ten years in total there.
JOHNSON, Q.C.:
Q. Okay. Then you went on as I understand it to become an associate dean of the Business School at St. Mary's University?
DR. CLEARY:
A. Yes.

JOHNSON, Q.C.:
Q. And then that brings us up to 2008 when you joined Queen's University as the BMO professor of Finance and director of the Master Finance Program, is that right?
DR. CLEARY:
A. Yes, that's correct.
JOHNSON, Q.C.:
Q. And what did the—being the founder and director of the Master's of Finance Program at Queen's University entail?
DR. CLEARY:
A. It was part of the deal when I went there. They wanted to set up a Master of Finance Program, and they brought me in to help them set it up. So basically structuring the whole program, designing the curriculum, setting it up in Toronto to, which was a strategic decision which we ended up competing directly with Dr. Booth's program that he had to fly off to teach in, but anyways, both programs seem to be running along side by side and happily (phonetic).
JOHNSON, Q.C.:
Q. And Dr. Cleary, we—I also note from your CV,

which just for the record is appended to your main evidence, that you hold a designation of CFA. Can you tell us what that designation is, please?

DR. CLEARY:

A. Okay, well I've got, since I've been here a couple of times, "come from away" which I understand is similar to what I hear in Nova Scotia growing up, but it's actually a charter financial analyst, and it sounds little bit like the professional accounting designation, the CFA or previous to that we had CA and CMA. So it's a global organization close to 150,000 members. It's actually conceived by Ben Graham who is Warren Buffet's mentor. It's a designation that's held by a wide number of finance professionals, investment bankers, portfolio managers, analysts and the like. And I've been involved in that program since I got my designation in 2001 in various capacities, teaching the curriculum, preparing readings for the curriculum. I also served in the Atlantic Canada CFA Society for about seven or eight years, my last year as president

before I moved to Queen's University where I then joined the Toronto CFA Society and served on their board for three years. And again, that's - the curriculum is updated on a regular basis by finance professionals. So it's—the economists at one time called it the "gold standard of financial designations."

JOHNSON, Q.C.:

Q. And I understand that you also worked in commercial lending?

DR. CLEARY:

A. That's correct. After I finished my MBA, I spent some time with the Royal Bank of Canada in the commercial lending.

JOHNSON, Q.C.:

Q. And Dr. Cleary, I note from your detailed CV that you have approximately 30 peer-reviewed publications in finance and business academic journals both in Canada and internationally, is that correct?

DR. CLEARY:

A. That is correct.

JOHNSON, Q.C.:

Q. And you have authored or co-authored a

number of books and book chapters as well as developed a number of online courses and educational modules in the finance area, would that be correct?

DR. CLEARY:

A. That's correct. Fourteen textbooks the last I counted, and then a number of chapters and so on as you mentioned.

JOHNSON, Q.C.:

Q. And you have been the recipient of several awards for papers you have presented at finance conferences around the world?

DR. CLEARY:

A. Yes, I've received a few.

JOHNSON, Q.C.:

Q. And by my count you have presented on finance-related issues at more than 40 finance conferences since the late 1990s?

DR. CLEARY:

A. Yes, at least.

JOHNSON, Q.C.:

Q. And you are the editor of the finance area of the Canadian Journal of Administrative Sciences?

DR. CLEARY:

A. That's correct.

JOHNSON, Q.C.:

Q. And you are the associate editor for the European Journal of Finance?

DR. CLEARY:

A. Yes.

JOHNSON, Q.C.:

Q. Dr. Cleary, although this is your first time presenting evidence before this Board, you have provided expert evidence before and in particular you've provided testimony before the Board in Alberta, is that correct

DR. CLEARY:

A. That's correct, on two occasions, one in their generic cost of capital proceedings for the 2013 cost of capital hearings.

JOHNSON, Q.C.:

Q. Right.

DR. CLEARY:

A. And then in 2014 for the regulated rate providers.

(9:15 a.m.)

JOHNSON, Q.C.:

Q. Okay. Now you have also filed two reports with this Board in this proceeding; the

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first dated February 17th, and the second being Surrebuttal Evidence dated March 31st, and you have provided Replies to Requests for Information from both Board staff and Newfoundland Power. Is that correct?

DR. CLEARY:
A. That's correct.

JOHNSON, Q.C.:
Q. Were these reports and answers prepared by you?

DR. CLEARY:
A. Yes, they were.

JOHNSON, Q.C.:
Q. Are there any changes that you would like to make to those reports or to your RFI replies at this time?

DR. CLEARY:
A. No, there aren't.

JOHNSON, Q.C.:
Q. And do you adopt the reports as your testimony in this proceeding along with your RFI replies?

DR. CLEARY:
A. Yes, I do.

JOHNSON, Q.C.:

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Q. Okay. You have up on the screen, Dr. Cleary, provided basically a PowerPoint presentation that I'm going to ask you some questions about so that you can give an overview if you will in the areas that you've looked at for the purpose of Newfoundland Power's General Rate Application. And if we – I guess I'll start off, Dr. Cleary –

MS. GLYNN:
Q. Mr. Johnson, can we just mark this?

JOHNSON, Q.C.:
Q. Oh sorry. Yes, I'm -

MS. GLYNN:
Q. Mark this for the record.

JOHNSON, Q.C.:
Q. Sorry.

MS. GLYNN:
Q. And it would be Information Number 34.

JOHNSON, Q.C.:
Q. You'd think I'd know that by now, wouldn't you? So Dr. Cleary, Newfoundland Power has stated in this proceeding that they are an above-average risk Canadian utility. What are your comments regarding this statement?

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DR. CLEARY:
A. So as you can see on the slide - to me this is a new assertion, and from what I gathered from being at the proceedings last week it's a new assertion to everybody involved. And on reading the transcript that it was apparent that Ms. - Mr. Smith and Ms. Perry had relied primarily on the evidence of their expert, Mr. Coyne, to come to this conclusion or to go along with this conclusion I guess. It seems – well, I'll talk about what my evidence as we go along, but I thought it would be a good way to segue into my evidence by discussing two of the main reasons that Mr. Coyne stated that it was based primarily on two factors, Muskrat Falls and NL's weak economic forecast. My evidence suggests that these are overblown and that NP is an above-average (sic.) risk regulated utility at best. So with that in mind, maybe we could turn to –

JOHNSON, Q.C.:
Q. I take it you meant to say it's an average risk regulated utility.

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DR. CLEARY:
A. Sorry. An average risk, sorry, an average risk utility at best.

JOHNSON, Q.C.:
Q. Okay. Okay, so –

DR. CLEARY:
A. Sorry, I can't read my own slides. I'm a little nervous up here, but -

JOHNSON, Q.C.:
Q. Okay, no problem. With respect to Mr. Coyne's first assertion regarding impact of the economic outlook, what does your evidence show, Dr. Cleary?

DR. CLEARY:
A. So firstly with respect to the economic outlook, I thought I'd keep it fairly brief, but just go through what - the evidence that I provided. And as we've heard, there – we have kind of diverse growth prospects going on, both globally and within Canada. We have of course the drop in oil prices and commodity prices which is helping some and hurting others. The U.S. economy is, you know, finally dug itself out of a mess that it dug itself into. It's starting to grow

and of course that's a positive for Canada, our major trading partner. On the other hand we have the Euro that's still in – you know, still cleaning up their mess in the banking system and Japan that's basically been in recession since 1990s. So they're still chugging along very slowly. And also, as we've heard through the trial, that China's growth is slowing. It's interesting that after the discussions last week there was an interesting article in the Globe talking just about that transition from an industrial economy to a consumption economy, and projected to grow at just over six percent, and so a big – not the double-digit growth we've seen before which of course has taken its toll on commodity prices along with the transition in their economy. So we have some oil importing countries that are doing well, some of the other Asian countries, and then we have exporters such as Brazil and, you know, Canada to a certain extent not doing so well. And if we look at the bottom line there which is in Table 2 of my evidence, overall one would look at that

and say that that's not a bad consensus forecast for growth for the world, around three percent for both years. Improving for the U.S. at 2 ½ percent and of course there's that slow growth in the Euro zone that was noted. So globally we could say it's not terrible, but mixed. It depends on where you're sitting, which country. Now if we translate, what that looks like for Canada or how that global scenario factors and affects Canada, and here's some numbers from the consensus forecast from IMF and OECD. We see that basically we see solid, but unspectacular real GDP growth in the two percent area. Then again, we've got this two-speed economy going on with the oil and gas industries and the non-energy commodity industries, you know, not doing so well at the present time and haven't over the last two - three years rather. And then we see in the non-resource sector which is about 84 percent of the economy that seem to be chugging along and in fact improving a little bit as a result of the drop in the Canadian dollar. And we saw that also, when

I actually had time to read the paper this weekend, you know that the unemployment rate had dropped from 7.3 percent back down to 7.1 percent. So and hopefully we'll start to recover as oil prices are going up and so on and so forth and the other sectors. Now how does this translate into the Newfoundland and Labrador economy? Well, here's – if you look at Table 7 from my evidence, these were the Conference Board of Canada forecasts for – and I highlight in red the 2016 2017 numbers because they are the test period in question here. And we can see that at that time they were forecasting for just a slight decline during 2015 with also a decline, a bigger decline, in 2016, and then a slight growth in 2017. In their update that was presented and I think Mr. Coyne discussed it in his evidence, we saw the 2015 appear to turn out much worse than expected, minus 5.4 percent. So that's the bad news. The good news is that maybe some, hopefully a lot of it, has washed through the economy and they're forecasting, you know at least slightly

positive now in 2016, and then getting, well not quite normal, but still improving to 1.1 percent for 2017. I also noted in my evidence that – and it didn't update this in the winter section, but the utility sector you can see is positive all along, and that's consistent with what I kind or ague in my evidence and I'm going to talk about it in the next couple of slides that utilities are more resilient to economic change because it's something that people need. It's one of the last things that they're going to cut back on. So and you know to kind of sum up on this, of course the economic outlook could be better. We'd all be happier, but Newfoundland Power has demonstrated resiliency to previous downturns. And I discuss this in my evidence, but also the 2015 annual statements came up since I prepared my evidence, and at the time we didn't really have an idea of what the GDP growth would be in 2015. It now appears that it wasn't as – it was worse than expected, yet in Newfoundland Power's revenues grew by 3.7

percent, its operating earnings grew and it earned an ROE of 18 basis points over the allowed of 8.8 percent. So that's consistent with some of the evidence provided in Figures 5 and 6 as I'm just going to show you in a second. So in – I'll come back to that summation statement in a second. So this is Figure 5 from my evidence. And what I've charted here is real GDP growth for Newfoundland and Labrador versus the sales growth of Newfoundland Power. And you can see there's just one year where sales did not grow. So the blue line again is the revenue growth for it. So that's a percentage change in revenue growth, and we can see that's it's grown fairly consistently through it, in fact I think the average was 3.4 percent growth over the period. Now, real GDP for Newfoundland and Labrador on the other hand grew an average of 2.5 percent over the period. So that's a couple of things to note, but the main point I wanted to note is there's six years during this period during which real GDP growth was negative, and

during all six of those years, sales growth was positive. So that indicates some resiliency to economic downturns. And if we want to add 2015 which wasn't part of my original chart, then we have seven years where that's happened. So that to me indicates, as I would expect, that Newfoundland Power would be resilient to economic downturns. It's not good for them, but they've been resilient in terms of earning their profits and continuing to be a profitable utility. One could say, well, okay their sales increased, but how did that work out in terms of – how did that work out in terms of their operating earnings? Well the next slide shows quite clearly, and I didn't plot GDP against it, but it's the same period and you can see that EBIT and EBITDA - so just EBIT stands for earnings before interest and taxes, and EBITDA stands for earnings before interest, taxes and depreciation amortization. So those are two common measures of operating earnings. EBIT would be more commonly used than EBITDA, but by both accounts you can see that it grew

steadily through the year and again the only blip being 1998, and then after that, they grew not spectacularly. You would not expect that from a regulated utility in a defined area, but they're operating in a defined area, but steadily. So again, just to conclude, with regards to the argument that the economic decline has made Newfoundland Power above-average business risk, I would say that my evidence clearly shows that that's not an appropriate conclusion.

JOHNSON, Q.C.:
Q. Okay. How would you respond, Dr. Cleary, to the other primary reason used for asserting that Newfoundland Power is now above-average risk, namely the Muskrat Falls Hydro Electric development?

DR. CLEARY:
A. Okay, so the - there's a couple of issues that have been mentioned in evidence on this and one is with respect to the expected cost increases that are going to materialize when Muskrat Falls goes online if you will. And from my understanding, 2018 would be

somewhat optimistic, so somewhere maybe late in 2018. So first of all again I – there's no evidence that Newfoundland Power would not be able to pass these costs on to their customers. It's a cost of service arrangement. There's various pass-through mechanisms in place. They have a very supportive regulator, and this - you know I don't think there's debate over that issue. But the argument that they would lose significant customer base, I don't find that very compelling. Obviously with cost increases it's a concern, and I'm not saying it's nothing to be concerned about because the one thing I learned, you know being in St. John's last week and in around, is I know there's significant concern about Muskrat Falls. I knew it from reading the materials and preparing, but when you're on the street talking to people, it's certainly very much in everybody's mind. But the bottom line is we had this cod moratorium crash during the 1990s and there was a small loss in customer base, and that was when, I think it was about 40 percent cost advantage to oil. The other part about it is during the test period, we're looking at 2016, 2017, well first of all those costs haven't come through yet. So I don't understand the rationale of increasing the cost now because they're going to increase in two years. That's number 1. Number 2, if you look at the forecast period, it's not a period of strong economic growth, and when we're looking at switching costs of 10 to 20 thousand dollars, I don't see people going out and that's the time to convert to something and spending 10 and 20 thousand dollars on it. At least I know I have five kids and it certainly wouldn't be foremost on my mind. I'd be trying to get through the next five months. So I don't see any evidence that the costs are not going to be able to be passed on. Is the cost increase you know a good thing? Of course not. Can it be dealt with? I believe it can be dealt with, so I don't see that as a major risk.

(9:30 a.m.)

