(9:00 a.m.)
CHAIRMAN:
Q. All right. Good morning, everybody. Any preliminary matters?
KELLY, Q.C.
Q. No, Mr. Chairman.
CHAIRMAN:
Q. I just got one, please.
KELLY, Q.C.
Q. You're up first.
CHAIRMAN:
Q. Yeah, well, you seen this cane I've been using. I got an appointment tomorrow morning at 8:15 with a orthopedic surgeon, and it's like getting to see God, apparently. So I don't know how long I'm going to be. So we were thinking maybe we'd start at 10:00, would that be all right?
KELLY, Q.C.
Q. Certainly, fine.
CHAIRMAN:
Q. You know, I may be sooner, but I don't want to keep people waiting, but if I miss this appointment, it's just as well for me to, you know, forget about it. I'll be crawling

around. So if that's acceptable, we can start at 10:00 tomorrow morning.
KELLY, Q.C.
Q. That's fine, Chairman.
CHAIRMAN:
Q. Okay, thank you very much. So I guess we're back to you, are we, sir?
MR. LAURENCE BOOTH, RESUMES STAND, CROSS-EXAMINATION BY IAN KELLY, Q.C.
KELLY, Q.C.
Q. Yes, thank you, Mr. Chairman. I'll continue with Dr. Booth in just a moment. One of the things I've done is I've provided a handout and I don't know if Board counsel want to mark that first.
MS. GLYNN:
Q. We'll mark that as Consent No. 19.
KELLY, Q.C.
Q. 19. Now, Dr. Booth, I won't come to that right away, but when we finished up yesterday, Dr. Booth, we were looking at the various--some of the judgment factors that go into determining the cost of capital and into your analysis and evidence and we had talked about methodology and I want now to come to the

capital asset pricing model itself and we'll talk a little bit about that, and I guess we can agree, there are three basic factors that go into the capital asset pricing model. There is the market risk premium, the beta, and then interest rate.
DR. BOOTH:
A. That's correct.
KELLY, Q.C.
Q. Okay. Now we'll talk first then about the market risk premium or the overall premium in the market. That's an area that obviously requires an exercise of judgment as well?
DR. BOOTH:
A. True. Judgment, as I say, constrained by the facts. We do have 80 years of history and we can't just throw that out.
KELLY, Q.C.
Q. I'll accept that, and so that we don't spend too much time, if I take you to Consent 18, the Chairman of the BCUC was asking you a week or so ago about the capital asset pricing model. I'll take you over to 721, just to set up his question.
DR. BOOTH:

A. Yes.
KELLY, Q.C.
Q. Line 6 and 7 and 8, he gave you a quote from H.L. Mecken, "there is always an easy solution to every human problem, neat, plausible and wrong" and he asked you, I take it, it would not be your epitaph of CAPM, and you gave him a fairly lengthy answer, and I don't want to take you through all of it. I'll take you over just to page 722, to the top of the page.
DR. BOOTH:
A. Yes.
KELLY, Q.C.
Q. The point, "secondly you want to capture risk, and the CAPM captures that and it captures that in a really elegant way by saying what's the overall market risk premium, and all of our evidence is based upon judgment constrained by facts. The facts are the market risk premium five to six percent, conceivably seven percent." So we have a range of judgment of five to seven percent?
DR. BOOTH:
A. No, I said--I mean, the median in Canada is five percent or 5.1 percent. The median from

the experts is six percent in the US. Conceivably, it is possible, it's a slim possibility it could be up at seven percent. I did testify that around November, December this year, I would have put the market risk premium at about eight percent because the markets were so skittish back in the fall that I could easily believe that the market risk premium at that point in time was eight percent, because the market risk premium varies with the business cycle and conditions in the capital market.

KELLY, Q.C.

Q. So we got five to six, conceivably seven. We'll take that to start, and part of your analysis, as I understand it, comes from Professor Fernandes' study that he did?

DR. BOOTH:

A. That's correct, I look at that as confirmation. I directly estimate my own market risk premium, which I've been doing for a considerable period of time, and my estimate is five percent. I look at the survey by Fernandes and say, oh look, that's what my colleagues have been saying, and I use that as

a reasonableness check, and in fact, use that to say, well, if my colleagues basically think it's five percent, or the significant number think it's either five or six, I use that to say, well, look, I could be marginally low.

KELLY, Q.C.

Q. Okay. Now that was a study in 2008?

DR. BOOTH:

A. It was a study done in the spring of this year, January and February. It was an e-mail survey of finance professors around the world asking them what they thought the market risk premium was, if I remember correctly, 2008, 2007 and asked them whether they changed their market risk premium over time, and it was -

KELLY, Q.C.

Q. Right, because in the table we had on the screen yesterday, it shows market risk premium used in 2008.

DR. BOOTH:

A. That's correct.

KELLY, Q.C.

Q. Okay, and that was a survey of finance or finance professors, not a survey, for example, of financial economists or bank economists or

chief financial officers at institutions, people like that?

DR. BOOTH:

A. He's done a survey of chief financial officers, but he hasn't published it, but I would guess that will be coming out soon.

KELLY, Q.C.

Q. Okay.

DR. BOOTH:

A. But my testimony does have evidence of the market risk premium or expected rates of return by the TD Bank, by the Royal Bank of Canada, and it has evidence from Damodaran of survey evidence in the United States to the market risk premium. So that evidence is already in my testimony.

KELLY, Q.C.

Q. So within that study and your testimony of five to six, conceivably seven, you're at five percent, correct?

DR. BOOTH:

A. That's correct.

KELLY, Q.C.

Q. And if I take you to the NP-CA-12, you used 4.5 percent in 2005 and the first time you

used 5 percent was in January of 2007. So somewhere in 2006, you increased your market risk premium from 4.5 to 5 percent?

DR. BOOTH:

A. That's correct.

KELLY, Q.C.

Q. Okay, and the market risk premium changes over time?

DR. BOOTH:

A. It changes -

KELLY, Q.C.

Q. As obviously it has in your estimation.

DR. BOOTH:

A. Well, absolutely. It's changed in the estimation of every board that's used an adjustment mechanism as well. It's changed both what we would say was secularly or over time since the early 1990s, as I explained in my direct testimony, and then it does change marginally over the business cycle. I think it changed significantly probably last fall, before the market condition stabilized.

KELLY, Q.C.

Q. And so we have you at five percent. We have a range of five to six, conceivably seven. We have Ms. McShane at 6.75 and we have Mr. Cicchetti who has done his analysis and he gets a utility risk premium of 4.35 and he seems to have a beta of about .6, .66, which would you give you an inferred market risk premium for him of somewhere in the 6.6 range?

DR. BOOTH:

A. I would accept that. I mean, I hadn't done that backward analysis of his work. I suggest you ask him that question.

KELLY, Q.C.

Q. I will indeed. I just want to establish out of this discussion that there is a range. You're currently at the bottom end of what you concede the range to be and others have different judgments as to where to be within that range?

DR. BOOTH:

A. No, that's absolutely incorrect.

KELLY, Q.C.

Q. You don't agree with that?

DR. BOOTH:

A. I totally disagree with that, because as I showed in Fernandes', where Fernandes showed it's conceivably the market risk premium is

two percent. There's as many people who think it's two or three percent as there is that think it's seven percent. So when I say conceivably, all I'm saying is well, there is a slim possibility that it could be up at that level of range, but all the historic evidence is that it's five percent and based upon historic evidence in Canada and the United States, it's four and a half to five and a half percent over the last 80 years. Most of my colleagues think that it's five percent. Almost as many think it's six percent, and I mean, the other thing is that what are actual professionals using, and here, I ask questions for what does Mercer think, the people that are valuing and providing the assumptions for Newfoundland Power's pension? And I forgot to mention this yesterday, but these people aren't coming in here as expert witnesses. They're valuing the Newfoundland Power pension and--let's see. This was in the materials that I was going to talk about yesterday, but in response to CA-NP-25, I asked what were the assumptions that Mercers were using to value the Newfoundland Power pension, because my

understanding is that's part of a new deferral account for Newfoundland Power, and I asked what they were using to--well, it looks like I got the wrong reference here.

KELLY, Q.C.

Q. Dr. Booth, we'll get along a lot faster with this if I put the questions and we kind of focus on the question. I'm asking about the market risk premium now and the question of judgment, and is it therefore -

MR. JOHNSON:

Q. Mr. Chairman, I mean, there was a technical malfunction in terms of the witness being able to refer to it, and now Mr. Kelly uses that excuse to move on before the witness can actually support what it is he's saying in response to Mr. Kelly's question. That's not fair.

CHAIRMAN:

Q. I'd kind of like to hear what -

KELLY, Q.C.

Q. I'll -

CHAIRMAN:

Q. - Mr. Booth got to say on that matter, Mr. Kelly. I don't -

KELLY, Q.C.

Q. Fine.

DR. BOOTH:

A. On page 15 of the Mercer report, the value of the Newfoundland Power pension, and I seem to have the wrong reference to the information requests, but it's around about page 77 or 78 of my testimony. That analysis by Mercer, who were basically valuing in the pension, they came out with long run expected rates of return of the Canadian and US equity markets of 8.5 percent, and they estimated the fixed income return of 4.4 percent, which means an implied risk premium of 4.1 percent. Now their fixed income wasn't particularly Canadian, includes default risky bonds, so that's probably above what we would look at as the true return on Canadian bonds, and the equities, it's difficult to say exactly where they came up with--how they calculated the 8.5 percent, but their estimate is 4.1 percent, and if Newfoundland Power said, "well, Mercers, we're not going to use you. We're going to use Ms. McShane instead to provide estimates of the rates of returns in the

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Newfoundland Power pension," I suspect that with those estimates, there wouldn't be an unfunded liability in the pension plan. So these are experts in the financial markets. The Royal Bank of Canada's experts are experts. TD economics are experts. Damodaran survey of US investors are experts. They all come up with estimates of the market risk premium considerably lower than mine.

KELLY, Q.C.

Q. And out of that whole big answer, Dr. Booth, haven't we just established that there is a large element of judgment in what it should be? Now you've just given us an example of the people who think it should be below five. You're at five and others are above five. They're at 6.75 and conceivably seven.

DR. BOOTH:

A. Yes.

KELLY, Q.C.

Q. So there's an element of judgment in that determination?

DR. BOOTH:

A. There is an element of judgment, but as I've said, it's judgment constrained by the facts.

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When we look at the facts of what does Mercer think it is, professionals in pension valuation, what do investors think it is, what does private economic forecasters think it is, what do people not involved in this hearing think it is, they will come out at my estimate or lower than my estimate. You're referring to the upper end of a range which is provided by estimates on behalf of the company and behalf of the Board staff. But the objective, external evidence is that a market risk premium is less than my estimate. So you've got to say what are the facts out here and how do you weight them.

KELLY, Q.C.

Q. That seems to be a matter of disagreement, Dr. Booth. The next -

DR. BOOTH:

A. I don't think it's a matter of disagreement in terms of what Mercers, the professional actuaries hired by the company to value the pension fund, think the market risk premium is. That's objective evidence. It's here. It determines the unfunded pension liability of Newfoundland Power and these people were

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hired not to provide expert testimony to this Board in terms of the fair rate of return, but to provide expert support for valuing the Newfoundland pension plan.

KELLY, Q.C.

Q. That runs off a different interest rate, doesn't it?

DR. BOOTH:

A. No, what we've got here are just the long term expected rates of return, which is the asset performance on the asset side of the pension plan. You're referring to the way in which the pension plan's liabilities are valued, which is to use the long term corporate bond yield, which is laid down by the Canadian Institute of Actuaries.

KELLY, Q.C.

Q. Dr. Booth, the second element, because let's move on, otherwise we'll be here 'til Christmas. The second element that you have to look at in the capital asset pricing model is the beta, correct?

DR. BOOTH:

A. That's correct.

KELLY, Q.C.

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Q. And the beta is the relative risk of comparable investments, comparable utility investments and that has to be looked at at an expected or forecast or future beta is what we're looking for, correct?

DR. BOOTH:

A. Correct.

KELLY, Q.C.

Q. And so there are a number of judgment elements in that, clearly. One is the determination of comparable securities?

DR. BOOTH:

A. That's correct.

KELLY, Q.C.

Q. Okay, and we're not necessarily looking for comparable operating companies, but companies with similar investment risk, agreed?

DR. BOOTH:

A. That's correct.

KELLY, Q.C.

Q. Okay. But the biggest part of the problem is in the use of the historical data, isn't it? Because what we're really looking for is the expectation going forward into the future and just looking at the raw data is problematic in itself, agreed?

DR. BOOTH:

A. No, I wouldn't say it's problematic. The raw data is what the raw data is. You look at the raw data and then you try and work out what's generated this raw data.

KELLY, Q.C.

Q. Okay.

DR. BOOTH:

A. That's where judgment and experience and expertise come in. As I said yesterday, the raw data, you can hire a statistician to calculate the raw numbers.

KELLY, Q.C.

Q. That's exactly my point. If we look at the raw data, then one has to exercise judgment as to what the expected beta is going to be?

DR. BOOTH:

A. That's correct.

KELLY, Q.C.

Q. Right. In fact, let's go to page 34 of your testimony, and you make the point -

DR. BOOTH:

A. Yes.

KELLY, Q.C.

Q. - down through lines 12, 13, 14, 15 on that page, the second problem.

DR. BOOTH:

A. Yes.

KELLY, Q.C.

Q. Using actual betas, which are simply mechanical and you go on to the next couple of paragraphs to talk about the use of judgment and adjusted betas.

DR. BOOTH:

A. That's correct.

KELLY, Q.C.

Q. Okay, and if we go over to the table on the next page, you have in the far column a set of beta calculations, correct?

DR. BOOTH:

A. That's correct.

KELLY, Q.C.

Q. And the beta that you ultimately adopt as your judgment is a beta of .5?

DR. BOOTH:

A. That's correct.

KELLY, Q.C.

Q. Right, and so if we go over to the calculated betas, and I understand these are five-year

calculations. So if we take, for example, the last line, the 2008 beta, it's .26 over at the end of the line?

DR. BOOTH:

A. That's correct.

KELLY, Q.C.

Q. Okay.

(9:15 a.m.)

DR. BOOTH:

A. That's just a simple average of the betas of the underlying companies.

KELLY, Q.C.

Q. For the five years?

DR. BOOTH:

A. Yeah.

KELLY, Q.C.

Q. Right, and so if we go back--if we just kind of go up that line, in order to get .5, for example, we've got to go back to 1998 that you could actually observe a mathematical calculation of .5 or so?

DR. BOOTH:

A. That's right. You've got to go back to before we had these two major stock market crashes, the internet bubble and what I might call the

credit crisis crash of last year.

KELLY, Q.C.

Q. And if you look down between those two, we even have betas that are close to zero, and in one case, even a negative beta, which is kind of counter intuitive and would essentially be an investor expecting to lose money going forward.

DR. BOOTH:

A. That's right. These are actual historic estimates of the way in which the stock moved with the market and as I mentioned in my direct testimony, the betas go down whenever you get a major stock market crash because what happens then is the market crashes. Utilities don't crash, they're relatively stable, and you get one or two observations that indicate that these are what we expect them to be, defensive stocks, and that affects the estimate of the beta for the five years during which that observation is in the estimation period.

KELLY, Q.C.

Q. So the big -

DR. BOOTH:

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A. As soon as that drops out of the estimation period, you start getting the betas reverting back to where they normally are, which is .4 or .5.

KELLY, Q.C.:

Q. So the big challenge is figuring out what that beta should be going forward and you exercising your judgment, come up with a beta of .5. Ms. McShane has a beta of .65 to .7.

DR. BOOTH:

A. She's clearly exercising a lot more judgment than me, yes.

KELLY, Q.C.:

Q. Okay, and if we look at Mr. Cicchetti, he uses some value line analysis which has .66 to .69.

DR. BOOTH:

A. Well, he's not using judgment. He's using mechanical formula which doesn't apply to utility betas.

KELLY, Q.C.:

Q. Okay. We're going to ask him a little bit more about that, but there's a range of judgment over what the appropriate beta is going forward?

DR. BOOTH:

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A. Well, there's two things. There's mechanical adjustment without any judgment and then there's judgment, and what I'm using is judgment. So I'm looking at the data and saying, well, we can't discard this data. This data actually tells us something. Data is always useful, and you have to understand why we got these betas. So I wouldn't go through and say, look, I don't know anything that's going on. I'm just going to mechanically adjust these because I'm a statistician and I don't know anything. I do know something. I know that those betas went down because of the crash of the internet bubble and the fact that Nortel dragged the market up and down, and I can see that the betas are now going to go down for the next couple of years because we've got this data from basically September 2008 through this year where the stock market went through a vicious decline and then it's gone through a recovery and the utilities have barely moved, and that's what generates this very low beta.

KELLY, Q.C.:

Q. And nobody argues that we shouldn't look at

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the data. Nobody argues that the data is not the data. The question is how does one judge it and what conclusions should one take out of it on a go-forward basis. That's really the issue, isn't it?

DR. BOOTH:

A. That's true. I'm explaining to you what this data is because I sometimes get some lawyers saying "oh, look at this number here, minus .05. That number is silly," and I'm just explaining that number is not silly. I know exactly why that happened and anyone who understands what's happened in the capital markets over the last ten years will be able to explain what's happened.

KELLY, Q.C.:

Q. And the one thing we -

DR. BOOTH:

A. And going forward, just to answer that, you keep coming back to going forward, going forward, the fundamental question is do you think we're going to get another internet bubble? Are we going to get another Nortel dragging the Canadian market up with it and then crashing? Or conversely, are we going to

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have the Americans sort of severely damaging their financial system again? And I'd have to admit that in the past, I've said, look, we're not--we've learned. We're not going to have another internet bubble. So we're not going to see betas down at .1, .2. Betas will revert to their low run average, .4, .5, something in that range, and then along comes the credit crisis and we have another crisis in the capital market. So what I will grant you is that I'm assuming in my going forward beta estimate that utilities will revert to the normal sort of pattern of their betas, consistent with not having another disaster in the stock market. If we have another double dip recession and we have another disaster in the stock market, we're going to continue to have betas down at .1-.2.