A. I also notice that supply reliability came up in the evidence presented by Mr. Coyne,

but that it - you know, on several occasions it's been acknowledged that nobody really can conclude on this. There's a detailed study underway and I'm kind of the same as anybody else. I don't know exactly how this thing is going to turn out. And to me just because it's – I understand that there's, you know, a large distance involved, 1100 kilometres or whatever it is, but I still don't – can't conclude that a new plant 1100 kilometres away is going to be less reliable than one that's close to the hub, but anyways, as I said, I don't speculate on that. I think that's something probably for the next hearing.

JOHNSON, Q.C.:

Q. Dr. Cleary, how does the above-average risk assessment for Newfoundland Power compare with your conclusions?

DR. CLEARY:

A. Coming into it I found that very surprising to assert that given what I had read, you know read about the situation and what I know about Canadian regulated utilities. And when I went through the previous

hearings and decisions, it was quite clear that both sides agreed that Nova Scotia – or sorry, Newfoundland Power was an average-risk regulated utility. That seems a logical statement to me. They operate a virtual monopoly; they're in electricity distribution. They're not in generation. They're well protected through various procedures and mechanisms and they operate under extremely supportive regulatory regime. So for example, the DBRS August 21st, 2015 Rating Report states that, "The procedures and mechanisms in place allows Newfoundland Power to recover all prudently spent operating expenses and earn a reasonable return." So I don't think that there's – that the rating agency seemed to think that all of a sudden Newfoundland Power is going to be able to recover prudently-spent expenses, and similar with capital expenditures by having preapproval for the capital expenditures that take away the risk of those not being recovered. So my general conclusions there, I call them my qualitative conclusions based on, you know,

analyzing the facts as they were, that's pretty consistent with what the debt rating agencies are saying. So as noted in the response to one of my RFIs I said, Moody's – the first two points under "Rating Drivers" were "low-risk regulated electric utility; "supportive regulatory and business environment." The DBRS in the report noted previously, "The confirmations reflect the stable nature of the Company's regulated electricity distribution business and its solid financial risk profile." So none of this to me looking at it suggests that they have above-average risk by any definition, and my quantitative analysis of the business risk below confirms the conclusions by just examining the facts as I have.

JOHNSON, Q.C.:

Q. Dr. Cleary, we note that this slide that we have before us refers to your quantitative analysis of business risk. Can you tell the Board why you undertook a quantitative analysis of business risk? And can you also provide the Board with the main conclusions of your quantitative analysis of

Newfoundland Power's business risk?

DR. CLEARY:

A. Yes. Thank you. The reason I undertook a quantitative analysis is because most people would agree that business risk is reflected in operating earnings as I'm going to get to in a second. And being a finance guy, if there's a way that you can quantify things instead of just waving your hands and saying, "This is more risk," and "This is less risk," it's always nice if you can go jump to punch line to you will, because all of those factors that have been discussed here that affect the business risk, a large number of factors, but you put them all together and the impact should be on business risk or the operating earnings. So with that in mind, I said okay, let's see if what I believe to be so, that Newfoundland Power is low business risk, that these U.S. utilities, because they're holding companies and for a variety of other reasons I'll discuss I think they're a much higher business risk. When I look at the numbers, is that what it's telling me? So first of

all I thought I'd just start out by just a couple of definitions of business risk. So CFA curriculum and I discussed the CFA curriculum earlier. Business risk is the risk associated with operating earnings. They're risky because total revenues are risky as well as the cost of producing those revenues. Dr. Roger Morin, who presented in the 2003 hearings here and I believe probably before that as well, refers to, "The relative variability of operating profits induced by the external forces of demand, foreign supply of the firm's products, by the presence of fixed costs the extent of diversification or lack thereof of services and by the character of regulation." Okay? So again talking about operating profits and in fact Mr. Coyne agreed with the presence that operating risk shows up in earnings when he was on the stand. So I don't think that there's a great debate that when we talk about business risk, we're generally talking about variability in operating profits. When we talk about total risk, we're talking about

variability in operating profits and also the variability in bottom-line profits caused by financial leverage. And that's the financial risk component which I'll get to in a few moments. So with this in mind, I know from looking at textbooks and the CFA curriculum and actually looking at analyst reports and whatnot, that one common measure is of operating income volatility or business risk is the coefficient of variation of EBIT. And why the coefficient of variation of EBIT is because, as I mentioned earlier, EBIT are earnings before interest and taxes is probably the most commonly employed measure of operating income. Why do – what's does coefficient of variation mean? It means you divide the standard deviation by the average rather than just use the standard deviation. Why do you divide the standard deviation by the average? Because you do so to account for differences in size. So for example, if we took one company that had an EBIT of 50 million, and took the standard deviation of it, it might be say 15 million. If we took

another one, and it had an EBIT of 500 million, and it was the same volatility, it might have a standard deviation of 150 million, but they have the same volatility, but the scale makes the conclusions using the standard deviation way of. When you divide by the average, it accounts for this difference in the size. You divide by the 50 million or the 500 million, and so you get a relative scale that makes sense. So I use three different variations of this coefficient of variation of EBIT. So from now on I'll just refer to it as CV of EBIT. So the first one is the standard deviation of EBIT over the entire 20-year period that I looked at, divided by the expected EBIT. I determined the expected EBIT by taking the 2014 EBIT and multiplying it by one plus the median growth rate in EBIT over the entire period. So it gives you an indication of how big it would be next year. I also used another one which I call five-year rolling estimate of the coefficient variation of EBIT where I take the standard deviation of EBIT over the previous five years and divide it by the average of EBIT over the previous five years. And then I – that gives me 15 five-year estimates, and I take the average of those 5 estimates. Finally and probably more simply, I just take the coefficient variation of the EBIT over sales ratio which is kind of like the EBIT margin or operating profit margin that people would often refer to. This is generally close to it or actually it, depending on people's definitions of operating profits. So this one works very simple, and I just take the standard deviation of that ratio over time and divide by the average of EBIT, the sales over that time. I would note that the third measure, the EBIT to sales is not subject to growth in EBIT or due to rate base or whatever because it's just a ratio through time and the fact that a company has little - is able to earn an allowed operating profit margin if you will, through time with little variability in that profit margin suggests that there's not much variation in their EBIT, that they're not very high one year and negative another year. Okay, so

this is - these are the main results from that analysis, and hopefully I think it shows up fairly clear, at least it does in mind, but the main points show up very clear. If you see the two high bars on the left, in the middle and on the third thing, those are the coefficient variation of EBIT or the five-year CV of EBIT or the CV of EBIT to sales for the U.S. firms. And they're all well over .20, close to .30 in some cases. In fact, for the CV EBIT over sales there over .30. Now that - they look very high in relationship to the - the red and the purple bars are for the Canadian proxy group that I use which are Canadian operating utilities or close to I guess with Gaz Metro. It's not quite, but it closer than a holding company. And the other two Nova Scotia Power and Enbridge Gas are operating companies, and then of course on the last there we see Newfoundland Power which is a little bit below the Canadian proxy group and we see that less than half of the U.S. or in some cases less than a third. So they're much, much smaller. I

don't think you – this kind of to me is a very definitive word on the discussions that we had in terms of, you know, we talked about the U.S. utilities and the fact that they were holding companies, the fact that they had more generation risks than Newfoundland Power, that there was regulatory differences and there was historic test year versus forward test year. And all of these, you know, different issues that we were discussed and probably some more non-regulated competition for those U.S. utilities, all of the things that I would, you know, conclusions I would come to qualitatively show up very clearly in the analysis. And one of the comments in the rebuttal was that this was inappropriate because I'm using holding companies for the U.S. sample and I'm using operating companies for the Canadian companies and I'm, like, of course it's inappropriate to compare holding companies to operating companies and that's exactly what I was trying to show here, that you can't—I wouldn't say quite apples and oranges, but

they're apples and crab apples, if you will. So, they're a different beast. So, the U.S. ones are clearly riskier. So taking them at face value and comparing them to the Canadian utilities is not a valid comparison which is, in fact, why I don't use the U.S. ones in my future analysis. The other point I did want to make, sorry, before I rush off this slide, if you look at the last column over there, that's the EBIT to sales ratio and you can see that all of the are in the 15 to 20 percent range. So, if you look at that from an investor point of view, maybe a private equity investor, you want to buy the business, if you wanted to buy a business and you could get the same operating profit margin and less volatility in that profit margin, then you would say that's a much better purchase. If you're risk adverse, you'd say well, okay, Newfoundland Power is 17.6 percent average EBIT. The U.S. utilities are 18.6 percent. So, fairly close, but the volatility in those operating profit margins are much lower for Newfoundland Power.

Okay, so with that all being said and I think I've pretty much mentioned these as we go along that this evidence shows clearly that Newfoundland Power possesses much lower business risk than the U.S. proxy group, not surprisingly, as discussed, slightly lower business risk than the other Canadian operating utilities. Although I don't focus on the difference here because my general impression and what I know is most regulated Canadian utilities that aren't heavily in generation are very low risk anyways. So, the other thing that I did want to mention is there's a lot of discussion about betas last week and I did discuss betas in my evidence. It's also consistent if you look at—I don't think there was any debate that the U.S. utilities had higher betas. It was whether it be .5 or .6 was the discussion and whether U.S. was .6 and Canada was .5, for example. Well, let's just say that's the truth. I think Mr. Coyne's evidence is .67 and .6, but if you looked at it and you said, okay, if they have the same business risk, then they should both have a beta of

.5. Let's say .5 is the number you start with. Now, if one utility has more financial risk than the other, ie. Higher leverage, then we would expect its beta to be .6. I'm just pulling these numbers out for illustrative purposes and the other one would stay at .5, it has lower financial risk. But on the other hand we know that the U.S. utilities have less leverage, yet their betas are .7 versus .6 or .6 versus .5. It clearly shows that the U.S. utilities in this sample have higher business risk because they have lower financial risk, yet they have higher betas. So, that's consistent with my analysis. And it's consistent with all the discussions that have been going on about the comparison of these two.

So, in short this quantitative analysis supports very strongly the assertions I made earlier.

JOHNSON, Q.C.:

Q. Dr. Cleary, what about Newfoundland Power's financial risk profile?

DR. CLEARY:

A. Okay, so again, business risk, very low, certain much lower than the U.S. proxy group using in these proceedings. Financial risks, well, there's generally two ways you'd look at the financial risk. You'd look at the allowable ROEs and the equity ratios or ERs. And if we look and I just summarize the data and tables, 9 and 10 of my evidence. And as mentioned, Newfoundland Power has slightly above average allowed ROE and well above average equity ratio. I don't think this point has been—no one has disputed this factor in the proceeding. So, that's just a given fact. Turning to the other way of looking at this is to look at credit metrics as another measure of financial risk. And when we start doing that, the primary concern—well, I shouldn't say the primary—one of the concerns is with the debt rating agency. Now, Mr. Coyne's evidence suggests that the debt rating in—I was accused—I shouldn't say accused, but it was alluded to in the rebuttal evidence that I was conducting my analysis on the mistaken belief that Newfoundland Power was A rated

when, in fact, they BAA rated by Moodys. So, Mr. Coyne's argument suggests that it's one notch—Newfoundland Power's debt rating is one notch below the Canadian proxy group of A-. I take exception to this statement because this ignores the issue—sorry, this ignores that the issue rating on the first mortgage bonds is actually A2 by Moodys. And that's noted in the Moody's report. It's also noted in the Fortis Investor presentation that Dr. Booth provided in his evidence. It also ignores the fact that Newfoundland Power is rated A by DBRS. And all of the ratings that Mr. Coyne uses are S&P ratings and there's no reason to suggest that an S&P rating and a Moody's rating will fall in the same line. In fact, I would argue that it's more likely that it would be closer to the DBRS, although I can't say for sure because they all do their own thing.

So just for example, FortisAlberta Inc., they're A low by DBRS, A-, which is the equivalent of A low by S & P, and B-AAA1 stable, the sample as Newfoundland Power by Moody's. My belief, if there was an S & P rating for Newfoundland Power, it would probably be A- or probably A, somewhere in there, but I cannot say that's the case, but it seems to me more likely just looking at the evidence. So let's take a look at what my – when I did a metric comparison in Table 11 of my evidence, rather than prepare – try to go out and gather all the data and prepare all these metrics myself, I said, well, let's just look at somebody who's doing this on a consistent basis, and so I chose the DBRS because they tend to have ratings for all the Canadian utilities, and then you need two ratings, so some go with S & P and less go with Moody's. If you look at these numbers based on the most recent debt rating reports that were available to me at the time I did my analysis, which was February, I believe, you can see that on all three metrics Newfoundland Power is better than all of these others Canadian regulated utilities, and perhaps I'll just point out a couple of things here. CU Inc., that you see on the top, is different than CU Limited, which Mr. Coyne used. CU Inc., is

actually a holding company, but it's a holding company of the operating companies. Where CU Limited is above it, it's very confusing if you see the charts for them, but they own CU Inc., and they also own some other businesses. So it's not an operating company, but it's close to an operating company that's comprised of operating companies. Enbridge Gas, FortisAlberta, FortisBC Inc., and Nova Scotia Power, we know are all operating companies, and Gaz Metro Limited Partnership is a holding company primarily of three operating companies which is distribution of gas in Quebec and in Vermont, New Hampshire. So they're not quite operating companies, but they're further down the line than a holding company. Anyway, along these lines we can see that Newfoundland Power is A rated, which is – you know, these are ranging from A high to A low. They clearly are much better on total debt to capital, which is consistent with the fact that they have the higher allowed equity ratio than other Canadian utilities. Their cash flow to debt

is also extremely high at 17.7 percent, well above the average, and, in fact, above any of the numbers for any of the other utilities. The same can be said about the EBIT interest coverage ratio at 3.06, which is also well above the numbers for the industry average. The 2.16, I would kind of note, is an average. Yet all of these utilities are A or A low rated, or A high, right. So there's that interest coverage and there's the 2.2, and I notice there's been a lot of discussion about that, and I will come back to this point later, but there it is under 2.2, and all of those are A rated and they have lower equity ratios too, I might add. So, in fact, out of all of those six companies, there's not one of them that has any of those three metrics that's better than Newfoundland Power. So clearly, according to the credit metrics, and according to the allowed ROE and ERs, that Newfoundland Power has lower financial risk these comparable companies.

JOHNSON, Q.C.:

Q. Dr. Cleary, what conclusions do you have

regarding Newfoundland Power's total risk profile?

DR. CLEARY:

A. If we combine the discussion above, clearly Newfoundland Power is low business risk and they have lower financial risk than similar Canadian operating utilities; why, because they have slightly above average ROEs and much higher than average allowed ERs, or equity ratios, and they have better metrics. Combining low business risk and low financial risk tells me they have low total risk, which is, you know, what I would expect from a regulated utility. Earning an ROE above the allowed ROE for 19 of the last 20 years confirms this, because I would look at ROE as a measure of total risk because it reflects business risk. It's reflected in operating income, financial risk is the transition from operating income to net income, and ROE captures both of those impacts; business risk and financial risk. In fact, it's 20 of 21, if we want to include 2015 where they also earned above their allowed ROE. So there's no evidence to suggest they're above average risk. If anything, it's might be slightly below average, but I don't think it's necessary to make that judgment relative to other Canadian utilities. They're low risk, and if I look at the rating reports for them and for other Canadian utilities, the strength it always low business risk and they always rate excellent on it, so I don't see anything in my analysis that suggests otherwise.

JOHNSON, Q.C.:

Q. Dr. Booth, could you please next discuss your credit metric – I'm sorry, Dr. Cleary, could you please discuss your credit metric analyses for Newfoundland Power?

DR. CLEARY:

A. Yes, thank you. So what I've done here is I've got three tables related to credit metric analysis, and if we look at the first table, it's Table 13, and this is under existing rates and all of the data here for 2015, 2016, 2017, were taken from Exhibit 3, I believe, of Newfoundland Power's evidence, and if we look at these numbers, what I did

was I took the numbers as indicated in an RFI response, and I provided the Excel sheet exactly where the numbers came from and how I came about them, and I calculated these metrics according to the standard guidelines provided by Moody's in one of their documents and also for DBRS provided in one of their documents I went through, and if we look at these numbers, we can see – first of all, it's probably useful to spend a moment to look at the difference between the Moody's rating criteria, where they fall in terms of B-AA to A, so on and so forth. If we look at the Moody's metrics for the cash flow, pre-working capital, plus interest over interest, so that's like a cash flow interest coverage ratio, and a cash flow to debt ratio and cash flow minus dividends to debt ratio, and then finally the debt to capitalization ratio, we see that Newfoundland Power, these ratios remain strong and they remain in the B-AA mid to high range, or even touch upon the A low. Now one might say, okay, well, where does this A rating come from. The metric

criteria for Moody's are, I would say, U.S. centric, and all we have to do is look at the last one there, the debt to capitalization ratio, their criteria for the debt to capitalization ratio is that it would be less than 50 percent. Of course, there's no Canadian utility that I can think of that has more than a 50 percent equity ratio, so they're never going to get A on that criteria. Again as we know, the allowed ROEs and equity ratios in the U.S. are higher, probably offsets their higher business risk, but the criteria that Moody's makes, they haven't really tailored it to Canadian utilities as much. So if we then look at the DBRS metrics, we see that along the cash flow to debt, the debt to capital, and the EBIT to interest which is another name for the interest coverage ratio, that they're in the A high to AA low category, so very strong. Even under existing rates, they would remain in that category. So the next thing I thought that I would do that would help the Board in their decision was to look at what would happen under various ROE and

equity ratio scenarios. I'm going to skip over Table 14 because that's using the 45 percent equity ratio. We'll look at Table 15, what happens if you vary the allowed ROE and vary the equity ratio. So when we get to this point, we can see that the ratios are still well within the Moody's B-AA category, and the DBRS metrics remain well in the A range, and that's for 2016 on this slide, and then on the next slide for 2017. Again the metrics are not all the debt rating agencies look at. In fact, they're going to look at business risk and it's pretty much a stamp that it's excellent for business risk, you know, unless something unforeseen happens, but these Canadian utilities are going to rate very high in business risk, and if their metrics, you know, remain within the range that they have been, they're going to maintain that rating. I would note that even under some of the scenarios presented, of course, the metrics weaken if we reduce the equity ratio and the ROE, but they would still be stronger than some of those utilities listed in the previous table because they were well above average. So even if they do weaken, it doesn't mean that they're falling off a cliff, it just means that they're coming back to the average from well above average.

JOHNSON, Q.C.:

Q. Dr. Cleary, do you have any comments regarding the credit metrics provided by Newfoundland Power both for previous years and pro forma metrics based on future estimates?

(10:00 a.m.)

DR. CLEARY:

A. Yes, I do. First of all, this came up in my rebuttal evidence, and there's a difference in the interest coverage ratios that are being reported using the same financial statement information, or at least I can honestly say I was never provided the exact details of all of the information used in the calculations of these interest coverage ratios, which is kind of a – I'll come back to that in a second, but that's the only one where we seem to disagree on. So as noted in my evidence, rather than go forecast, if

I go back and look at 2013/2014, two years that are already in the books, so to speak, we had slight – well, enough of a difference, maybe almost a 10 percent difference, where I got 2.48 and 2.52 using the numbers from Exhibit 3 and the revised version of Exhibit 3. Oddly, DBRS has even higher numbers than me. So it's a little bit of a puzzle as to what's going on here, but I would note that even at the 2.3, which one would have to consider at the lower end of what this ratio actually is, that they're still in good shape and still above average. Now the funny thing is when we go to the cash flow related measures, that we get almost the same ratios, both in the pro formas and the other. There's an old finance saying that earnings can vary with various assumptions, so on and so forth, but at the end of the day a company, their cash flows in and their cash flows out, it doesn't matter what you call them, earnings, losses, or whatever, they should all be the same because cash flow in should equal cash flow out. I guess, maybe I'm going to say

"not surprisingly", but if you look at this next table, and it's almost useful to look in segments of two to compare Newfoundland Power 2016, for example. In the rebuttal evidence 7.5 percent ROE and the 40 percent equity ratio, and in my Table 15, you can see the cash flow to debt coverage are fairly similar. We're off a little bit there, 15.9 versus – they actually have a higher ratio than me. The same for the cash flow to interest coverage, they actually have a higher number than me, but then the interest coverage again, they're about that 10 percent lower than my estimate. If we go over to the next two columns and we look at it, we see very close for cash flow to debt coverage, and this is again for 2017 and the 7.5 percent and 40 percent equity ratio. It's 14.5 versus 14.78; 3.5 versus 3.5, so exactly the same, and again 10 percent lower in the interest coverage ratio. Then finally in Undertaking 4, I believe, that was discussed two weeks ago, I guess now, we see that for 8.3 percent ROE and a 40 percent equity ratio, Newfoundland Power had

15 percent, I had 15.3 percent, and we had virtually the same for cash flow interest coverage, and then there's about that 10 percent difference on the interest coverage ratio. So this led me to scratch my head and try to figure out what's going on here. So I thought maybe I'd just take a moment to go through how this interest coverage ratio is calculated. There's two different ways you can do it, okay, and I just brought up some simple numbers here. You can start - do a top down, and start with revenues, take off your operating costs. That leaves your EBITDA, your earnings before interest, taxes, and depreciation. If you then take off your depreciation and amortization, that gives you EBIT, or earnings before interest and taxes, the 22 in this example. If I then take off the 6 in interest, we get 16 for earnings before taxes, and if we applied, say, a 25 percent tax rate, then we get the net income of 12. So the top down, I could start at 100, and when I get to 22, I'd be done. The bottom up, I'd start at 12, I'd add back 4, as you can see in the bullet

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above there, I'd add back the 4 in taxes, I'd add back the 6 in interest, and I'd get 22. So you should get the same number no matter which way you come from. Of course, you'll always get the same number if you provided all the information. In the evidence, this is what was pulling my hair out, I was either given the top down information or the bottom up information, so I couldn't confirm the whole picture. So just to carry on with this point without belabouring it too much, but if I do look at Table 1 in U7 where Newfoundland Power provided calculations used to figure out their earnings test ratio, which is actually the interest coverage ratio, except with the new interest on the bond issue added onto that interest amount, so the existing interest plus the extra interest on the bond. Also I would add, the other reason that number is lower than the interest coverage ratio is because they use, from what I understand from reading the transcript, they use the EBIT from the trailing 12 month period as opposed to the

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future EBIT. Now if you think of that, EBIT has been growing steadily from my chart, so that's going to leave that number – it's going to be lower than the interest coverage ratio used by Moody's, for example, but it's in their bond indenture, so it is what it is, but I'm just explaining why those two ratios might be different. So if we look at it, the number that they constructed by going by revenues and operating expenses and so on, they got $80,199,000.00. They didn't give the net income or earnings before taxes data, but if we subtracted the interest figure that they did provide, which is 41,454, that's the new interest after the issue, we get an earnings before taxes figure of 38,745. If we then apply 29.14 percent tax rate, which is pretty consistent with what they paid through the years and was provided by them in Exhibit 3, that gives me a net income figure of 27,455. Now the common equity figure, again they didn't provide it, but I worked backwards and figured out that it's probably going to be about 440 million, because I took the 495

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that they had forecast for 2017, subtracted the 55 million that they're going to pay for the dividends, that should give me about 440 million. If I use that number and take 27,455 and divide by it, I get an ROE of 6.24 percent, which that's why I've got the question marks there because this is supposed to be a scenario where you're evaluating an 8.3 percent ROE. The numbers don't add up to me. Am I using the wrong common equity – it would be nice if I had all the data so I could tell you exactly what's going on, but I had to work backwards. Did it work out; sure, because implied debt figure was 674 using – basically, they had 600 million and 75 million debt issue. That implies 675, and again I'm guesstimating 440. Does that work out; yeah, it's close to a 40 percent equity ratio. It's 39.5 percent. So it seems they got the 40 percent equity ratio going on, but these numbers do not give an 8.3 percent ROE. If I assume that they got the ROE correct at 8.3 percent, I could also back out that the equity figure would have to be

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330,780, which would imply an equity ratio of 33 percent. So again this confusion may be if all the data was provided could be avoided, as I mentioned. My data is out there, it's an Excel spreadsheet, I used all the company data. Everyone can see my calculations, so it's easy to figure out what I did in terms of estimating this metric. There's a discrepancy, and I'm not quite sure why, so I just thought it would be useful to the Board to point this out.

JOHNSON, Q.C.:
Q. And I take it, you have a separate table –
DR. CLEARY:
A. Oh, sorry.
JOHNSON, Q.C.:
Q. Yeah.
DR. CLEARY:
A. Yes, so in contrast, I do go through and I start with an 8.3 percent ROE – sorry, just by contrast, here's what I do. It's an 8.3 percent ROE and the 40 percent. There's lots of ways you can get to a 40 percent equity ratio. I chose a very simple way, issue 102 million in debt, and you don't have to do

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the liquidating dividend, it doesn't really matter how – you know, obviously that's a decision Newfoundland Power would make, whatever makes the most sense for them. Based on that, I then figured out what the interest on that would be. I used the 4.45 percent that Newfoundland Power issued bonds at in September of 2015. I see no reason why it would increase 1 percent. If government rates go up 1 percent, the yield spread is going to narrow, so the two are going to offset to a certain extent. Anyway, it didn't really make – the interest calculation was not the difference, it was the EBIT. So then I started with the net income to earn 8.3 percent, added back the 29 percent taxes, added back the interest as calculated, and that's how I got these numbers.

JOHNSON, Q.C.:

Q. Dr. Cleary, based on your analysis, what conclusions have you reached and what recommendation do you have for the Board regarding Newfoundland Power's capital structure?

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DR. CLEARY:

A. So as mentioned, I think they're low business risk, they're a virtual monopoly, low risk distribution area, strong regulatory support, resiliency in revenue, EBITDA through time, low volatility in operating income. I would add also operating income margins that are comparable to average with less volatility in them, low financial risk because they have about average ROE and well above average equity ratio, the credit metrics are above average, and they've earned an ROE – you know, as I said at the bottom of the business and financial risk gets reflected in the ROE and their ability to earn their allowed ROE. The fact they've been able to do so for the last 21 years confirms their low total risk. I would not agree with the assertion that they're above average risk, and I would say they're average, if not a little bit below. Therefore, I would suggest that the 40 percent equity, I recommend decreasing equity ratio to 40 percent, and that would bring it in line with their Canadian peers.

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I don't think the 45 percent is necessary. My credit metric – I mean, my risk conclusion suggests this is the case, they're not riskier on either business risk or financial risk level than comparables, and my credit metrics scenario analysis confirms that they'd remain within the same rating areas that they are now, and they'd still probably be slightly above average on the credit metrics. I would also note that if we're going to change – if you were going to change it, it's a particularly good time to issue debt because they're in historic lows for utilities. With low interest rates, even though the spreads have gone up since 2013, it's been offset by the decline in the base rates, so it's all time low or pretty close to it.

JOHNSON, Q.C.:

Q. Does that conclude your direct, Dr. Cleary?

DR. CLEARY:

A. That does. Thank you.

JOHNSON, Q.C.:

Q. Thank you very much.

CHAIRMAN:

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Q. You're finished, Mr. Johnson?

JOHNSON, Q.C.:

Q. I am, sir.

CHAIRMAN:

Q. Mr. Kelly.

DR. SEAN CLEARY – CROSS-EXAMINATION BY KELLY, Q.C.:

Q. Dr. Cleary, welcome to Newfoundland and Labrador. I understand, if I take you over to page 1 of your evidence that you filed, original evidence, that in terms of your experience in giving cost of capital evidence in relation to utilities, you're fairly new at this, correct?

DR. CLEARY:

A. Yeah, this would be my third hearing. It's rare to be called new at my age, but refreshing, I would say.

KELLY, Q.C.:

Q. We all have to start somewhere.

DR. CLEARY:

A. Yes.

KELLY, Q.C.:

Q. As you told Mr. Johnson, you testified in Alberta and wrote a report there?

DR. CLEARY:

A. That's correct.

KELLY, Q.C.:

Q. You haven't written a report or testified in any other jurisdiction other than the report that you note for the chicken farmers of Ontario in line 12 on the screen. Am I correct in that?

DR. CLEARY:

A. With the exception that I have prepared a report for the ongoing Alberta hearings.

KELLY, Q.C.:

Q. Yes, that's what I'm saying.

DR. CLEARY:

A. Yes, the ones that are occurring right now.

KELLY, Q.C.:

Q. You filed a report and testified in Alberta?

DR. CLEARY:

A. Yes.

KELLY, Q.C.:

Q. And there's one report in relation to the chicken farmers of Ontario in Ontario?

DR. CLEARY:

A. Right, and just to clarify because I am under oath, I have filed a report for the Alberta hearings that are currently

underway.