KELLY, Q.C.:

Q. Which really wouldn't tell us then anything about investor expectation?

DR. BOOTH:

A. Well, I think right now, investor expectations, we're not going to have that because the market has recovered and the economy has recovered and the Americans have fixed their financial system. So just as I indicated before, after the recovery from the internet bubble, we can see that beta is gradually increasing, which is what we would expect once we're out of a serious stock market crash like the internet bubble, and I fully expect after the experience of 2008, the beginning of 2009 washes out of the estimation period, the estimates of the beta will revert to the low run averages and that's all I'm assuming.

KELLY, Q.C.

Q. So the one thing we agree on is that the mathematical numbers are obviously too low and the question of judgment is what should they be as we look forward?

DR. BOOTH:

A. That is correct.

KELLY, Q.C.

Q. That's the question.

DR. BOOTH:

A. Judgment constrained by the facts.

KELLY, Q.C.

Q. Now the third item, and I don't want to spend

very long on this because I don't think we're really very far apart at all, is what the interest rate should be forecast for next year, correct?

DR. BOOTH:

A. That's correct.

KELLY, Q.C.

Q. That's CAPM requires that piece of information as well, and that requires an element of judgment and the two estimates are not particularly far apart on that, 425 and 450.

DR. BOOTH:

A. That's right. I think in the case of Kathy McShane and I, it's just simply a question that my testimony was filed three or four months after hers and the economy strengthened since then, and what happens is the economy strengthens, demand for credit goes up and interest rates tend to go up.

KELLY, Q.C.

Q. And then I suppose, Dr. Booth, there's an element of judgment in terms of the overall result. You look at the overall result out of the CAPM formula to determine whether that is appropriate?

DR. BOOTH:

A. That's correct. I would say it goes back again to Pierre Trudeau's remark as a smell test. You just don't mechanically come up with estimates. You come up with estimates and then you look at the big picture and you say, well look, does that make sense? And does that--is that a recommendation, are those numbers that I can live with in terms of a recommendation? Do I think that's fair and reasonable?

KELLY, Q.C.

Q. And so, at the end of the day, if you look at the capital asset pricing model, what you get out of it, if I can put this to you, is if you put in low inputs, you'll get out a low number, and the corollary is true. If you put in high inputs, you'll get out a high number. So the question ultimately is in the inputs going into the model, isn't it?

DR. BOOTH:

A. That's the same as everything. In computing we used to have a phrase "GIGO", garbage in, garbage out. If you put garbage numbers into any model, you're going to get garbage numbers

out. If you don't understand what you're doing, you're going to get garbage numbers out. This is why when I teach this material, we never mention comparable earnings because that isn't in any textbook, it's not an acceptable measure of estimating fair rates return, but we do talk about discounted cash flow and we do talk about capital asset pricing model. They're the two basic methods for estimating fair rates of return. I get more problems with students estimating fair rate returns with DCF because the estimates are more prone to error. The capital asset pricing model, why most people like it is you can't be that far off, because you pick up the newspaper you can estimate the risk free rate, and the market risk free rate, we may sit here and say, well, conceivably it could be 2 percent, conceivably it could be 7 percent, conceivably it could be 8 or 9 percent, but historic evidence constrains that. It says it's around 5 percent, 6 percent. So once you plug those numbers in, you take 5 or 6 percent, you add the long term risk free rate, and you're at 9 or 10 percent for the market,

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and that's higher than Mercer estimates it, but that's consistent with 80 years of capital market history. So you've got to look at the whole picture and say does it make sense, and that's where there is an element of judgment, but you can't come out and say that Newfoundland Power needs 11 percent and it's less risky than the market, which means the market needs 30 and 40 percent going forward because he's not compounding that forward, nobody would be in the bond market, everybody would be in the equity market. Those are phenomenally high risk premiums and they've never been experienced on a consistent basis.

KELLY, Q.C.:

Q. I want to talk a little bit next with you about the buying markets and bond yields and see what we can agree with there. You'll agree with me that equity holders have a greater risk than bond holders?

DR. BOOTH:

A. They're exposed to just about every risk, so they weigh all of the risk that go into determining a fair return.

KELLY, Q.C.:

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Q. Right, whereas bond holders, and take, for example, Newfoundland Power's bond holders, are fully secured against the assets of the enterprise?

DR. BOOTH:

A. That's right, Moody's upgraded them, yes.

KELLY, Q.C.:

Q. Now graded A.

DR. BOOTH:

A. Yes.

KELLY, Q.C.:

Q. And graded A by DBRS for some considerable time. So over the last several years, since 2008, we'll agree that the spreads have increased?

DR. BOOTH:

A. Absolutely. Every time we go through a recession, spreads increase, and this time with the crisis of last fall, they increased to what I regard as record highs.

KELLY, Q.C.:

Q. And Newfoundland Power's bonds and the bonds of other utility companies in Canada are primarily held by pension funds and life insurance companies?

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DR. BOOTH:

A. Mainly held by institutions. There's been attempts to try and broaden the market so individuals can buy exchange rated funds that consist of bonds, or they can buy bond mutual funds. That's sort of an indirect investment. It's very difficult for you or I to buy bonds.

KELLY, Q.C.:

Q. They're held by the pension funds and the life insurance companies?

DR. BOOTH:

A. Mainly because those funds have got long lived liabilities and they need long lived assets to match those liabilities.

KELLY, Q.C.:

Q. Exactly the point. In fact, they're held by those funds for long term long periods. They're not normally bought and sold by the life insurance companies or the pension funds?

DR. BOOTH:

A. That's right. That's why the bond market is less liquid than the equity market, as a rule, except for the Government of Canada bond market.

KELLY, Q.C.:

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Q. And you talked yesterday at some length about your view of the liquidity crisis and the forced sale of bonds. I put it to you there's no indication that utility bonds in Canada have been sold off by pension funds or life insurance companies. In fact, it would be quite the contrary to what they would need to do for their own interests?

(9:30 a.m.)

DR. BOOTH:

A. I think it's fair to say that the major institutions didn't sell off their bonds because they were basically unionized. Those bonds were there to match those liabilities. Most of the trading in the bonds is done by bond market mutual funds where they're trying to sort of buy and sell in order to generate a few extra points and beat the indexes, or they're done by the short term traders, but it's not done by the institutions. So I've been asking -- every time there's a hearing involving an investment dealer, somebody from BMO or Royal Bank, I've asked them the same question, can you provide me the data on the trading for, say, Terasen Gas bonds or Gas

Metro's bonds, and they constantly tell me the same thing, this is proprietary, we can't provide this data. So unless I get that data, you can't sort of actually make direct assessments on exactly what was sold off.

KELLY, Q.C.:
Q. So you have a theory as to what happened, but it's pretty clear that what didn't happen is Newfoundland Power's bonds didn't get sold or other utility bonds in Canada?

DR. BOOTH:
A. What Newfoundland Power would have is -- I'm not quite sure who the investment dealer is for Newfoundland Power, but Newfoundland Power, they would have an indicative yield because it doesn't trade that often. So all that would happen is if, for example, it was BMO, if I ask for data on yields on Newfoundland Power's long term debt, they'd provide indicative yields, and you then ask how many trades occurred in that, and the answer generally will be very few, but just to talk about my theory, it's not a theory. The fact is the Federal Reserve in the United States took huge efforts, and, in fact, I've

got it in one of my exhibits, one of my appendices, I think it's "G", listing the tremendous efforts the United States went through to inject liquidity into its capital markets because liquidity disappeared last year. So what we're talking about is not my theory, we're talking about if you look at the Bank of Canada's bond sheet and all of the purchase agreements the bank went into to try and inject liquidity into the Canadian banks, and also to the US banking system. I mean, this wouldn't have happened if there wasn't a liquidity crisis last year.

KELLY, Q.C.:
Q. But the impact on bond yields, especially Newfoundland Power's bond yields, and other Canadian bond yields, is not a direct effect of the sale of those bonds by holders. At most, it's a "knock on" effect from other issues?

DR. BOOTH:
A. It's primarily a "knock on" effect, but as I said, trades didn't occur. They just said, well, I mean, what would be the indicative yield, what would be the price if somebody

tried to sell 10 million dollars worth of Newfoundland Power's bonds, and they said, look, in this market, given how much liquidity, we would quote you this yield, but no transactions probably occurred of that.

KELLY, Q.C.:
Q. But you do know that Newfoundland Power issued bonds back in the spring with a spread of 275 basis points?

DR. BOOTH:
A. That's right, and that spread is now down to 160/170.

KELLY, Q.C.:
Q. About 187, if we look at Undertaking 2.

DR. BOOTH:
A. Okay, but when was that undertaking?

KELLY, Q.C.:
Q. Let's just pull it up.

DR. BOOTH:
A. Okay, because --

KELLY, Q.C.:
Q. Sorry, Undertaking 1, BMO indicative yield on October 2.