KELLY, Q.C.:

Q. Then the next thing I want to take you to is – well, before I move on to that, I take it that you don't purport to have any expertise in terms of utilities operation or utilities regulation per se?

DR. CLEARY:

A. No, that's not my background.

KELLY, Q.C.:

Q. Can I take you next to page 11 of your report, and this deals with your interest rate forecast, and if I can flip over to page 12 first at the bottom of the page, Samantha, down around line 17 or so, you come up with an interest rate forecast of about 2.6 percent, and you do that by looking at the 10 year rate and then looking at the spread between 10 and 30 years rates, if I take you back to page 11, correct?

DR. CLEARY:

A. I'm not – I can see on page 11 where I mentioned that the average spread between the 10 year rate and the 30 year rate is about 50 basis points.

(10:15 a.m.)

KELLY, Q.C.:

Q. Right, over 12 years. Then you come over to page 12 at the bottom and you say, "The January 2016 consensus forecast for 10 year Canada bond yields were 1.7 percent for the end of April 2016, 2.1 percent for the end of January, up from a 2015 year end value of 1.4 percent. If we assume the increases occurred", and I'll skip through the next sentence, and then you say, "Assuming that the long term average 50 basis point spread of 30 year yields over the 10 year yields persists throughout 2016 and 2017, this implies long term rates would increase from their 2015 year end level of 2.16, for an average of 2.25 through 2016 and would like around 2.16 by January, 2017". So you -

DR. CLEARY:

A. Excuse me, sorry, it's 2.6 percent by January 2017.

KELLY, Q.C.:

Q. 2.6 percent. So you take the interest rate forecast for 2016 and you combine it with a 12 year average of what the spread will be,

correct?

DR. CLEARY:

A. Yes.

KELLY, Q.C.:

Q. And –

DR. CLEARY:

A. Sorry, I would note that that 2.25 percent would be somewhere during 2016, and clearly 2.6 percent would be at January of 2017.

KELLY, Q.C.:

Q. Understood.

DR. CLEARY:

A. Okay.

KELLY, Q.C.:

Q. My question to you is, the spreads which were in 2015, as you noted on the previous page, were about 76 basis points, correct?

DR. CLEARY:

A. Right.

KELLY, Q.C.:

Q. They still are 76 basis points?

DR. CLEARY:

A. Probably somewhere in that vicinity.

KELLY, Q.C.:

Q. Right, and they are forecast to remain at

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about 75/76 basis points to the end of 2016?
DR. CLEARY:
A. They could be.
KELLY, Q.C.:
Q. Could be? Well, let's put up Dr. Booth's surrebuttal at page 3.
DR. CLEARY:
A. I can honestly say that forecasting the spread between 10 and 30 years was nothing that I looked at for this particular hearing because it wasn't central to my evidence, but I seem to recall that number.
KELLY, Q.C.:
Q. But since you dealt with it, I want to deal with it.
DR. CLEARY:
A. I understand, yes.
KELLY, Q.C.:
Q. And if we look at the Canada lines and we look in 2016, and you can pick whichever 2016 one you want, if we take the third quarter, it's 165 and 240, at the end of the 2016 there's 70 basis points, the spreads are 75 basis points throughout 2016.
DR. CLEARY:

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A. Sorry, my eyes are not very good despite being new, I guess. It looks like 65 basis – again this is RBC, so it's one source, but it's probably – the bank economists all tend to be fairly close, so I would accept that it's quite possible.
KELLY, Q.C.:
Q. And then you have to look out through 2017 to see what the interest rates are going to be because we have a 2017 test year, agreed?
DR. CLEARY:
A. Agreed, but if you look at the same data that you're looking at during 2017, you see that spread narrowing to 60 basis points in quarter one, you see it narrowing to 45 basis points in quarter two, to 40 basis points in quarter three, and 30 basis points in quarter four, which makes my .5 not all that bad off because it's .3 one year and .7 the other year.
KELLY, Q.C.:
Q. But the spread is still forecast to be 75 to the end. So if you're going to look at 10 year bonds, you have to look at the forecast spread, otherwise you look at the 30 year

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bonds and either way you're well into the 3s throughout 2017, correct, because even the 10 year spread, as you go out – 10 year bond yield by the end of 2017 is 3.05 percent?
DR. CLEARY:
A. Well, that's what this table is suggesting.
KELLY, Q.C.:
Q. Okay.
DR. CLEARY:
A. It's not my evidence, nor would I say that I necessarily share that belief. I do believe they're going up. I think it's going to take a while.
KELLY, Q.C.:
Q. Now the next thing I want to turn to is page 13 of your evidence, and at page 13 you start talking about the Newfoundland economy.
DR. CLEARY:
A. Uh-hm.
KELLY, Q.C.:
Q. Come down to the bottom, Samantha, and the discussion runs over to the top of the next page, page 14. Keep going a bit, Samantha, please, and bring up the table. There you

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go. Now if you – at the top of the page at line 2, you say, "So there is general agreement that the economic growth will be slow for Newfoundland in the short term", and then if you look at the Table 6 data you've got, the Table 6 data actually shows not that the growth will be slow, but that the growth will be negative, agreed?
DR. CLEARY:
A. Agreed.
KELLY, Q.C.:
Q. So calling the growth slow is a little bit of a rosy perspective?
DR. CLEARY:
A. It was not meant to be misleading, but I would agree in hindsight, negative is fine.
KELLY, Q.C.:
Q. Then we know that, in fact, the growth has turned out to be much worse in 2015. It was actually –5.4 percent, correct?
DR. CLEARY:
A. According to the Conference Board estimates, yes.
KELLY, Q.C.:
Q. Using the Conference Board estimates.

DR. CLEARY:
A. Yes.
KELLY, Q.C.:
Q. And that 5.4 percent followed on the heels of a 2.9 percent drop in 2014, correct? We'll look at that later on.
DR. CLEARY:
A. I will take that subject to check.
KELLY, Q.C.:
Q. Okay, so we've had a couple of pretty bad years of real GDP growth – real GDP decline, correct?
DR. CLEARY:
A. Yes.
KELLY, Q.C.:
Q. Come over then to page 15 where you begin the discussion on line 8, and you then – I'll give you an opportunity to read the whole paragraph. I'm going to pick it up about half way down when you're ready.
DR. CLEARY:
A. If you could just give me a second.
KELLY, Q.C.:
Q. Sure.
DR. CLEARY:

A. Thank you. Okay.
KELLY, Q.C.:
Q. Okay, about half way down you say, "Beyond 2017, the Conference Board predicts that the unemployment rate will fall below 12 percent and decline steadily to around 11 percent by 2020 on the back of 2018-20 real GDP growth rates of +1.4 percent, +7 percent, and –1.6 percent respectively. Finally, it is interesting to note that the Conference Board expects the contribution to NL GDP from the utility sector to remain positive in 2016 and 2017, 0.4 percent and 0.6 percent respectively, and also in the ensuring three years, 0.8 percent, +1.3, and +5.9 respectively". Then you say, "This is consistent with the low risk nature of utilities such as Newfoundland Power whose demand is less cyclical than most industries". That's what you say. Now I want to explore those premises in a bit more detail, and can we scroll up your table a bit there, so we put the table up, and some of this table you had in Slide 5 earlier this morning?

DR. CLEARY:
A. That's correct.
KELLY, Q.C.:
Q. Now the first thing we have to do with this table is to correct the two errors in the real GDP line for 2019 and 2020?
DR. CLEARY:
A. Yes, I did that –
KELLY, Q.C.:
Q. In an RFI.
DR. CLEARY:
A. In an RFI. I quoted the nominal numbers there instead of the real ones, which I was referring to in the passage above.
KELLY, Q.C.:
Q. That's NP-CA-002, and you actually have the correct numbers up above, so it's just a transcribing error?
DR. CLEARY:
A. Yes.
KELLY, Q.C.:
Q. The 9.2 should be 7.0, correct?
DR. CLEARY:
A. That's correct.
KELLY, Q.C.:

Q. And the +.4 for 2020 should be –1.6 percent?
DR. CLEARY:
A. That's correct.
KELLY, Q.C.:
Q. Now real GDP growth is the goods and services being produced into the economy at a constant rate back in – I think they used 2007 dollars, don't they?
DR. CLEARY:
A. I believe it's 2007, but some fixed year.
KELLY, Q.C.:
Q. I think it's 2007. So that doesn't – the change in GDP per se doesn't capture the price effects of the fall in the value of oil and the effect of the declining prices on the Newfoundland economy. This is just measuring the total of goods and services produced in real terms?
DR. CLEARY:
A. Conceptually, yes. After you take out the influence of inflation, the bundle of goods and services actually increase.
KELLY, Q.C.:
Q. Exactly. So if, for example, we look at this and we say that there is a –0.2 to take

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the 2015 number by way of example, that's the percentage change from the previous year?

DR. CLEARY:
A. That's correct.

KELLY, Q.C.:
Q. Right. We'll come back to this. If we could put up Slide 5 for a second, so on Slide 5, when we look at the top line and you've got –0.2 and then –0.8, that's a -.8 reduction from what your GDP would have been in 2015, correct, or was in 2015?

DR. CLEARY:
A. That's correct, so if it was, like, 100, it's 99.2.

KELLY, Q.C.:
Q. Good example. So if you come down to the next line and you have a drop of 5.4 percent and a growth of .1 percent, that is materially worse than what is reported for 2015 and 2016 on the top line because you've had a big reduction of 5.4 percent, correct?

DR. CLEARY:
A. That's correct.

KELLY, Q.C.:

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Q. Right, and that's true as you go forward looking at the numbers, et cetera?

DR. CLEARY:
A. It's true, but I just would like to qualify that. The fact is we're looking forward to 2016 and 2017. I understand what you're saying is that even though it's positive, it's negative, but the fact is 2015, while it was a rough year and you mentioned 2014 was also a rough year, they're behind us now and, you know, the fact that we expect to grow is a good thing, and also – what I should have mentioned earlier is again we're talking about 2014 and 2015, and Newfoundland Power sales grew in both years, they earned their ROE – above their ROE in both years.

KELLY, Q.C.:
Q. Dr. Cleary, if you look at that – we'll look at the line that you got on the top one there, and you see 7 percent in 2019. What would account for that?

DR. CLEARY:
A. Honestly, I can't remember. It was quite a while ago when I read the Conference Board

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forecast.

KELLY, Q.C.:
Q. Can I help you? About that point in time, Hebron, which the construction is now winding down, is going to get towed out and it will start pumping oil in the offshore which will go down to Texas. So it's oil coming out of the ground and Hebron long before that will have moved from construction and development into production with less employment, agreed?

DR. CLEARY:
A. That makes sense. I knew it had to do with some of the major projects going on.

KELLY, Q.C.:
Q. So seeing 7 percent in 2019 doesn't tell us anything about employment, does it, because it's oil being pumped out of the ground?

DR. CLEARY:
A. To say it would tell us nothing about employment, I would not agree with that. It will definitely have an influence. There's trickle through influence as in economies. As to what that precise – it's not as direct an influence as if it was, you know, a

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mining project or something that was going to gainfully employ Newfoundland and Labrador people, but definitely will have a positive influence on the economy.

KELLY, Q.C.:
Q. But in the oil sector, once the project goes into production, the production employment is less than the construction and development employment, is that not the case, or are you not familiar with the oil industry?

DR. CLEARY:
A. I'm pretty familiar with it. I grew up in Nova Scotia, and I would agree with -

KELLY, Q.C.:
Q. You agree with me?

DR. CLEARY:
A. To a certain extent.

KELLY, Q.C.:
Q. Okay.

DR. CLEARY:
A. It does also create employment for locals, but I would agree that not 100 percent.

KELLY, Q.C.:

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Q. Now, we're talking about employment, let's have a look at what the Conference Board of Canada actually says about employment and the best place to find that is if we go back to Newfoundland Power's original filing and we look at the Conference Board report that's contained in that and Samantha, if you could go to the Newfoundland and Labrador section of it at page 1, go through the initial bit until you get to the part that deals with Newfoundland and Labrador. There you go. Now, Dr. Cleary, if you look over on the left-hand column where it says "real GDP growth for 2014", there's your negative 2.9 percent, do you see that?

DR. CLEARY:

A. Yes, I do.

KELLY, Q.C.:

Q. That's 2014, so we lost 2.9 percent in 2014 –

DR. CLEARY:

A. Sorry, can I just clarify?

KELLY, Q.C.:

Q. Sure.

DR. CLEARY:

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A. Because I think we have three Conference Board publications –

KELLY, Q.C.:

Q. We do indeed.

DR. CLEARY:

A. This is the summer of 2015, right?

KELLY, Q.C.:

Q. Right, because it's got the best discussion of employment, okay, so we lost 2.9 percent in 2014 and another 5.4 percent in 2015 for an aggregate loss of over 8 percent, correct?

DR. CLEARY:

A. Sorry, can you repeat that?

(10:30 a.m.)

KELLY, Q.C:

Q. We saw from the, previously, from the most recent data that in 2015 the economy shrank 5.4 percent and we now know that in 2014 it also shrank 2.9 percent.

DR. CLEARY:

A. So that 2.9 percent has been confirmed, that's not an estimate?

KELLY, Q.C.:

Q. This is the summer 2015 data, that's a final

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number.

DR. CLEARY:

A. Yeah, I know, sometimes it takes a while for the estimates to become real, I was trying to confirm –

KELLY, Q.C.:

Q. In fact, if you look at it, you'll see the Fs after 2015 and 2016?

DR. CLEARY:

A. Yeah, I know, I'm just trying to verify it, okay. So 2.9 percent, the 5.4 percent has not been verified, it's still an estimate, but presumably it's –

KELLY, Q.C.:

Q. Right, but we now have the 5.4 percent from the most recent 2015 numbers as a final, so we've lost over 8 percent in total, are we agreed?

DR. CLEARY:

A. Yes, I would have to agree with those numbers and I would also note that Newfoundland Power's sales and their profits went up during both years, so it comes back, it strengthens my argument I was making earlier that they're very resilient to

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downturns.