DR. BOOTH:
A. So this is pricing?

KELLY, Q.C.:
Q. Yes.

DR. BOOTH:
A. Okay, so, I mean, that's fine, I didn't realize --

KELLY, Q.C.:
Q. So about 187 basis points.

DR. BOOTH:
A. Okay, the -- I was using 160/170 because that's what Terasen Gas -- BMO's underwriter for Terasen Gas, they indicated Terasen Gas would be between 155 and 160.

KELLY, Q.C.:
Q. So if we look at that, they have come down from the high of a spread of 275, but I just want to pick up a comment that you made yesterday and just explore this with you for a minute. Can I take you over to page 142 of yesterday's testimony, and Mike can put it on the screen there for you. Do you have that, Dr. Booth?

DR. BOOTH:
A. Yes, I do.

KELLY, Q.C.:
Q. If I can take you down to -- pick it up about

line 12, for example. You say, "The spreads in the corporate bond market are getting down to where we would expect them, given the severity of this recession. They are still marginally high. In my judgment, they are still 15 to 20 basis points higher than I would expect, given the state of the economy, but they're not ridiculously high compared to where they were three to six months ago", and you're not saying that the spread is now down to only 15 or 20 basis points, if I follow you correctly. What you're saying is it's 15 or 20 basis points higher than where you expect it to be?

DR. BOOTH:

A. Yes, and that's based upon not particularly analysis of Newfoundland Power's bond, it's based upon the Scotia Capital indices of A bond yields, and normally the top out at 150 or so during a recession, and this time they're still around about 160/170. So I would say that there's still some uncertainty in the market, there's still some resistance to buying corporate debt, and the yields are still higher than I would expect at this stage

in the business cycle.

KELLY, Q.C.:

Q. Right. So if I take you now over to the company's evidence, page 313, and I take you down to line 7 and 8, the credit spreads in 2007 were 1.40", in other words 140 basis points, and 1.06 in 2005. So we still have increased credit spreads over the previous bond issue of in the order of 50 to 75 basis points? Do we agree on that?

DR. BOOTH:

A. Yes, and I'd also point out, as I pointed out in my direct, that 2005 and 2007 was pretty much bracket at the top of the market when there was huge liquidity and spreads were basically low. If you go back to the last time we had a recession, had a low down in Canada -- technically, we didn't have a recession, but basically 2001, 2002, 2003, when spreads went up, then spreads for Newfoundland Power's debt, I think, at that time were not that much different from where they are now.

KELLY, Q.C.:

Q. Right.

DR. BOOTH:

A. Because this is a normal cyclical behaviour.

KELLY, Q.C.:

Q. But compared to where we were when we were last -- for example, in 2007, setting rates into 2008 test year, spreads are now still 50 to 75 basis points higher than where they were at that point in time?

DR. BOOTH:

A. That's right, because this is a cyclical behaviour. I mean, spreads just go up and down with the business cycle, and we're not at the same stage in the business cycle now that we were in 2005/2006. Believe me, I'd love to be back in 2005/2006, and we'll get there in another two or three years.

KELLY, Q.C.:

Q. Another two or three years is your estimation.

DR. BOOTH:

A. Yeah.

KELLY, Q.C.:

Q. That's interesting.

DR. BOOTH:

A. That's off the top of my head, but, I mean, we're looking for next year will be a recovery

from a serious recession. The Bank of Canada is predicting 4 or 5 percent growth into 2011. So I would anticipate we'll be back to euphoria, liquidity, and strong equity markets in 2012/2013, and then the banks will make a whole bunch of bad loans again, and we'll be in another recession, 2016.

KELLY, Q.C.:

Q. Is it fair to say you have a fairly optimistic view of getting out over the next two to three years, if you think we'll be that far along in two years, three years out?

DR. BOOTH:

A. Well, you just look at the past. We've actually had recessions, and I keep telling this to my students because if you graduate during a recession, you're going to have a tough time getting a job and the lifetime impact on your earnings is huge, but we had a recession in the early 70s, early 80s, early 90s, early 2000s, but what's remarkable is that ten year cycle hasn't occurred this time. This time we've had it earlier because of the problems in the US sub-prime market destroying big chunks of their financial system.

Normally, I would have expected a recession in another year or two years time, given the sort of basically a ten year cycle in the business cycle.

KELLY, Q.C.:

Q. Dr. Booth, I want to come back briefly to a question we talked about yesterday, which is US data, and let me take you back to Consent 18, the BCUC transcript. I'll take you to page 634.

DR. BOOTH:

A. Yes.

KELLY, Q.C.:

Q. And if I take you down beginning at line 15 -- even start down at line 17, "You've not followed US utilities because you don't consider them to be relevant". Your answer, "That's correct". The comment you made yesterday, "I've been dragged into looking at US utilities because US witnesses constantly bring them in as proxies", and the question, "Have you ever appeared as an expert witness in the US regulatory proceeding relating to a public utility", and answer, "No". Both those answers still correct?

DR. BOOTH:

A. That's correct. I've got no desire to appear in the United States as a witness. I've got a day job and I do enough in Canada to basically keep me busy, so -- and as I said, I'm starting to look at the US simply because we have so many US witnesses coming in to provide testimony in Canada, and I just don't think that's appropriate. You have to look at their evidence; otherwise, it goes uncontested. So I'm looking at US utilities more and more because it's necessary. If we keep bringing US witnesses into Canada, somebody has to sort of make sure their testimony is actually correct.

KELLY, Q.C.:

Q. But you're not following the US utilities per se, are you?

DR. BOOTH:

A. I'm not following them in the sense that if you took me through the questions that Mr. Johnson took Ms. McShane in terms of what's Duke Power doing, or what's AGL doing, then I wouldn't be able to answer and say, well, look their regulated business is this, this, or

this is deferral account. That's the context in which I don't feel that at the moment I have the expertise to testify on unique risks exposed to US utilities.

KELLY, Q.C.:

Q. Okay. Dr. Booth, I'm going to move on next to another question. This deals with a series of questions. This deals with the Automatic Adjustment Mechanism.

DR. BOOTH:

A. Yes.

KELLY, Q.C.:

Q. Now in 1998, in the Board's Order, the Board expressed the view that there could be changes in financial market conditions which would suggest that the formula is not accurately reflecting the appropriate return on equity, in which case it would be reviewed, and I take it from your evidence that there is agreement that that occurred last year, spring of this year?

DR. BOOTH:

A. I can -- my evidence is, and I've testified to this, I can fully understand why, given the depth of the problems we had last fall, why

the utilities would say, well, this is just -- I see change in what's happening in the markets, we want to be reviewed, and as I testified for the Terasen Gas before the BCUC, and it's in my testimony here, the crisis last fall was the worse we've seen in 71 years and when you severely damage the financial system, you damage the whole economy, and that's what precipitated the Great Depression, it precipitated analogies with the Great Depression too last fall, and I can fully understand why in that situation why the utilities would say this is a seismic change in the markets, let's see whether the Automatic Adjustment Mechanism and the ROE is still fair. So I can understand why the utilities did that.

KELLY, Q.C.:

Q. And with spreads, for example, back in the spring of 275 basis points, you don't disagree that it's appropriate to review the operation of the formula going forward?

DR. BOOTH:

A. I can understand why they do it -- they did it. By the spring, you could see that the

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markets were healing, and you could see, for example, the equity market hit its low March 9th, and we already saw that the US banks, the American Government had already basically said we're guaranteeing the big 19 US banks, we're not going to allow them to fail, whereas there was still a suspicion that CitiBank and Bank of America would go bankrupt and these two control 20 percent of the US banking market. So if you allow those to go bankrupt, heaven knows what would have happened to the US financial system.

KELLY, Q.C.:

Q. In your evidence, you've used some pretty strong language, as you did yesterday, the most serious recession, for example, since 1982. I won't take you through all the references.

DR. BOOTH:

A. There was panic in the financial markets last fall. I mean, it would be crazy to deny that. I mean, anybody who lived through -- as an equity investor, lived through September, October, November last year, would say what the heck is going on. In fact, I was

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testifying before the National Energy Board in the TQM hearing the day the Toronto stock market dropped like about 900 points, and people were sort of looking on their Blackberrys what was happening, and after the day's hearing opposing counsel, as well as us, we had a couple of beers and we said what on earth is happening in the market. I mean, it was a shock. There's absolutely no question about that.

(9:45 a.m.)

KELLY, Q.C.:

Q. Can I take you to NP-CA-19. If I take you down to lines 19 and 20, you say, "The conditions that existed in the capital market from September 2008 to March 2009 could not be regarded as normal". So during that period at least, we'd agree that we had appropriate period to trigger the appropriate review by the Board?

DR. BOOTH:

A. Yes, I can understand why the utilities would request that, and my understanding is if the utilities request a hearing and they feel that the allowed rate of return is not reasonable,

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then most Boards will call a hearing.

KELLY, Q.C.:

Q. And if we look across the country, the National Energy Board has already now discontinued the use of its Automatic Adjustment Formula?

DR. BOOTH:

A. Yes. What its done is it's still going to publish the Automatic Adjustment Formula because a number of the class one pipelines are on settlements that rely upon the NEB formula, but we're expecting at any moment for the NEB to call a hearing for Nova Gas because that's moved from provincial Alberta regulation to federal regulation, and TQM itself, because the TQM decision was only for the two years, 2007 and 2008. So they've got to deal with 2009 in the future.

KELLY, Q.C.:

Q. So NEB has discontinued its formula, and the formulas are under review in British Columbia, Alberta, and Ontario?

DR. BOOTH:

A. Alberta, it's a normal hearing because it was five years since the 2003 generic, with the

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2004 decision. So my understanding is that was basically just to review the formula, but clearly the --

KELLY, Q.C.:

Q. But the question is the operation of the formula, whether to continue it will be part of that -- is part of that process?

DR. BOOTH:

A. Clearly I think that became part of the process as the financial market meltdown continued, and the BCUC clearly had a request by Terasen to discontinue the formula for a period of time and to then reconsider the formula in the future. The Ontario Energy Board had a letter, I think it was January, and they had a technical conference, not a hearing --

KELLY, Q.C.:

Q. Just recently?

DR. BOOTH:

A. A couple of weeks ago.

KELLY, Q.C.:

Q. Eight weeks ago, right.

DR. BOOTH:

A. And they're wedded to the formula. They not

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going to change the risk premium method for the ROE formula for the Ontario utilities, but they wanted to know whether it still continues to be valid and whether they should change any of the parameters, and that's really a technical conference to think about changing it. I don't know whether the OEB would just unilaterally change it without a hearing, but having said that, they imposed it unilaterally without a hearing.

KELLY, Q.C.:

Q. They kind of started the process. Where it goes remains to be seen?

DR. BOOTH:

A. That's correct.

KELLY, Q.C.:

Q. We agree on that much.

DR. BOOTH:

A. And the Regie in Quebec, they had a hearing into Gas Metropolitan, GMI, and they -- Gas Metro, the parent company owns half of TQM, and they applied for a change in the regulatory status to move to a network approach, similar to that adopted by the National Energy Board for TQM.

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KELLY, Q.C.:

Q. And if we -- just one last area just to explore on this a little bit. I take you to Consent 18 again, over to page 688.

DR. BOOTH:

A. Yes.

KELLY, Q.C.:

Q. And if I take you down to line 15.

DR. BOOTH:

A. Yes.

KELLY, Q.C.:

Q. This was a proposal which, I gather, you had put forward in British Columbia. You would support a trigger for a review of the BCUC ROE formula if the formula generated a utility risk premium less than twice the current spread on TGI, which is Terasen, long term debt over equivalent maturity long Canada bonds.

DR. BOOTH:

A. Yes. This was actually proposed by ATCO in the generic hearing in 2003 before the -- what was then the Alberta Energy Utilities Board.

KELLY, Q.C.:

Q. So if we took that and we applied that same

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sort of methodology, and, for example, if we had back in the spring the 275 basis point spread, twice that would be 550, which would be significantly above the risk premium from the formula.

DR. BOOTH:

A. That's right. As I said, what I was trying to think of was a way of separating the normal cyclical behaviour in spreads from abnormal behaviour in spreads. So I wouldn't want to trigger a hearing simply because spreads had gone from 80 to 150 because that's what you would expect when you go into a recession, that's entirely predictable. So I was trying to think of a way of triggering a hearing when you get a unpredictable change in spreads, and clearly what we had in the fall and in the spring were spreads well beyond what would be regarded as normal for that stage in the business cycle.

KELLY, Q.C.:

Q. And, Dr. Booth, currently we looked at Undertaking #1 with a spread at 187. So if I took that and multiplied it by two, I'd have 374, correct?

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DR. BOOTH:

A. Yes.

KELLY, Q.C.:

Q. 375, round figures, and your proposed ROE is 775, with 450 as the interest rate, which would give you a risk premium of 325. So even on your analysis versus the current spread, even on that basis, we would still be over this formula trigger point. Do you agree --

DR. BOOTH:

A. I may be dreaming, Mr. Kelly, but I think we're in a hearing talking about fair ROE right at the moment.

KELLY, Q.C.:

Q. Exactly. So we're not quarrelling over the fact that the formula operation needs to be reviewed by the Board, I take it?

DR. BOOTH:

A. No. I think -- I mean, my trigger, just to put it in context, was relative to the BCUC formula. So that spread was what was suggested by ATCO, and I could understand why it would be reasonable in the context of the ROE adjustment formulas, but I entirely agree, and as I've said repeatedly, that we've had

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the worse financial crisis in 71 years. There have been certainly changes in the bond market. I think most of them -- the problems last year were due to the American banks and forced selling of a whole bunch of bonds, but I can fully understand why the utilities would look at that and say things have changed, we need to have a hearing. So I don't object to having hearings when there's significant events that have occurred in the capital markets, where there's reasonable grounds to say we need a hearing to review this. What I don't want to see is hearings every year on basically the same information being put before the Boards when there's more important things for the Boards to do. So I firmly agree with an adjustment mechanism. I don't think there's a lot of sense in reviewing exactly the same things every year right across Canada.

KELLY, Q.C.:

Q. Thank you, Dr. Booth. Those are my questions.

CHAIRMAN:

Q. Mr. Simmons.

DR. LAURENCE BOOTH - CROSS-EXAMINATION BY MR. SIMMONS:

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MR. SIMMONS:

Q. Dr. Booth, I'm going to pick right up there where Mr. Kelly left off, and in particular in relation to the Automatic Adjustment Formula, and if I understand your evidence in relation to the business cycle, you've told us that you would normally anticipate there to be a ten year cycle, the natural business cycle that we would expect, it's been shortened a little bit here because of the events that occurred in late 2008, extending into early 2009, and those events you regard as being outside of the normal business cycle and they're extraordinary?

DR. BOOTH:

A. Absolutely extraordinary. When you actually go and see what the American banks did in terms of their lending practices, you throw up your hands and say how could anyone do this, and the failures of the Standard & Poor's, in particular, in writing structured financial products in the United States, it's really exposing problems in the credit rating market in the United States, and, in fact, the US Courts have just announced a couple of weeks

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ago that they can now be sued because of the ratings they applied to these structured products. So serious problems in the United States that have percolated into Canada and reverberated all away around the world.

MR. SIMMONS:

Q. Mr. Kelly, I understood him to be asking you whether you agreed that in those circumstances, it would have been appropriate for Newfoundland Power to seek a review of the use of the Automatic Adjustment Formula, given those market conditions, and I heard you to say in answer that you understood why they were asking for the review, how that would trigger that?

DR. BOOTH:

A. That's correct.

MR. SIMMONS:

Q. To want to ask for the review. Is there a difference here between saying because of those market conditions, we need to reset the rate for 2010, and saying because of those market conditions there is now some fundamental change, so that off into the future the use of the Automatic Adjustment

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Formula has to be reconsidered?

DR. BOOTH:

A. There is a big difference. My view would be that from September to March, as I indicated yesterday, we were in a situation of uncertainty. We simply didn't know whether the US Government was going to allow CitiBank, Bank of America, and a whole series of other US banks that were in serious financial trouble to go bankrupt, and the process -- there was so much uncertainty that we saw these record high spreads in the bond market, we saw the Canadian dollar drop from a premium down to 77 cents at one point, a significant drop in the value of the Canadian dollar. We saw the Canadian Government intervene to generate liquidity into the markets. The US Government, as I've said, have taken herculean efforts, both on the part of the Treasury in terms of the programs they introduced, and on behalf of the Federal Reserve. At that point, this was by far and away the biggest financial crisis that we have had for 70 years. So if that's doesn't trigger -- if that doesn't justify utility asking for a hearing, it's difficult to see what would justify it, but that's all in the past. Mr. Kelly took me through a lot of things, shouldn't look at the past, should be looking at the future, and the thing is that the US Government has taken all of these measures, they have guaranteed the top 19 US banks. The liquidity spreads or the credit spreads in the short term market have come down. So the US banks are now able to raise capital like the Canadian banks. The economies are recovering with massive fiscal stimulus in the United States. The Canadian economy is recovering. Just about every country in the world has had a recession. We're no longer in this situation of uncertainty where we didn't know what was going to happen. We're now back to a normal business cycle, and as I indicated to Mr. Kelly, I think the A spreads are still high from where I would expect at this stage in the business cycle, but they're not dramatically higher. So I would say at this stage -- would I adjust the adjustment formula simply because "A" spreads are possibly 15/20 basis points higher than I would have expected them at this

stage; the answer to that is no, not really. I don't see that as being significant enough to adjust the ROE formula because even if you assume all of that is due to a risk premium, you're talking about 15/20 basis points, tops, and that is not all due to a risk premium, it's due to other factors in the bond market.

(10:00 a.m.)

MR. SIMMONS:

Q. So in 2010, which is going to be contemplated to be the test year on this application, we can expect there are still going to be some effects lingering from the economic crisis that happened in '08, into early '09, and those effects will have to be taken into account when the rate of return on equity and the rate of return on rate base is set for 2010, but if you are correct, after 2010, you are expecting the financial markets to return to more of a normal situation?