KELLY, Q.C.:

Q. Follow along with me now. Let's go to the bottom of the next column over where they discuss labour market and I'm going to pick you up about three lines from the bottom. "Overall the unemployment rate will drop from 12.7 percent in the first half of this year to an average of 12.1 percent in 2016 as the number of Newfoundlanders looking for work shrinks. With slack in the labour market, household consumption will be anemic over the next two years and the government tax collection from households will be lower." And to give you the rest of it, let me take you over to page 3 at the bottom, under "Domestic Demands Remains Weak", "The next five years are going to be belt tightening for the Newfoundland and Labrador consumers. The labour market has been hemorrhaging jobs since last year and we expect the losses to continue over the median term. Investment in most of the province's mega projects has peaked and workers are losing their jobs. On average we expect about 1300 positions to be eliminated each year from now until 2019. Along with weaker demand for labour, workers will see their wages slashed this year as employers try to keep costs down as they face weaker commodity prices. Wages and salaries, the industrial composite, are forecast to drop by 2 percent this year, the first such decline in a decade after expanding at the breakneck pace of 5.6 percent per year over 2015 and 2014. Looking ahead, wage growth will be modest beyond next year as labour demand pressures wain." Next page, Samantha. "The job losses have pushed the unemployment rate up to 12.7 percent for the first half of this year; however, it will not remain there for long as the shrinking of the province's labour force will put the rate down to around 12.1 percent for next year. The slide in the unemployment rate will then continue through to 2019. The job losses, combined with lower wages, will dampen consumer spending over the next two years." And I'll stop the discussion there. Now,

that's what the Conference Board is saying is the cost. Before I get you to comment, I want you show you some of the Conference Board key economic indicators on the next page. If you can pull that up, Samantha? And we're on the right-hand columns, I don't know if you can make it so you can get it all on the screen, Samantha, or will make numbers too small? There we go. Now, three lines down we have the GDP at basic prices, that's the real GDP and if we go over to the far-right side, 2014, '15 and '16, there's are real GDP numbers, -2.9 et cetera that we saw on the first page, correct?

DR. CLEARY:
A. That's correct.

KELLY, Q.C.:
Q. Right, now come down to "Employment" which is about, there we go, thank you Samantha. If you could come across, you'll see in 2014 employment dropped 1.9 percent; in 2015, 1.3 percent; in 2016, .7 percent and while we're on unemployment, can you go over to the next page, Samantha? Employment continues to drop in 2017, -.3, -.5 and finally 0 in

2019. Do you see that, Dr. Cleary?

DR. CLEARY:
A. Yes.

KELLY, Q.C.:
Q. Okay, come back to the labour force participation rate on the previous column, you'll see in 2014 the labour force participation rate is 61 percent, do you see that?

DR. CLEARY:
A. Yes, I do.

KELLY, Q.C.:
Q. Do you see it drops to 60.8 in 2015, 60.1 in 2016? If we go to the next page, it goes to 59.9; 59.4; and 59. So the Conference Board is saying we have a 2 percent drop in the labour force participate rate, correct?

DR. CLEARY:
A. That's what the numbers suggest, yes.

KELLY, Q.C.:
Q. That's what the numbers say. In fact, I'm going to give you one more. If you come down to "Housing Starts" and look at 2014, you'll see it's -26 percent in 2014, -26 percent in 2014; -23 percent in 2015; -18.6

percent in 2016. Come over to the next page, -7.8 percent in 2017; -7.7 percent in 2018; and -7.7 percent in 2019, agreed?

DR. CLEARY:
A. Yes, that's what the numbers say.

KELLY, Q.C.:
Q. Right. Now, what the Conference Board says quite unequivocally is the drop in unemployment is due to the fact of people losing their jobs and people moving out of the labour force, agreed?

DR. CLEARY:
A. I'd have to see the quote.

KELLY, Q.C.:
Q. That's the quote we just took you through and those are the numbers behind it.

DR. CLEARY:
A. Okay.

KELLY, Q.C.:
Q. Can I take you back now to page 15 of your evidence and can we scroll, bring it down a little bit so we get the top bit, Samantha? There we go. So the sentence at line 13 where you say "Beyond 2017, the Conference Board predicts that the unemployment rate

will fall below 20 percent and decline steadily to around 11 percent by 2020 on the back of 2018, 2020 real GDP growths, et cetera. That's not what the Conference Board is saying at all. The Conference Board is in fact saying that despite those numbers in GDP growth, unemployment will go down, but because people have lost their jobs and people have withdrawn from the labour market, the labour force participation rates goes down.

DR. CLEARY:
A. Well hold on, what I'm saying is correct. I said that the unemployment rate will be declining and secondly, this is the Conference Board forecast from the fall and you're reading to me from one from the summer, upon which my evidence was not based, right, so –

KELLY, Q.C.:
Q. In fact, I went and looked at the fall one and the Conference Board says the same thing about unemployment and employment rates and labour participation rates in the fall one.

DR. CLEARY:

A. But my statement has nothing to do with labour participation. I mean, my statement is true, the unemployment rate is forecast to decline. You're trying to qualify what the unemployment rate falling means by looking at other factors, that the participation rate –

KELLY, Q.C.:
Q. You say on the back of GDP growth, implying that the GDP growth is going to bring down the unemployment rate. That's not what's bringing down the unemployment rate. In fact, we have declining employment in the province consistently six years out into the future. In fact, scroll up the screen again, Samantha. Bring up his Table 7 on page 15. In fact, if you look at the employment line from the fall data, you'll see it's negative in 2015, negative in 2016, negative in 2017, negative in 2018, a small +1, .1 in 2019 and negative again in 2020, consistent with the data we looked at from the summer forecast. Employment continues to fall, Dr. Cleary, agreed?

DR. CLEARY:

A. It appears that way.

KELLY, Q.C.:
Q. It appears that way. Okay, now the next thing I want to talk to you about is your last line which is "The utility sector GDP contribution." And what we're seeing there, just so we're clear, those numbers, just like we looked at for real GDP changes, that's the change in the utility sector contribution to GDP year over year. So in this one, 2015 was up 9.9 percent, but it's 9.9 percent of a much smaller number than the total GDP, correct?

DR. CLEARY:
A. I would actually say a smaller number because that 9.9 percent would have been based on a shrinkage of -0.2 percent.

KELLY, Q.C.:
Q. True, but the utility sector of total GDP is a very small fraction of total GDP for the province, we have construction, manufacturing, government sector, et cetera, utilities' GDP, so when you're looking at those numbers, percentage changes on the bottom, they might be bigger percentage

changes, but they are percentage changes of a number much small than the total GDP, agreed?

DR. CLEARY:
A. Well, of course, they're a fraction of GDP but the point of this, presenting it, is the fact that they are more stable than the overall economy which is also consistent with the argument that utilities, as a part of the TSX composite index, for example, are a small part of it and they would represent the stable part and the mining and the oil and gas industries and the real estate would be the more volatile components of those GDP, of that market.

KELLY, Q.C.:
Q. Dr. Cleary, what's in the Conference Board's utility sector other than electricity?

DR. CLEARY:
A. Primarily electricity.

KELLY, Q.C.:
Q. It's water and sewer projects, amongst other things.

DR. CLEARY:
A. And hydro—well, not hydro, Labrador –

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KELLY, Q.C.:
Q. And Newfoundland Hydro.
DR. CLEARY:
A. Yes.
KELLY, Q.C.:
Q. Now let's just think about this for a second. It's clear from the evidence that Newfoundland Power is not selling more kilowatt hours of energy to customers, so 9.9 percent in 2015, that's year over year growth in the utility sector, do you have any idea what that is, what the drivers were?
DR. CLEARY:
A. Well first of all you said that they're not selling any more kilowatt hours, but I heard testimony here that in fact they are. It's growing slower, but I thought the number I heard was about 1 percent rate, so –
KELLY, Q.C.:
Q. That's a historic.
DR. CLEARY:
A. Right, but I think that that was the number that was acknowledged over the test period that it ever expected –

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KELLY, Q.C.:
Q. No, no, no, you've misunderstood the evidence. Is that what you took out of it? Then you've misunderstood the evidence. But I just want to stay with my question.
DR. CLEARY:
A. Sure.
KELLY, Q.C.:
Q. Do you know what would drive the utility section 9.9 percent growth in 2015?
DR. CLEARY:
A. Sorry, I can't recall right now.
KELLY, Q.C.:
Q. You don't know?
DR. CLEARY:
A. I did know when I prepared the report and I apologize.
KELLY, Q.C.:
Q. I'm going to help you with a couple of things. The City of St. John's brought on a new water treatment plant. The City of Corner Brook brought on a new water treatment plant. Newfoundland and Labrador Hydro spent a great deal of money, including a new gas turbine. Turbine construction

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itself doesn't fall in this column, but the additional planning and expenditures that go with it, do. So those are the big drivers for about 2015, does that sound right to you?
DR. CLEARY:
A. That sounds consistent.
KELLY, Q.C.:
Q. Right, and if we look out across 2016, '17, '18, we get out to '18, '19 and '20 and the numbers go up. Do you know why those numbers would go up?
DR. CLEARY:
A. I would say that it's a slight increase in 2018 and '19 and then 2020 is a big increase. I guess part of it may have to do with Muskrat Falls and I'm not quite sure.
KELLY, Q.C.:
Q. What does that mean?
DR. CLEARY:
A. The increase in rates or the increase in supply costs, I guess.
KELLY. Q.C.:
Q. No, Dr. Cleary with respect it's not. This is the utility sector contribution to GDP,

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so it's measuring real things, isn't it? What it is is quite simple. It's more kilowatt hours of energy being produced at Muskrat Falls, sold out of the province to Nova Scotia. It's not the rising price, it's the kilowatt hours going out, correct?
DR. CLEARY:
A. Well that makes sense because I do know that it's a substantial increase in generation, yes.
KELLY, Q.C.:
Q. But it's sales outside the province. So when you look at it, this line is driven by a whole bunch of factors, but not by Newfoundland Power's sales, agreed? And in order to put that in perspective, let me take you to the current forecast. Samantha, if we could go to document 4 in the Newfoundland Power material? Sorry, to the Newfoundland Power forecast, which is before that. It's in the same—there you go, go to page 5 at the second paragraph from the top and you will see there, Dr. Cleary, it says, "Energy sales under"—this is three lines from the bottom, second paragraph, "Energy

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sales under proposed rates, which include the elasticity effects of the proposed 2.5 percent increase are forecast to increase by .6 percent in 2016 and 0.1 percent in 2017." Virtually flat, do you see that?

(10:45 a.m.)

DR. CLEARY:

A. Yes, I do.

KELLY, Q.C.:

Q. Right, and that's—let's turn back one page now to page 3 in the last paragraph. The last paragraph says, "Overall growth in key economic indicators, such as service sector gross domestic product, employment levels, household disposable income and housing starts will be significantly lower during the forecast, as compared to recent history. Given Newfoundland Power's customer base, energy sales' growth is primarily influenced by the domestic economy and these key economic indicators." So it's the ones we looked at about the employment effects, the lower—people losing their jobs, people being out of work and the housing starts which we saw were consistently down, which drives

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Newfoundland Power's position, agreed?

DR. CLEARY:

A. That's what this report is suggesting.

KELLY, Q.C.:

Q. Right, and this report is the forecast report for the test year, agreed?

DR. CLEARY:

A. Agreed.

KELLY, Q.C.:

Q. Now, I want to turn next, Dr. Cleary, to talk a little bit about business risks and maybe the place to start with is if we go to NP-CA-018 and Samantha, if you could go over to, I think down the next page—sorry, just go back for a second, another bit back. Next page, there we go. Now, this is how the ratings are set out by Moody's, correct, for their qualitative and quantitative factors?

DR. CLEARY:

A. Yes, that's correct.

KELLY, Q.C.:

Q. Right, so the qualitative factors are essentially 60 percent and the quantitative factors are 40 percent?

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DR. CLEARY:

A. That is correct.

KELLY, Q.C.:

Q. Now, let's go to your report next at page 17 and if we look the quote there, that's a quote from the Consumer Advocate, not from the Board, isn't it?

DR. CLEARY:

A. That's correct and I acknowledged that in response to a RFI.

KELLY, Q.C.:

Q. Right, in fact, NP-CA-004?

DR. CLEARY:

A. It could be.

KELLY, Q.C.:

Q. Put it up Samantha? So you confirm that?

DR. CLEARY:

A. Yes, because I do, you know, I describe it as such, right above there I say "according to the Consumer Advocate", so it's not suggesting it was a Board

DR. CLEARY:

A. - vision, I just thought that was a very good synopsis of Newfoundland Power.

KELLY, Q.C.:

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Q. So, you took the Consumer Advocate's description of Newfoundland Power –

DR. CLEARY:

A. I didn't take it. When I was writing up my report, I remembered reading it and said, oh, that's a very good synopsis of the things that I've concluded. So, that's why I used it.

KELLY, Q.C.:

Q. Now, can we put that back on the screen, Samantha, page 17. There we go. And in that quote, it talks about "yet fairly steady customer growth three lines down". An as we just saw that's not there anymore, is it? We looked at 2017 with 0.1 percent for the next year. Agreed?

DR. CLEARY:

A. Yes, I would have to, in retrospect, that's one statement that's maybe not as consistent with today.

KELLY, Q.C.:

Q. Right, that's a change that has occurred as we look forward out over the test year. Agreed?

DR. CLEARY:

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A. Yes, agreed.

KELLY, Q.C.:

Q. Now, you heard or I assume you've read Mr. Smith's evidence that a 1 percent drop in sales from the 1 percent to what we'll have next year is equivalent to about 2 million dollars in operating costs contribution, do you remember that?

DR. CLEARY:

A. I can't recall that specific figure.

KELLY, Q.C.:

Q. Okay. Will you take it, subject to checking the transcript, I can give you the transcript reference, March 31, page 96.

DR. CLEARY:

A. Could you repeat that again?

KELLY, Q.C.:

Q. A 1 percent drop in growth means you don't get contribution of—it's worth 2 million dollars at the operating level, after you—6 ½ million in total revenue, got to take out the purchase power expense, 2 million dollars loss, at the operating level.

DR. CLEARY:

A. Well, I mean if he said it, that's fine. I don't know without really, truly thinking about it if that number makes sense to me.