DR. BOOTH:

A. I think they're returning to normal now, so I wouldn't put it off to 2011. In my judgment, 2010 is going to be a normal recovery year, and right now we're seeing forecasts -- for

example, people expect earnings forecast for most major corporations to now be beaten by the companies because as you get into the upswing in the economy, firms beat the earnings forecast because they downsized a lot of their fixed costs and once you get a recovery, you get a quick uptake in earnings, and I would expect 2010 to be recovery year, 2011 will be back to normal, but as I said in my direct, normal is not good. I mean, normal is, given the stage in the business cycle, what's normal. People seem to think that normal is 2005, 2006, 2007. Those were not normal. That was the top of the business cycle, and that's just as abnormal as the bottom of the business cycle. Right now we're early in the business cycle compared to 2002 and 2003 when the ROE was litigated because we had just come out of a very bad recession, but we're on the upswing, and things are pretty close to normal compared to where we are in the business cycle. As I've said, spreads from probably 15 to 20 basis points higher, but it's not -- most of the lingering problems from the six month period from September to

March, '09, have been dealt with. Unless we discover that the US banks have got a lot more liabilities and a lot more debts to write off, and they're written off, close to a trillion dollars worldwide, it's close to 1.3 trillion dollars in bad debts have been written off. That's a huge amount of money and there can't be that many bad debts left in the US financial system. So assuming that they've written off enough and that there's not a double dip, it's difficult to see how you can have any more lingering effects from the financial crisis. So I would say we're back to normal, given the stage in the business cycle, which is the fact that we're still in an uptake.

MR. SIMMONS:

Q. Yesterday when you spoke about the Automatic Adjustment Formula and its introduction, I understood you to say that you had recommended or supported the 80 percent factor in the formula back when it was originally introduced.

DR. BOOTH:

A. That's correct.

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MR. SIMMONS:

Q. Did I understand that correctly?

DR. BOOTH:

A. Yeah.

MR. SIMMONS:

Q. We've heard from Ms. McShane, and I think we'll hear from Mr. Cicchetti as well, that they have some other views on what the appropriate factor is to use other than the .8 or the 80 percent, and I wonder if you have any current views on whether your foresee any need to look at adjusting that 80 percent factor in the future, assuming the Automatic Adjustment Formula continues to be used after 2010?

DR. BOOTH:

A. If the formula were to be rebased, I would now use an adjustment for it probably closer to 1, and the reason for --

MR. SIMMONS:

Q. And why would you do that?

DR. BOOTH:

A. Well, the reason for doing that is that when the formula was introduced in '93, '94, the big problem was the long Canada bond yield,

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not the equity market, but the long Canada bond yield, because we had long Canada yields of 9.25 percent, and because we had 6 percent inflation, we had huge Government deficits. So we had a problem that expected inflation gets factored into the long term Canada bond yield, plus the uncertainty about exactly what the Government is going to do, whether it's just going to inflate its way out of the deficit, or whether it's going to tackle the deficit issues. The Government took the right approach. We had tough medicine in Canada in several years, so we missed out on a lot of the prosperity in the early and mid 90s that the rest of the world experienced, but we're benefiting from that now because the inflation premium has gone out of long term Canada bond yields, the Bank of Canada now has credibility in the capital markets to stick to 1 to 3 percent inflation, and as a result, we've reaped the rewards, and one of those rewards is low interest rates, low capital market opportunity cost in Canada, and as long as the Bank of Canada sticks to 1 to 3 percent, long Canada bond yields are going to fluctuate

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around 4 to 6 percent, somewhere in that range. So the adjustment formula worked because of a structural change primarily in the finances of the Government of Canada, the tax structure in Canada, the rate of inflation, most of those changes have worked their way through. I don't see there being huge potential for tax reductions in Canada. I think we've stripped out most of the excesses in Government spending, and I don't see any ground swell of public opinion for further tax reductions or further program cuts. I don't see the rate of inflation getting out of control. I think the Government has done a very good job in terms of fiscal stimulus, of limiting the amount of fiscal stimulus Canada, and stretching it out over multiple time periods. In fact, if the truth be told, you look at the Government budget deficit, very little of it is structural spending, unlike in the United States. So I see the Government of Canada returning to a surplus over a three to four year period because most of it is what we call automatic stabilizers that fluctuate with

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business cycle. So that's a long answer, saying that the justification for .8, .75, that we used fifteen years ago was based upon capital market conditions where most of that is now out of the system. We're now down to a system where the rate of inflation incorporated into bond yields is 1.5/ 2
percent, and I don't see that changing very much. There's not a lot of risk in terms of Government financing, the way there was 15
years ago, because we've had structural surpluses for the last ten years, and I expect that to return. So if there is an adjustment, it's more likely to be 1 to 1 now. It's difficult to see why it should continue to be .75 to .8. There's no reason for it to be . 5
at all. If you work through the arithmetic of a utility that on average, say, has a beta of .5, if you use an adjustment of .5, and apply the market risk premium, it perfectly offsets a change in the long Canada bond yield, and as a result, the overall expected return on the market is constant, which means we can throw all the risk premium models out the window. That argument I put before the NEB, the BCUC,

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the Manitoba PUB, consistently for the last fifteen years, and no Board has accepted an adjustment of .5 because it doesn't make any sense whatsoever. It flies in the face of financial theory, and it flies in the face of commonsense. The equity markets are totally unresponsive to Canada bond yields, and as a result, it just doesn't make any sense. So I think when I put that evidence, myself and my late colleague, Dr. Berkowitz, before the NEB, the Manitoba PUB, and the BCUC, we recommended .8, other witnesses recommended 1, the company witnesses generally recommended .5, and I guess the NEB just split the difference and came up with .75, and that's proven to be remarkably correct.

MR. SIMMONS:

Q. The effect of using a factor of 1 instead of .8 or some lower factor, if I understand correctly, that would mean that between general rate applications and between test years, the potential for customer rates to change would actually be higher with that higher factor than it is if a lower factor is used?

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DR. BOOTH:

A. That's correct. The -- I've been asked in the past about this. My view is as long -- and I've said this several times, as long as the Bank of Canada commits to 1 to 3 percent inflation, and you believe that because the capital markets believe that, then basically the long Canada bond yield will average out the same over the business cycle. So you will have lower rates as the rates when you have a recession, the way we just had it, and you'll have high rates the way that we had in 2005 and 2006 when there's pressure for capital, and as a result capital costs go up. So there will be variations over the business cycle, but it will average out at about 5 percent or so, 5.25, 5.50 for the long Canada bond yield. So I'm personally indifferent to whether you fix the ROE for a five to ten year period at, say, 8.5 percent, consistent with, say, the 5.25 percent long term Canada bond yield. So if Ms. McShane says that 5.25 percent is the long term Canada bond yield, I have no objection to that. It might be 5.5, but that's about right. So if you just put that

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into the ROE Adjustment Formula, came out with an ROE and then fixed it for the next ten years, I'd be perfectly happy with that. What it would mean is the ROE will be slightly over during bad years and slightly under during good years, but over the full business cycle, it will average out. As I indicated in my direct testimony, I've got no problems with doing that. I think it's marginally generous to the company both to have an adjustment mechanism or to fix the yield, but over the -- everything will average out over the business cycle. So if you wanted to put in place 8.5 percent, fix it for the next ten years, subject to dramatic changes in the capital markets, I'll be happy with that. If you wanted a 1 to 1 adjustment, I'll be happy with that. If you wanted a .8 adjustment, I'll be happy with that because it basically averages out over the business cycle. What I would not be happy with is cherry picking, saying, well, we'll have this adjustment during these bad years and then when the good years come along, we'll throw it away and we'll just take the higher ROE. You've got to be consistent over

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the business cycle.

MR. SIMMONS:

Q. So there would seem maybe to be two approaches that can be taken in the long run to how the Automatic Adjustment Formula would be used. One would be to try to structure the formula to make it reflect actual rates in the market that the company is affected by as closely as possible, which would promote matching the cost of producing power to the rates paid by consumers at the time that they pay their rates. The other approach would be not to worry about that so much and rely on the long term fluctuations in the business cycle and the symmetry to produce a fair return for the company and fair rates for the consumers of the power?

DR. BOOTH:

A. That's right. When you take out a mortgage, you can either take a five year mortgage at a fixed rate or you can take a one year mortgage and then get all the uncertainty in one year rates. They're both fair. So it's perfectly fair to have a rate that resets every year on capital market conditions. It's also perfectly fair to take out a fixed rate over the same time period. So I think both of those are fair. Personally, I think the best thing for rate payers, and also for the company, is to fix it over a period of time, so you don't take all of the volatility in capital markets threw into rates, which is why I'm perfectly happy to fix the adjustment mechanism and keep it where it is at the moment, or I'm perfectly happy to have a fixed rate based upon Ms. McShane's estimate of the average or long term Canada bond yield of 5.25 percent, because that's where it's been for the last eight or nine years. Long Canada bond yields have been around 4 or 5 percent. So whether you adjust by .8 or 1, the change in the ROE has been relatively small.