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KELLY, Q.C.:

Q. Okay, you haven't done that analysis?

DR. CLEARY:

A. Well, my analysis shows that if the sales increase and with a 20 percent or 19 percent operating profit margin, then if sales increase 1 percent, then EBIT would increase about .2 percent, right, sorry, it would be .2 percent of that 1 percent increase.

KELLY, Q.C.:

Q. The evidence on the record will indicate that it's worth—1 percent sales growth is about 2 million dollars at the contribution.

DR. CLEARY:

A. Well, sorry, again the 2 million dollars has to be put in context. I don't really—I'm not quite clear on the number of 2 million dollars.

KELLY, Q.C.:

Q. Well, let's go to the transcript then if you want to see it.

DR. CLEARY:

A. Sure.

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KELLY, Q.C.:

Q. March 31, Mr. Smith, at page 96, I believe it is.

DR. CLEARY:

A. I prefer to do as subject to check if that's fine with you.

KELLY, Q.C.:

Q. We've got it on the screen now. Mr. Smith says, "I guess what I would say is when you have a 1 percent sales growth in terms of revenue into the company that looks like 6.5 million dollars. And, of course, Newfoundland Power is about a third of the bill. So, we would get about 2 million dollars of that extra revenue coming in to the company. When you're down to .1 percent, obviously the numbers are 10 percent of that. So, instead of an additional 2 million dollars, you're down to something like two hundred thousand into the company as additional revenue when your sales decline". Accept it now?

DR. CLEARY:

A. Would you mind if I just read this for a second, if you could be patient with me.

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KELLY, Q.C.:

Q. By all means.

DR. CLEARY:

A. Thank you. Again, you know, the numbers say what they say, but I would also note that a 1 percent increase, you could flip it over the other way, too.

KELLY, Q.C.:

Q. Sure, but that would be a 1 percent increase in the circumstances that we just looked at with the Conference Board of Canada talking about falling employment levels, falling housing starts. There is no realistic possibility that that is going to incur out through the forecast period, is there?

DR. CLEARY:

A. It's not projected to be.

KELLY, Q.C.:

Q. It's not projected to be, right. And if you lose the additional contribution, Dr. Cleary, as a finance man, it has two problems associated with it. Number one, you don't have the ability to cover increases in costs between test year periods. And number two, you don't have the

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additional revenue to cover the interest on capital programs until it gets incorporated in rate base at the next GRA. Agree with those two principles?

DR. CLEARY:
A. Not necessarily they would be to the next GRA.

KELLY, Q.C.:
Q. Sorry?

DR. CLEARY:
A. Not necessarily the next GRA. There would be a lag from the test year in terms of getting passed through the RSA or the capital expenditures. Did you—sorry, the interest on capital expenditures –

KELLY, Q.C.:
Q. Interest on capital expenditures because the company has to fund the capital expenditures, do the work, wait until the next GRA to get them incorporated into rate base. Somebody has got to carry that in the meantime. That's the company where the additional contribution from sales growth helps. If you don't have it, you don't have it, agreed?

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DR. CLEARY:
A. I would agree that positive sales growth is better that negative sales growth.

KELLY, Q.C.:
Q. Right and if you have negative sales growth or no sales growth, it presents challenges because you don't have the extra contribution to cover increased operating costs and interest costs on capital projects.

DR. CLEARY:
A. But those prudently, you know, incurred costs would be get passed on.

KELLY, Q.C.:
Q. No, they don't, not between test years to the next GRA.

DR. CLEARY:
A. Right.

KELLY, Q.C.:
Q. So, the only way you could do it is have more frequent test years, more frequent GRAs, agreed?

DR. CLEARY:
A. Well, that's always true.

KELLY, Q.C.:

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Q. Okay.

DR. CLEARY:
A. That's always true that if your forecast for the test years and you exceed your cost for the test years, that you're going to have to carry it until it's redone.

KELLY, Q.C.:
Q. And now we don't have the growth to help with that. So, what goes with your package, you see, is okay, we're going to have to come back more often to address problems.

DR. CLEARY:
A. Sorry, I'm starting to get a little bit confused here that you're suggesting to me that now Newfoundland Power cannot forecast test years well during a projected decline in revenues or sales.

KELLY, Q.C.:
Q. You're not following how the regulatory process works. Let me try you again. You do a forecast.

DR. CLEARY:
A. Right.

KELLY, Q.C.:
Q. So we have –

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DR. CLEARY:
A. But doesn't that forecast not include a forecast for a decline in -

KELLY, Q.C.:
Q. Right, for 2017.

DR. CLEARY:
A. - kilowatt hours.

KELLY, Q.C.:
Q. For 2017 the forecast is set.

DR. CLEARY:
A. Right.

KELLY, Q.C.:
Q. But out to the next one, any increase in operating costs before the next one—so, if you were trying to be out in 2018, any increase in operating costs in 2018 doesn't get picked up.

DR. CLEARY:
A. I understand what you're saying, but what you're suggesting is that they're not going to be as good at forecasting during this period although they've been very good at forecasting in the past.

KELLY, Q.C.:
Q. No, you're not getting the point because –

DR. CLEARY:
A. Well, continue to explain to then -
KELLY, Q.C.:
Q. Okay, no, I –
DR. CLEARY:
A. - why what you're suggesting is not saying that there's extra risk because they're going to be able to forecast as well as they have in the past. That's what I'm taking from this.
KELLY, Q.C.:
Q. Okay. I'm going to leave –
DR. CLEARY:
A. I understand that there's forecast risk involved.
KELLY, Q.C.:
Q. Right.
DR. CLEARY:
A. We can both agree on that, but I don't see the logic why they do a worse job at forecasting than they have over the past 25 years.
KELLY, Q.C.:
Q. It's not a matter of forecast risk. Forecast risk is another risk, it could be

lower. But if you have a three year GRA period and it's 2016 and 2017 is the test year, then what happens in 2018, if you have no growth and operating expenses have gone up, the company has to swallow it or come in for GRA. Are you with me now?
DR. CLEARY:
A. I'm with you now, but the implication I was getting was you were suggesting that for 2016 and 2017 –
KELLY, Q.C.:
Q. No, no, you misunderstood my question. So, you don't have it in 2018 and you don't have any addition to cover the interest on your capital programs going out through 2017, 2018 until you come back again. Those are the financial risks which go with no growth. Do you follow me now?
DR. CLEARY:
A. Potential risks.
KELLY, Q.C.:
Q. Okay. Well, the potential is because of growth which is an agreed item in the forecast. So, I'll go on.
DR. CLEARY:

A. Sorry, but it's a forecast, right.
KELLY, Q.C.:
Q. Yes.
DR. CLEARY:
A. It's not laid in stone. These are economic forecasts. You can't say they're going to turn out exactly as planned.
KELLY, Q.C.:
Q. Absolutely agreed which is why the risk could turn out to be worse and it could be forecast as well.
DR. CLEARY:
A. And it could turn out to less, and it could turn out to be less.
KELLY, Q.C.:
Q. Well, the provincial economy would have to have marked improvement from what the Conference Board says it would be. Let me take you to another question now. We know, the Board knows because it has already approved substantial expenditures for Newfoundland and Labrador Hydro, 119 million for the gas turbine, 230 million for the 230 kilovolt line, 77 million for the capital program for 2015 and 184 million for 2016

capital expenditures; about 600 million in total.
DR. CLEARY:
A. That sounds about right, as I recall.
KELLY, Q.C.:
Q. And they're going to flow through to customers once Hydro's GRA is dealt with and these expenditures get dealt with, quite apart, from any event, Newfoundland Power's expenditures. Are you aware those effects?
DR. CLEARY:
A. Yes, I would actually like to make a comment on that .6 billion dollar figure that you mentioned. They're not all going to occur this year. They're going to be spread out through time.
KELLY, Q.C.:
Q. Agreed.
DR. CLEARY:
A. And when I look at the forecasts from the exhibits provided by Newfoundland Power, they're forecasting capital expenditures somewhere just over 100 million per year during the test period and that's fairly consistent with their historical capex, at

least the information I have available. So, lumping the whole 600 million in that one time suggests that this is abnormal, but it's not—you know, the bottom line is the annual capital expenditures seem to be in line with what they have been long term, at least using the company's forecast.

KELLY, Q.C.:

Q. That 100 million for Newfoundland Power is normal, but you're not suggesting, Dr. Cleary, that 600 million for Newfoundland Hydro is normal, are you?

DR. CLEARY:

A. No, I'm just saying that it's within—spread out—put in context, as spread out over a number of years. It's not an extreme outlier, put it that way.

KELLY, Q.C.:

Q. Those costs have to flow through to consumers before we get to Muskrat Falls, do we agreed on that much?

DR. CLEARY:

A. Yes.

KELLY, Q.C.:

Q. Okay. Mr. Chairman, we're at 11:00.

CHAIR:

Q. Okay.

(11:00 a.m. – Recess)

(Resume 11:33 A.M.)

CHAIRMAN:

Q. So, Mr. Kelly, we are back to you, sir.

KELLY, Q.C.:

Q. Thank you, Mr. Chairman. Dr. Cleary, I take it you are genuinely aware that since the last Newfoundland Power General Rate Application in 2013, that Newfoundland Hydro has had some very serious problems on their generating system causing reliability problems through 2013, '14, '15?

DR. CLEARY:

A. Yes, I'm aware there's been some reliability issues recently.

KELLY, Q.C.:

Q. Including the Dark NL experience in 2014.

DR. CLEARY:

A. Correct.

KELLY, Q.C.:

Q. Now out of that, the Board had Liberty Consulting do a report. Did you look at the Liberty Report at any time?

DR. CLEARY:

A. No, I did not.

KELLY, Q.C.:

Q. You did not, okay. And the Liberty Report, amongst other things, pointed out that despite the new combustion turbine which was installed and certain capacity agreements that were put in place, that generation reserves are very low and the risk of outages remain high for the 2015 through 2017 winter seasons, are you aware of that?

DR. CLEARY:

A. I'm aware of the conclusions of said report, I didn't read the actual report.

KELLY, Q.C.:

Q. So you know that there continue to be reliability issues even during this test year period?

DR. CLEARY:

A. Yes.

KELLY, Q.C.:

Q. Okay, now the next thing I want to turn to is the Muskrat Falls' issues, which is you deal with in your report at page 22 and if you scroll down, Samantha, there you go, the

paragraph which begins at line 4 and you, at line 5, you point to Mr. Coyne's comment about potential weather related risks and you say at line 6, "This contradicts assertions made by Newfoundland and Labrador Hydro in response to CA-NLH-115 from the Board's Outage Inquiry where it states", et cetera. Obviously, I take it you read that RFI.

DR. CLEARY:

A. Yes.

KELLY Q.C.:

Q. Did you read others, other RFI responses on the reliability issues surrounding Muskrat Falls in the future?

DR. CLEARY:

A. I did not read the RFIs, more RFIs along those lines. The fact is that, and I think it's been acknowledged here at trial that the reliability issue is currently under study and that there's no definitive answer on it.

KELLY, Q.C.:

Q. So do I understand from this comment that you looked at one RFI out of the sum total

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of the hundreds that have filed in relation to the outage inquiry?

DR. CLEARY:

A. Well, the conclusion is that it's currently under study and that no definitive answer has arisen, which has been acknowledged by Mr. Coyne and so what else can I go on. If it had been decided, then that would be a different matter, but if it's currently under study and there's no definitive answer, how can I comment as to whether it will be increased or decreased as that one RFI responds to.

KELLY, Q.C.:

Q. I'm going to ask the question again which is did you look only at the one RFI?

DR. CLEARY:

A. With respect to this issue, yes.

KELLY, Q.C.:

Q. And I take it Mr. Johnson provided that to you?

DR. CLEARY:

A. I think it was brought into evidence and I read it when I read Mr. Coyne's response, right.

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KELLY, Q.C.:

Q. Okay, now can I take you next to NP-CA-10 and this is the RFI that asks about Muskrat Falls and if I take you down to line 13, you say "Since the matter is currently under review, Dr. Cleary has no way of knowing whether supply risk has increased, decreased or stayed the same; therefore, Dr. Cleary assumes that supply risk has not increased, at least not in any material way." So I take it your report is predicated on an assumption which you've made that supply risk will not increase?

DR. CLEARY:

A. Based on the evidence given that the evidence, one side is arguing it will increase; then there's evidence to say it will decrease. Then I think the logical assumption is to assume it's the same until you get evidence to tell you to revise your beliefs.

KELLY, Q.C.:

Q. Right, which is why I asked you about the Liberty Report and the RFIs because the Board would have a whole lot more

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information as a regulatory board about the risks associated with system reliability than I take it you have, which is why you made the assumption of just nothing, correct?

DR. CLEARY:

A. The status quo.

KELLY, Q.C.:

Q. You assumed, not a status quo because we know that the current status quo has unreliability associated with the problems from 2013, '14, '15. You actually assumed a status quo back to 2012, 2013, didn't you?

DR. CLEARY:

A. Well actually let's back track a little bit here. I'm assuming that there's no reliability, no increase in reliability issues.

KELLY, Q.C.:

Q. Since the last GRA.

DR. CLEARY:

A. Yes.

KELLY, Q.C.:

Q. And that would be a time before Dark NL and all these other expenses, so you're

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assuming, not the existing status quo today, you're assuming the status quo back in 2012 before the last GRA, correct?

DR. CLEARY:

A. Yeah, I guess you could say that.

KELLY, Q.C.:

Q. Yeah, okay. Now, I take it you're aware of "Murphy's Law", what can go wrong will go wrong and its corollary that when it goes wrong, it will go wrong at the worst possible time?

CHAIRMAN:

Q. O'Brien's Law, Murphy was an optimist.

KELLY, Q.C.:

Q. There you go. Now, that's always a problem in the electrical system and did you look at Mr. Smith's evidence of what will happen when Muskrat Falls comes on line if the Labrador Link goes down, from this hearing?

DR. CLEARY:

A. I read it and I can't remember exactly the passage. If you want to refer to the passage?

KELLY, Q.C.:

Q. I'll give it to you in summary form. If you want to see the transcript, I'll take you there. We have currently, these are round numbers, approximately 2000 megawatts of capacity on the island now. 500 is Holyrood which will be replaced by Muskrat Falls. If the line goes down, we'll lose that 500 and we'll get, if it's available, 300 back from Nova Scotia, giving us 1800 megawatts which is the equivalent of the peak load on the island now, round figures.