MR. SIMMONS:

Q. I had a couple of questions for you about the DCF method, which you didn't use directly as a means of returning ROE here, but it did form part of your risk premium analysis, if I understand correctly?

DR. BOOTH:

A. It formed part of my reasonableness check

after I came up with my estimates.

MR. SIMMONS:

Q. Right, and you said in your evidence yesterday that you did use the DCF method in the past, but you stopped using it in the 1990s because there had increasingly been problems with it, and I wonder can you tell me a little more about what the problems were that you encountered with using that method here in Canada and why you discontinued using it?

DR. BOOTH:

A. I used to use two samples of firms. One telephone sample, because at the time in the 80s and 90s, the local telephone companies were still subject to rate of return regulation, and we were lucky in Canada, we had Island Telephone in PEI, we had Newfoundland Telephone, we had Maritimes Tel, we had Quebec Tel, we had BC Tel, and for a time we had AGT, which became Telus.

MR. SIMMONS:

Q. So there was data available to use the method?

(10:15 a.m.)

DR. BOOTH:

A. There was data available, yeah, and not only

was there data available, but these were pure regulated utilities. So no problems involved in looking at firms involved in a merchant power function and other things. I also at that time tried to look at a sample of gas and electric companies, and at that time we had Maritime Electric, which was a traded company which was a pure electric company. We had Consumers Gas in Ontario with, I think, a 15/20 percent public float that you could actually use to valuate. You had Trans Alta out in Alberta which at that time was still an integrated electric utility in generation, distribution, and transmission. So we had a number of utilities in the gas and electric field that were close to being pure utilities. So you could actually estimate what is the stop price for this stream of dividends, and you could look at the growth rates, and one of the nice features at that time was that inflation was a significant factor, and why I say that was nice is because most growth is generated by inflation. If the economy is inflating at 10 percent per year, you've got 10 percent built in almost to the growth rate.

So at that time we could estimate the growth rates looking at rates of inflation, and we could look at real growth, and to estimate a DCF estimate. We did it that way, my late colleague and I, and other people did it the same way. So we had the data, we had the companies, and we could correctly estimate these opportunity costs. The Ontario Energy Board rejected DCF in part because Consumers Gas, the public float was bought out by Enbridge, and then Unicor that owns Union Gas became part of the west coast system, so you didn't have directly observable prices for the utilities that were being regulated in Canada. That, plus a lot of problems in estimating the growth rates, caused their demise in Canada. In the United States, it's more prevalent. The reason for that is they have growth estimates from analysts, and the only problem that I'm sure Mr. Cicchetti will get into is the fact that we know those growth estimates are biased because analysts -- these analyst's growth estimates come from sell side analysts, so they're basically selling the stock or promoting the stock, and we know there's an optimism bias in these growth estimates in the United States. Ms. McShane has accepted that in the past. So any estimates coming from DCF estimates based upon growth estimates from analysts, we have to adjust them downwards because we know that they're biased high.

MR. SIMMONS:

Q. So your reasons for not using the DCF method now, and not having used it since 1990, are twofold. One is that you lost the Canadian data that you would have used from comparable Canadian companies to input into the formula, and you are unwilling to go to American comparable companies, in part, because you didn't trust the reliability of the forecast data that was available for those companies?

DR. BOOTH:

A. Well, I wouldn't say me, I don't think anybody trusts the reliability of sell side analysts in the United States. They're under a huge conflict of interest, and all of the academic evidence indicates that they're biased high.

MR. SIMMONS:

Q. So those are the reasons, it wasn't anything about the methodology per se that you

considered inappropriate, and if you had the data you needed, you would probably still use the DCF method approach, would you?

DR. BOOTH:

A. Absolutely. In fact, I still use the DCF method in the way that people like TD and the Royal Bank and the big investment banks use it, which is to say they look at the forecast growth and they look at top down analysis of looking at where we are in the economy, what's the economic growth, what are the reasonable estimates for top level profit growth, and then they reconcile that with bottom up analyst forecast. They look at the dividends yield and they say what's a reasonable equity cost for the market as a whole, and that's DCF, plus the overall growth in profits in the economy. So I do that because that's -- it's a check. It's sort of saying, well, if you've only got 2 percent inflation and the economy is growing at 3 or 4 percent tops, you've got 5 or 6 percent growth in the economy overall. So it's difficult then to say, well, in aggregate, profits can grow at 10 percent forever when the economy can only grow 5 to 6

percent. So we look at those DCF estimates because that's intrinsicly what you get out of investing in stock, you get dividends, you get capital gains, and they come from the underlying profitability in the system. So I use it as a check, but a lot of the estimates from investment banks come totally from D/P + G, dividend yield plus growth.

MR. SIMMONS:

Q. You've already answered quite a few questions on your capital asset method calculations, but I read in your report that you used a couple different methods there; two variations, a two stage method, in addition to the more direct calculation to determine the results of that, and you've been questioned a good bit about the determination of the beta factor, and the element of judgment that goes into that. In your two stage approach, I see you refer to a factor that you call a "gamma".

DR. BOOTH:

A. Yes.

MR. SIMMONS:

Q. And would the same considerations apply to the determination of gamma, in that you do look to

evidence, but you also bring an element of judgment into the determination of that factor in that test?

DR. BOOTH:

A. That's correct. Ms. McShane, I think, estimates the interest sensitivity to utilities of .52. I use .5. It obviously varies with the amount of interest rate uncertainty in the economy. During periods when interest rates were really violently going up and down, the sensitivity differs because all of these coefficients are basically how sensitive is the stock price to a change in some underlying risk factor. If that underlying risk factor doesn't change during the estimation period, then you can't estimate accurately a sensitivity coefficient very well.

MR. SIMMONS:

Q. And using both of those methods, you came up with a 7 percent number that you used?

DR. BOOTH:

A. Yeah.

MR. SIMMONS:

Q. Which you further adjusted to account for floatation costs and a margin of error, resulting in 7.75 percent?

DR. BOOTH:

A. That's correct.

MR. SIMMONS:

Q. Which was your recommendation, and if I understand the last step in the process you use is smell test to see if that number looks right?

DR. BOOTH:

A. Sure.

MR. SIMMONS:

Q. What do you do when it doesn't?

DR. BOOTH:

A. I go back and I look at why doesn't the numbers look right, and if I was just to not use my judgment and just be a statistician and just use the realized risk premium, say, since 1956 and come up with 2 percent, and I was plugging that into, say, the capital asset pricing model, the way it's supposed to be used in non-regulated -- here using the treasury bill yield, then we've got 25 basis points plus 2 percent, and then you come up with nonsense numbers. So that's a smell test

when you sort of look at it and you say, well, look, I'm doing what they did on all these empirical tests, I'm coming up with 2.5 percent, if I add in 50 basis points, would I recommend 3 percent for an allowed rate of return; the answer is obviously nonsense, that's the smell test. You look at it and you say that's not reasonable. So you have to look at it in the context of understanding where we are in the business cycle, and I've said that repeatedly over the last day and a half, but it distresses me sometimes when people produce estimates and there's no discussion of the economy or the financial markets because all of this comes from the state of the economy. The key driving fair rates return is the expected rate of inflation, and when we have expected rate of inflation down 2 percent, we're not going to have the same allowed rates of return as we had 15/20 years ago when the rate of inflation was 5/6 percent. I mean, that would defy logic. So you have to understand the state of the economy and then you have to understand what's driven your estimates that go into the

fair return.

MR. SIMMONS:

Q. So those are the things you would have to consider when you use your smell test and see if the final result looks reasonable, given all these underlying factors and what you know about the markets and the economy, but when the number fails, what do you do? Do you go back and adjust factors that you've used in order to work through the processes of the different methodologies again to come up with different numbers, or do you just say at the end of your report "this is an unreasonable number and instead of 5, I think it should be 6"?

DR. BOOTH:

A. I do the same thing as if a builder builds a house and the house falls down. He says, "Wow, why did the house fall down, I'll go and investigate why the house fell down", and exactly the same when I come up with estimates, I will go through and say, well, look, given the long run experience in the market, given the level of interest rates, judgment constrained by the facts, you go back

and you look and say, well, why has the beta been .1. So I don't believe in just reporting numbers and saying these are the numbers. I believe in looking at the numbers and understanding what generated those numbers.

MR. SIMMONS:

Q. So you can't go back and change the underlying data that you've used, what you can change is either the methodology that you've used or the judgment that you've exercised? Those are the two elements that are within your control when it comes to using your methodologies and working out a final number, right?

DR. BOOTH:

A. To some extent, that's true. I think it's -- I have some Boards say can't we just throw out 2008, let's just pretend it didn't happen, and as a result we didn't suffer a 38 percent drop in the Canadian market, and as a result our historic risk premium estimates are higher, and my answer to that is, no, you can't do that, you just can't throw out data that you don't like, you have to go back and understand what drove that data and understand whether the underlying economic situation is going to persist into the future. So I would regard 2008 as an aberrant year, but we happen to have these aberrant years every certain period of time. Hopefully, it'll be another 70 years before the US destroys its financial system again, but I don't think it's going to happen in the foreseeable future.