DR. CLEARY:
A. Yes, I recall that conversation.

KELLY, Q.C.:
Q. Do you remember that discussion?

DR. CLEARY:
A. Yes.

KELLY, Q.C.:
Q. Now there's a couple of problems with that. Number one is you cannot run an electrical system like that, you have to have a spinning reserve. Do you know anything about that?

DR. CLEARY:
A. I understand that that's why you would want to have some generation so you have a

reserve.

KELLY, Q.C.:
Q. You have to have a reserve beyond that.

DR. CLEARY:
A. Right.

KELLY, Q.C.:
Q. And right now, that's about 15, 16 percent requirement, but let's just keep the math simple and call it 200 megawatts and let's take our Dark NL experience. As Mr. Smith explained, those numbers assume every piece of generating equipment runs at its optimal performance and in Dark NL, we've got ice in the Exploit's River which dammed up a penstock, 50 megawatts gone. Stephenville gas turbine didn't work, 50 megawatts gone. An axial vibration on another generating plant took out another 32 megawatts, so 132 megawatts gone just right there. So on any sort of analysis we are several hundred megawatts short of what you would need to keep the system stable if Muskrat Falls goes down. Now, do you have any idea where that's going to come from?

DR. CLEARY:

A. Some from Nova Scotia, I would assume.

KELLY, Q.C.:
Q. No, no, but that's already built into it. Even with that, we're going to be several hundred megawatts short for a stable system and I expect the answer is you don't know because we don't know. My next question would be, okay, and who is going to pay to put that generating capacity in existence to have a stable system going forward?

DR. CLEARY:
A. And again, this is all based on Murphy's Law, right?

KELLY, Q.C.:
Q. No, no, you have to have the spinning reserve, that's absolutely required and you can't assume every –

DR. CLEARY:
A. Right, but this whole scenario you're presenting to me is based on Murphy's Law basically, right?

KELLY, Q.C.:
Q. No, sir, about half of it is based on Murphy's Law and half is based on the requirement of a spinning reserve which you

need on the system. And so my first question was how is it going to happen? You don't have an answer and we don't have an answer. Who is going to pay for it? You don't have an answer, we don't have an answer but somebody is going to have to put it, there's more cost that has to come to deal with that reliability question, agreed?

DR. CLEARY:
A. But again this is based on the assumption of Murphy's Law that there is going to be such a—such an event would happen, right?

KELLY, Q.C.:
Q. Oh, if you read all the RFIs, as Mr. Smith explained, Hydro says in essence that if they lose the line, it could take two weeks to restore it and lines go down, that's just one of the basic issues. So there's no determination as to who is going to provide that sort of emergency generation. One option is Hydro might have to provide it; another option is Newfoundland Power might have to provide it which would require a significant investment in the system, agreed?

DR. CLEARY:
A. If that happened.
KELLY, Q.C.:
Q. If the Board concluded that that is necessary to deal with the contingencies and the spinning reserve requirements, somebody would have to invest more money in the system?
DR. CLEARY:
A. If they do come to that conclusion.
KELLY, Q.C.:
Q. The Board would be in the best position to assess the risk and need for those expenditures, agreed?
DR. CLEARY:
A. I would agree.
(11:45 a.m.)
KELLY, Q.C.:
Q. Okay, now that problem that we just talked about doesn't include the risks associated with the fact that the load is here in St. John's and all of the lines coming into St. John's have to go through a really narrow corridor on the isthmus of Avalon which is subject to severe icing problems. Do you

have any sense of the problem associated with lines on the isthmus?
DR. CLEARY:
A. Yes.
KELLY, Q.C.:
Q. Okay, and are you familiar enough with what would happen if one or more of the—if the DC line and the AC lines go down on the isthmus?
DR. CLEARY:
A. It would not be good.
KELLY, Q.C.:
Q. It would make Dark NL look like a comfort area because the amount of generation on the Avalon is very small, creating a rea problem. So the Board has to figure out how that's going to get addressed and who is going to spend money, potentially, to address that problem, agreed?
DR. CLEARY:
A. Agreed.
KELLY, Q.C.:
Q. Now, the next thing we have to think about is the 9-billion-dollar cost of the Muskrat Falls project itself and how that's going to

get handled, don't we, we have to think about that problem. And if I take you, we still have the RFI up on the screen, if I take you over to page 2 of your answer to lines 4 to 10.
DR. CLEARY:
A. Yes.
KELLY, Q.C.:
Q. Where you say, "So in other words, if NP's supply cost increase, it can pass on these increased costs to consumers through rates charged, as is usual for cost of service arrangements and if the increase was not anticipated, i.e. in the test year estimates, NP would be able to pass on such unexpected cost increases to consumers through the RSA; therefore, it is not clear to Dr. Cleary what increased risk this poses to NP. In essence, the risk is to the consumer who would pay higher rates but not to NP since NP can pass these additional costs through to consumers." So that assumes that the consumers have the ability to pay, doesn't it?
DR. CLEARY:

A. Yes, as I said, the risk is to the consumers.
KELLY, Q.C.:
Q. Right, if the consumers—and these would be the consumers that we just looked at earlier in my discussion before the break in the Conference Board report where we have decreasing employment levels, decreasing labour participation rates, declining housing starts and negligible growth in household income. We went through all of that, those are the consumers we'd be talking about?
DR. CLEARY:
A. Yes, unfortunately, but again the risk is to them and Newfoundland Power would be able to pass legitimately incurred costs on.
KELLY, Q.C.:
Q. Assuming that they have the ability to pay.
DR. CLEARY:
A. Yes.
KELLY, Q.C.:
Q. In other words, do you understand how that process is going to work?
DR. CLEARY:

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A. I do understand that one of the last things that you're going to stop paying is your power bill, even under tough times and I do agree with, obviously it's not a good outlook for the consumers if they face rising rates at a time when the economy is not growing strong.

KELLY, Q.C.:

Q. But do you understand how the purchase power agreements are going to flow costs through? Do you understand how that mechanism is going to work?

DR. CLEARY:

A. Not all the intricate details but I know that they get passed through.

KELLY, Q.C.:

Q. When in fact we don't know how it's all going to work, there's a lot that's got to get worked out in how this is going to work, which is what creates the uncertainty, so I don't expect you to know because we don't know.

DR. CLEARY:

A. But again, I would say that the evidence suggests that it has worked very well in the

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past, contrary to, you know, I'm sure that there's been tough times before and my evidence suggests there will be tough times again and that's just the nature of the economy, but the evidence shows that they have been able to do so in the past.

KELLY, Q.C.:

Q. Now these increase in electricity rates are forecast kind of at a minimum to be about 50 percent. Some of the rates were currently, a little under 11 cents a kilowatt hour, some of the rates go out as high as 21 cents a kilowatt hour, some of the projections which would be like an 80 percent increase in rates, that's a huge increase in the cost of electricity, agreed?

DR. CLEARY:

A. It's a big increase.

KELLY, Q.C.:

Q. And we didn't have those kinds of increases back in the cod moratorium days, did we?

DR. CLEARY:

A. No, but at the time it was the oil prices, the relative cost, right.

KELLY, Q.C.:

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Q. But we didn't have those increases in the cost of electricity back in the 1990s, this is a new problem that we are trying to deal with, isn't it?

DR. CLEARY:

A. I agree, but again as noted unfortunately you don't have a lot of alternatives and also if you look at, for example Dr. Booth's evidence which showed the average monthly electricity bill, the Newfoundland, you know, they're lower. It still doesn't mean that a 50 percent increase isn't a big event and obviously a negative event for the consumers, but it also doesn't suggest that they have a lot of options in terms of switching when your switching costs are 10 to 20,000 to switch to alternate sources and you're going to need some electricity regardless.

KELLY, Q.C.:

Q. Let me take you to page 2 of the forecast document, which is the document at Tab 4 again and if I take you over to, sorry, page 4, top paragraph and you see about four lines down, five lines down—three lines

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down, "a one percent change in the price of elasticity will result in a change in energy sales of less than one percent. Current analysis indicates that a one percent increase in the price of electricity will result in a .2 percent decrease in energy sales." That's the elasticity effect, do you remember that from Economics?

DR. CLEARY:

A. Yes, I do.

KELLY, Q.C.:

Q. Right, and that's the evidence on the elasticity effects. So if we had a 50 percent increase, that would be a 10 percent decrease in sales, wouldn't it?

DR. CLEARY:

A. That's correct.

KELLY, Q.C.:

Q. Right. And that would be a huge drop in sales, wouldn't it?

DR. CLEARY:

A. If, again, this is an estimate. If this estimate is correct, that would in fact turn out to be a large drop in sales.

KELLY, Q.C.:

Q. And so one of the problems is that we're really in unchartered territory, because the potential price increase is so big that nobody knows how people are going to react to the circumstances, do they? Would you agree with that statement?

DR. CLEARY:

A. I would say that's a pretty broad statement to say "nobody knows how they are going to react". Of course, you never know exactly, but you can suggest that -

KELLY, Q.C.:

Q. Sales will go down?

DR. CLEARY:

A. Sales would go down. By how much is hard to predict.

KELLY, Q.C.:

Q. So on the one hand, you can't therefore assume that consumers will continue to buy all the electricity, which is the thesis that you stated in NP-CA-10, can you? In other words, you can't have it both ways. You can't say I'm going to ignore what we know about the elasticity effects now because it's uncertain, and at the same time

turn around and say, I can pass through all of these increases with complete impunity because rate payers have the ability to pay? You can't have it both ways, can you?

DR. CLEARY:

A. I don't think I was trying to have it both ways. I suggested that they can pass through these costs, and the other thing I would note is that those increases are not going to happen during the test period. So to argue that you need increased rates today to compensate for that situation and – that would not be good, but also you can't assume that sales are going to decrease by .2 percent for each 1 percent increase in the rates.

KELLY, Q.C.:

Q. But all we're saying – you're addressing capital structure. All we're saying is given the uncertainties, given the fact that we know investments are going to be needed in the electrical system, we're saying you need to maintain the existing capital structure so that the utility is properly positioned to deal with these challenges

coming forward. Do you not agree with that proposition as a matter of both good financial management, first of all?

DR. CLEARY:

A. I would agree that you would want to have an appropriate capital structure that would put you in position to deal with that situation, and my recommendation is that 40 percent still puts you in a very good position to deal with that situation.

KELLY, Q.C.:

Q. Now when you say that, do you have any idea of what type of dollars would be needed to invest in the electrical system if Newfoundland Power was required to put up the money to deal with the generation issues that we just talked about?

DR. CLEARY:

A. I don't know the specific number, no.

KELLY, Q.C.:

Q. No, you wouldn't, so you can't therefore make the statement that 40 percent will be sufficient because you don't know how much would be required to invest to deal with the problems, sir?

DR. CLEARY:

A. I disagree with that, 40 percent would be in line with other Canadian regulated utilities. They also face risks, and that's more than a buffer when you consider that 38 percent Quebec and Alberta, and they're fine and they have worse metrics and lower ROEs than Newfoundland Power. So I think that the conclusion that you need 45 percent to deal with this, it's not apparent to me that 45 percent is "the" number. I think 40 percent is an adequate, ample, slack to deal with situations like that.

KELLY, Q.C.:

Q. Do you know of any utility in Canada or North America facing the kind of addition to the system rate base as will come from the Muskrat Falls addition?

DR. CLEARY:

A. Not relatively speaking.

KELLY, Q.C.:

Q. No, okay. Now let me take you back to NP-CA-10 and to the end of page 2 and top of page 3, and this refers to the statement which is in Moody's Report, and at the top of page 3, you say, "In short, the statement by Moody's is in all likelihood based on their discussions with NP". Do you have any basis to conclude that Moody's didn't do their own independent assessment of the risks associated with Muskrat Falls?

DR. CLEARY:

A. I have no specific evidence to suggest that, but I do know how debt rating agencies work, and a lot of what they do is based on consultations with the companies who they pay for their ratings.

KELLY, Q.C.:

Q. And do you not agree that a company like Moody's does its own independent assessment?

DR. CLEARY:

A. I would agree that they do some independent assessment, but they also do rely heavily on statements from the companies, and we saw that in Enron, which was discussed, for example.

KELLY, Q.C.:

Q. Now can I take you back to page 19 of your report for a minute, because you made the observation a couple of times about what

risk occurs in the test year period, et cetera, and at page 19, line 15, you make this observation, "Further, given its low risk business model, a company with strong regulatory support, there is no obvious reason that a weak economy represents a significant increase in permanent business risk for NP". Why do you use the word "permanent"?

DR. CLEARY:

A. Because the economic conditions are not permanent. It's definitely not a positive economic outlook, but -

KELLY, Q.C.:

Q. As we saw, those deteriorated economic conditions will extend way out to 2020 because we went through that earlier, but Muskrat Falls, which is a fixed cost which is going to come into the system, will go on far, far into the future, won't it?

DR. CLEARY:

A. Yes.

KELLY, Q.C.:

Q. So the risks associated with Muskrat Falls will, in fact, be a permanent change in

risk, will it not, the price impacts?

DR. CLEARY:

A. The price impacts will be permanent. If there's any other issues with respect to additional risk, we can't say for sure that there will be an increase in the additional risk.

(12:00 p.m.)

KELLY, Q.C.:

Q. Dr. Cleary, Dr. Booth kind of said "the elephant in the room was interest rates, but the elephant in this room is really Muskrat Falls", isn't it, and we've had a very spirited debate in this province about the colour of the elephant. There are those who say we really need Muskrat Falls because Holyrood is falling down and worn out, and there are those who say, gee, the cost of it is going to be prohibitively expensive, but the one – there are two things that everybody agrees on. Number one is Muskrat Falls costs are coming, and number two, it's a big elephant. Do you agree with that?

DR. CLEARY:

A. I'd agree that the costs are coming.

KELLY, Q.C.:

Q. And they're big.

DR. CLEARY:

A. I don't know what you mean by "big elephant".

KELLY, Q.C.:

Q. Well, 9 billion dollars is a big number relative to our systems?

DR. CLEARY:

A. It's a big number.

KELLY, Q.C.:

Q. And what we've got to be doing now is we've got to be focused on getting ready for those challenges. We got to have the operational things right, and we only got three years to do it, and we have to have the financial strength to deal with the challenges which are coming, and as a finance professor, do you not agree that we need to position now to be ready for those challenges?

DR. CLEARY:

A. As a finance professor, I think they're very well positioned now, and they would be very well positioned even with an equity ratio of 40 percent.

KELLY, Q.C.:
Q. But you don't have any of the understanding of the numbers that justify that conclusion. We talked about that a few minutes ago. I want to shift gears a little bit now and talk about the quantitative assessment that you've done. First of all, on the fair return standard, credit metrics or creditworthiness is only one of the three factors. Do we agree on that?
DR. CLEARY;
A. Definitely.
KELLY, Q.C.:
Q. We also need to have comparable returns and capital attraction, the ability to bring in capital?
DR. CLEARY:
A. Yes.
KELLY, Q.C.:
Q. Right, and capital attraction with the issues that we've just talked about will be an important factor because we may need money for various things, agreed?
DR. CLEARY:
A. Yes.

KELLY, Q.C.:
Q. Now one of the things you did in your report, if I can take you to page 23, it begins at the bottom of page 23 when you talk about business risk, and you read over to the top of page 24 with the definition – scroll up a bit, Samantha, there we go, and then you look at operating income volatility?
DR. CLEARY:
A. Yes.
KELLY, Q.C.:
Q. And that's essentially looking back to see what's happened in the past, correct?
DR. CLEARY:
A. Correct.
KELLY, Q.C.:
Q. So it's looking historical, not forward? By definition, that's what you got -
DR. CLEARY:
A. You look at historical information based on the premise, and this is why people look at historical information for anything based on the premise that it will be a useful predictor of the future.

KELLY, Q.C.:
Q. So it's based on the premise that the future will look like the past?
DR. CLEARY:
A. Not exactly, but that the past gives you some indication of what the future will look like, yes.
KELLY, Q.C.:
Q. Now can I take you to NP-CA-14, and the question that you were asked in this one is, "Were you aware of any Canadian or U.S. utility regulators that have used this measure of EBIT volatility to determine a utility's equity ratio", and your answer at line 6 is, "To the best of Dr. Cleary's knowledge, his measure of EBIT volatility have not been used in recent regulatory hearings in Canada, nor is he aware of any proceedings that rejected the use of such". So you're not aware of any regulator which has used this approach to determine creditworthiness or business risk?
DR. CLEARY:
A. And if you read down through the rest of the response, I find that surprising because the

coefficient variation of EBIT volatility, or EBIT volatility, if you will, is a standard measure of business risk seen in finance textbooks, accounting textbooks, the CFA curriculum. It's very widely known, so when I'm reading through the evidence and I'm looking at debates such as we're having and such as have gone on here about qualitative issues, which are important because they should lead you to a direction, it struck me that while it seems that there's a good way to get to the bottom of all this, if you will, and look at the operating income and if there's a lot of volatility in operating income, that suggests that there's volatility in sales that could be causing that, that there's volatility in your operating costs that could be causing that, and that's why the coefficient variation in EBIT is used as a way of categorizing firms as low business risk to high business risk. I come at it from another perspective that also I spent, as a commercial lender, as a textbook writer, as someone who prepares cases for teaching finance, I look at

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companies not just in the utility industry, but all different kinds of industries, and that is a standard tool that I would use to qualify, for example, that firms in the manufacturing industry have much more business risk than regulated utilities, and that would show up in the coefficient of variation of EBIT. So the fact that it hasn't been in any Canadian hearings, it doesn't mean that it's not a good approach to use because it strikes me, reading from the Canadian hearings, that it always ends up into a "he said, she said" kind of debate over some of these risks, which I think in some cases the differences are minor. Secondly, you know, I said, well, let's see if the data bears this out, and clearly when I did the analysis, all my qualitative conclusions were very strongly verified that holding companies from the U.S. with some non-regulated competition, with historic test years, infrequent hearings, more generation, of course, they have more business risk and then my measure verifies that. Secondly, I would note that this idea

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of using the coefficient of variation, which Mr. Coyne asked me a question about it, or mentioned it in rebuttal, I notice that he used the coefficient of variation ROE in those Quebec hearings that were referred to previously. So this idea that the coefficient of variation is something new, well, it's not really new, Mr. Coyne used it with respect to ROE. The reason I don't – I have no problem with using it with respect to ROE, but that to me is – that's measuring the variability in total earnings, which is a function of both business risk and financial risk, because ROE is net income. When you want to look at the business risk portion only, you look at the operating income, and as you can see – as you can recall from my presentation, there's not really a big debate that business risk is variability in operating income and that's the standard definition of it.

KELLY, Q.C.:

Q. Now to come back to my question, you're not aware of any regulator in Canada which has used this methodology to determine equity

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ratios, correct?

DR. CLEARY:

A. That would be correct, and also with respect to the U.S., to go through all of the hearings or whatever, but I have to do that some time because I strongly suspect that it's been used in a lot of U.S. hearings.

KELLY, Q.C.:

Q. But you can't tell this Board that any U.S. regulator has used it either?

DR. CLARY:

A. I cannot tell you that, no, I agree.

KELLY, Q.C.:

Q. Can we go to the next one, NP-CA-015, and in this one you were asked whether any debt rating agency uses this measure of EBIT volatility to determine the utility's business or financial risk, and your answer at line 6, "To the best of Dr. Cleary's knowledge, his measure of EBIT volatility have not been used in recent debt rating reports". So the debt rating agencies don't use it either?

DR. CLEARY:

A. I have not seen it in any debt rating

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reports, but I will say that I have seen it in equity analysts' reports.

KELLY, Q.C.:

Q. But not in debt ratings?

DR. CLEARY:

A. Not that I have seen. It doesn't mean they're not out there because there's lots of debt rating reports I haven't read.

KELLY, Q.C.:

Q. Sure, but you're not aware of any that you can point to where debt rating agencies have used it?

DR. CLEARY:

A. Not that I'm aware of.

KELLY, Q.C.:

Q. Now the next question I have – probably the best thing is if I take you over to page 35.

DR. CLEARY:

A. Of my direct evidence?

KELLY, Q.C.:

Q. Yes, please. I don't want to spend very much time on this, I think we can do this fairly quickly. At lines 8 through 20, in particular, I take you down to about line 10 to 11, you say, "I used the financial statement data provided in Exhibit 3 by NP to construct the estimates". So you did certain estimates based on certain factors to try to work out what you thought credit metrics would be, agreed?

DR. CLEARY:
A. Based on the numbers provided by Newfoundland Power, and based on their marginal tax rates they estimated for 2016 and 2017, based on their depreciation estimate, right, based on their factors affecting the CFO pre-working capital or pre-WC, excluding the net income, and then what I did was it allowed net income to vary with the ROE and ER assumptions.

KELLY, Q.C.:
Q. So you made certain estimates, and what we then have to do is see, well, what would a rating agency do with all this, and I want to take you to NP-CA-020 where we have all of the other factors, and you were asked, "Moody's Investor Services weights regulatory framework 25 percent ability to recover cost, and earn returns at 25 percent, diversification at 10, etc. Please

provide the values that Dr. Cleary believes Moody's Investor Services will attribute to each of the three factors, et cetera", and your answer was, "Dr. Cleary cannot predict precisely how an analyst at Moody's would evaluate NP relative to these criteria because there are too many factors involved and such a prediction is also based on individual judgment". Agree with that, that's your comment?

DR. CLEARY:
A. Yes.

KELLY, Q.C.:
Q. And so that –

DR. CLEARY:
A. Sorry, I should qualify that. The one thing I can predict is that, as is the case for virtually all of the regulated Canadian utilities and Newfoundland Power, that they will be rated excellent or extremely high on business risk, and that has been the case and unless there's a significant change in the operating environment or the regulatory environment, I would expect that to continue to be the case for Newfoundland Power as

well as most regulated Canadian utilities.

KELLY, Q.C.:
Q. Can I take you over to NP –

DR. CLEARY;
A. Sorry, and just to back up, this does make the point that 60 percent of this has not to do with the credit metrics, and, in fact, I fully believe that, and I do the credit metrics to show that because it's of interest to the Board, and I'm not hanging my hat on the metrics – if anything else, I'm just saying I'm pretty sure that on the other 60 percent they're going to rate excellent to very good, so let's make sure that they don't falter on the financial metrics, which is also part of it, and even if the metrics deteriorated a bit, I still believe that they would maintain their high rating based on that high business regulatory risk because that, as you pointed out, is 60 percent of the story, and because of that, sometimes the rating agencies are willing to overlook metrics that fall even out of the range, whereas in Newfoundland Power's case, I show that they stay clearly

in the range, but I've seen reports where companies, Canadian utilities, are actually below the range, but they still got the rating anyways.

KELLY, Q.C.:
Q. Now can I take you to NP-CA-022, and it's the answer at line 7 and 8 that I was interested in. You say your analysis was based on the premise that NP would issue additional long term debt to reduce the common equity ratio. Its calculations suggest that a debt issue in the vicinity of 125 million dollars would work. I'm a little bit puzzled as to how you got 125 million dollars?

DR. CLEARY:
A. Okay. Do you mind if I open up my – I can tell you conceptually that I assumed that the equity ratio didn't change – sorry, the common equity component did not change going into 2016, what was based on Newfoundland Power's Exhibit 3, and that rather than pay out a special dividend, which my understanding was what they were thinking was to pay out 55 million and reissue 75

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million in debt, I said, okay, what would it take to get this to a 40 percent equity ratio and with an extra 125 million, they would get to that 40 percent equity ratio because they would have then more debt on board.

KELLY, Q.C.:

Q. So what you're proposing is that Newfoundland Power should borrow 125 million dollars and kind of hold it in the treasury, is that kind of what I understand?

DR. CLEARY:

A. No, that's not what I'm proposing at all.

KELLY, Q.C.:

Q. Okay.

DR. CLEARY:

A. I'm saying under this scenario which would bring the equity ratio and the ROE, this is a possibility, knowing full well that Newfoundland Power has at its discretion, and they have people who work in the finance department who would figure out what would make the most sense for them in terms of a combination of issuing debt and paying dividends.

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KELLY, Q.C.:

Q. Okay.

DR. CLEARY:

A. So I'm not assuming that, but for illustrative purposes, I had to make some assumption. Having no way of knowing how they would do it, I chose that.

KELLY, Q.C.:

Q. That's helpful because I was trying to understand. So what that would mean is we'd issue 125 million dollars, whether we immediately need it or not, but, of course, that would have an interest cost to customers right away, wouldn't it?

DR. CLEARY:

A. Of course.

KELLY, Q.C.:

Q. Right.

DR. CLEARY:

A. As I said, I'm not recommending that, although I would say, and again as noted in my direct, that if you're going to change your capital structure and issue debt, this is a very good time to do it with the low rates, and that's why a fair number of

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utilities in Canada have been issuing debt over the past two to five years.

KELLY, Q.C.:

Q. I've got one more question I wanted to ask you about, and that is in your evidence earlier, I think when Mr. Johnson was asking you questions, you made an observation that most Canadian utilities have an S & P rating and a few utilities have a Moody's rating?

(12:15 p.m.)

DR. CLEARY:

A. I wouldn't say most. I would say more have an S & P rating than a Moody's rating.

KELLY, Q.C.:

Q. Right.

DR. CLEARY:

A. And almost all of them that issue debt have a DBRS rating.

KELLY, Q.C.:

Q. S & P in Canada eventually took over CBRS, agreed?

DR. CLEARY:

A. Exactly, Canadian Bond Rating Service.

KELLY, Q.C.:

Q. Do you know why Newfoundland Power doesn't

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have an S & P rating?

DR. CLEARY:

A. I understand there was an issue some years ago with potential downgrade or something along those lines.

KELLY, Q.C.:

Q. Right, and so we lost our CBRS, then S & P rating. It then took several years as part of the company's ring-fencing to get the Moody's rating to replace it, and as you indicated to the Board earlier, you need two in order to be able to issue the debt, right?

DR. CLEARY:

Q. Right, but as you mentioned, the ring-fencing has taken place, and as Dr. Booth mentioned, which I know to be the case, S & P has a policy where they do not give the operating company – sorry, they do not give the holding company a higher rating than the operating company, right.

KELLY, Q.C.:

Q. Are there any other rating agencies operating in Canada other than those three?

DR. CLEARY:

A. Those are the three that I note for utilities. I'm quite sure that some of the Canadian companies listed in the U.S. have Fitch ratings as well.

KELLY, Q.C.:

Q. Fitch is in the U.S., but those are the only three effectively in Canada?

DR. CLEARY:

A. Well, for the Canadian utilities, those are the three biggies.

KELLY, Q.C.:

Q. Thank you, Dr. Cleary, those are my questions.

DR. CLEARY:

A. Thank you.

CHAIRMAN:

Q. I guess I'm over to you, Madam?

GREENE, Q.C.:

Q. Yes, thank you, Mr. Chair. I have no questions for Dr. Cleary.

CHAIRMAN:

Q. Okay, Mr. Johnson, do you have any re-direct?

JOHNSON, Q.C.:

Q. No re-direct, Mr. Chairman.

CHAIRMAN:

Q. I guess we're finished, are we, for today, is that right?

JOHNSON, Q.C.:

Q. Yes.

CHAIRMAN:

Q. Gee, what am I doing? Excuse me.

VICE-CHAIR WHALEN:

Q. I have no questions. Thank you, Dr. Cleary.

CHAIRMAN:

Q. No questions. Thank you, sir.

DR. CLEARY:

A. Thank you very much.

CHAIRMAN:

Q. So tomorrow morning at 9 o'clock again, is that correct, or 9:30?

MS. GLYNN:

A. No, no, 9 o'clock.

CHAIRMAN:

Q. Okay, thank you very much.

(UPON CONCLUDING AT 12:18 P.M.)

CERTIFICATE

I, Judy Moss, do hereby certify that the foregoing is a true and correct transcript of a hearing in the matter of a General Rate Application by Newfoundland Power Inc. to establish customer electricity rates for 2016 and 2017 heard on the 11th day of April, 2016 at the Public Utilities Commission office, St. John's, Newfoundland and Labrador and was transcribed by me to the best of my ability by means of a sound apparatus.

Dated at St. John's, NL this
11th day of April, 2016

Judy Moss
Discoveries Unlimited Inc.

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