MR. SIMMONS:

Q. I just want to be clear that I understand what you're saying, is that if the end result number you get is in your judgment unreasonable, what would you then do? Would you either review your choice of methodology or the way you've used it, or would you review the judgment you've used for the inputs into that methodology?

DR. BOOTH:

A. Well, I don't review the judgment in the sense that I'm using judgment all the way through the process. I'm looking at the data that's coming out and I'm trying to understand it, and do I place a lot of weight on the betas from last year; no, because I know that they're driven by the stock market crash last year, and the fact that whenever the stock

market crashes, betas go down because utilities are defensive stocks. So the question is, I then look forward and say where are we in the business cycle and what's likely to happen. So I'm constantly looking at the statistics. It's not as if a number comes out and I say, well, that's a nonsense number. I sort of have a pretty good idea what the data is going to tell me, given the fact that I'm constantly watching what's happening in the economy and have been for the last ten or fifteen years. I mean, I can predict the market risk premium results are going to go up next year; why, because we've had a 50 percent recovery in the stock market since March, and 2009 will be a good year for the equity market, 2010 will be better possibly, and as a result the historic estimates are going to go up. Do I put a lot of faith in those year to year fluctuations; no.

MR. SIMMONS:

Q. Only one other question. When you complete your ROE analysis and your recommendation, is any part of what you do then to consider the impact that that recommendation would have on

the capacity of the utility to borrow on its credit standing, its credit rating, its credit metrics, and those factors?

DR. BOOTH:

A. Yes. The critical thing is we can look at the fair rate of return, and we have to look at whether those costs are fair and reasonable. We then have to look at whether or not the firm, the utility, can actually raise capital and provide service. Normally, any fair return of return comes out, it's going to imply that the utility's financial integrity is preserved and it can continue to raise capital. In some cases, that's not the case, and it's not the case usually because the firm has got a very high embedded cost of debt, and usually it's because it's a small firm, and as a result that embedded -- high embedded cost of debt is not going to be rolled away very quickly by refinancing at lower interest rates. So if there's restrictions in the bond contract, for example, as there traditionally are for a lot of Canadian utilities, a two times interest rate restriction, has to cover the interest twice in EBIT, then sometimes it

means that the firm can't raise capital. In fact, this has been a perennial problem for Enbridge Gas distribution in Ontario, it's currently a minor problem for Terasen Gas, both of which are very close to the two times interest coverage ratio. Particularly for Enbridge when it got volatile earnings, partly volatile earnings, as a result of weather. It doesn't have a weather normalization account. So sometimes Enbridge has been restricted from issuing long term debt because it can't meet the new issue test. So in those cases, you look at it and you say, well, if the equity return is fair, how can we cope with this problem of maintaining financial integrity, access, raising capital to provide financing, and the answer to that is not to reward the equity holders because these concerns generally got nothing to do with the equity holders. So you don't give the equity holders a bonus return simply because of temporary financial access problems. What you do there is you look at the ability of the firm to raise short term debt, and in the case of Newfoundland, that's not problem because they've got extensive short term credit facilities, and, in fact, according to Moody's, they've just had the material adverse conditions clause removed from their credit line. So that means they can do what small utilities or smaller utilities generally do, which is borrow short term, and wait to refund when the market conditions are appropriate. Generally in those conditions, I look to see the availability of the short term capital, and if there's a persistent problem, and this is what I recommended before the Ontario Energy Board, the traditional solution is preferred shares. You use preferred shares on a temporary basis because preferred shares boost the interest coverage ratio, allows the firm better access to financial markets, and doesn't reward the equity holders, and I've constantly said for the last ten years you don't reward the equity holders for problems in the bond market in terms of coverage ratios and access in financial markets, because those are just technical restrictions and nothing to do with the fair rate of return standard.

MR. SIMMONS:

Q. Thank you, Dr. Booth, I don't have any other questions.

(10:30 a.m.)

CHAIRMAN:

Q. Do you have any?

VICE-CHAIR WHALEN:

Q. I don't have any questions. Thank you.

CHAIRMAN:

Q. So it's your position that the economy is in recovery, whether it's a "V" shape recovery or a "U" shape, we're on our way back?

DR. BOOTH:

A. We're definitely on the way back. Unless every private forecaster, and the Government of Canada, and the Bank of Canada, have got it totally wrong, we're definitely on the way back. The results will come out, third quarter of this year we will economic growth, and as I indicated, France and Germany had economic growth in the second quarter.

CHAIRMAN:

Q. What about in the US?

DR. BOOTH:

A. The US has got more problems. The US definitely had some stimulus in the third

quarter because of the cash for clunkers that was part of the Obama package, basically giving Americans money to buy new cars to replace their old gas guzzlers. So that stimulated some demand during the summer. I think the problem --

CHAIRMAN:

Q. That's pretty phoney, though, isn't it?

DR. BOOTH:

A. It is pretty phoney. It's a temporary stimulus, but you've got to remember the vast bulk of Obama stimulus package hasn't gone into effect, just as half of the 20 billion of our deficit stimulus package hasn't gone into effect yet. It's all infrastructure spending that basically still has got to be spent, and there is a significant body of people in the United States that believe, given these lags, all of this Government spending will come on stream just as the impact of interest rates will start rebounding the US economy, and as a result, there's people in the United States actually afraid of inflation, which I regard as rather sort of hysterical. I just don't see any economic basis for that, but there's a

lot of commentators in the United States who are worried about inflationary pressures in the United States. These normally only come about because of a strong economy, but they're worried about it because somehow the US Government deficit, if the stimulus isn't taken away as the economy recovers, you get inflation. Then if the economy recovers, it's going to have a big stimulus for Canada as well.

CHAIRMAN:

Q. So you don't think it's possible for the United States to further debauch the dollar?

DR. BOOTH:

A. Their dollar?

CHAIRMAN:

Q. Yeah.

DR. BOOTH:

A. Canadian dollar is going to be the premium to the US dollar very, very soon, and if -- I mean, you can make these forecasts, but forecasts are almost always wrong in the sense that -- macro economic forecasts, not growth forecast and risk premium forecast, but macro economic forecast because policy makers

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respond to those economic conditions. So you can't say, well, look, if the US continues to run fiscal deficits of 13 and a half percent for the next twenty years, the US is going to be in a disaster situation because that cannot possibly happen. Sooner or later policy makers in the United States will increase taxes and reduce spending. Exactly the same as in Canada in the early '90s, we had huge problems, everyone recognized the problems, inflation was a real problem up until the late 1970s, early 1980s, and eventually the political will was there to solve the problem because it got out of line, and the political will will be there in the United States to solve their problems, whether it's in Obama's period, I don't know, but they have really significant problems in the US.

CHAIRMAN:

Q. And you don't think they're going to spill over into Canada?

DR. BOOTH:

A. No, in fact, any spill over is going to be good in the sense that if the US does just carry on, and all of this fiscal stimulus hits

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the US economy and they keep their interest rates low, so the US economy recovers, but it ends up being inflationary with US deficit problems, Canadian dollar is going to go to $1.15/$1.20. The recovery is going to stimulate demand for Canadian exports. So right now if you put export demand back to where it normally is, the Canadian economy wouldn't be in any trouble whatsoever. Nearly all of our problems are coming from the lack of export demand to the United States. If the US economy recovers and it doesn't solve their problems, our export demand will come back, so the Canadian economy will be humming along nicely, our dollar will go to a premium, we'll have low interest rates, we may even have a marginal room for further tax cuts. Already the corporate income tax in Canada is significantly lower than it is in the United States, and they have huge tax increases that have to come, either tax increases or program spending cuts. The US is essentially back where we were in the early 90s, and they've got harsh policy decisions to make, but either way, I think Canada -- I think Canada still

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has everything going for it. A few years ago, I said I can't see what's going to happen because every time we looked at all the criteria in Canada, it was a check box, tick, tick, tick, everything was working out fine. Who would have believed the Americans could cause so many problems in their sub-prime mortgage market. So I'm not saying that there's not things out there that could damage us, but these are -- and people say, well, what are these problems, and my answer is, I don't know. All we know is that every time at the top of the business cycle lenders made bad loans, and it doesn't matter whether it's sub-prime this time or whether it's sub or risk (phonetic) lending in the 60s and 70s, or it's telecom lending in the 90s, bankers end up losing money and causing problems in the financial system.

CHAIRMAN:

Q. And looking for bailouts?

DR. BOOTH:

A. Looking for bailouts. The Canadian banks haven't looked for bailouts. The Canadian banks are really solid. The World Economic

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Forum rated the Canadian banking system as the strongest in the world, which is why we've being relatively immune from all of these problems that have hit the rest of the world.

CHAIRMAN:

Q. I also read that there's a possibility that in the United States there's a commercial sub-prime problem as well. Do you know anything about that?

DR. BOOTH:

A. In the stress test of the US banking, they basically applied default rates for different loans, and the commercial loan market is in bad shape in the United States. The credit card market is in bad shape. The stress test that the US banks went through with the results at least to the beginning of May, indicated default rates of 22 percent in the US credit cards. These are horrific numbers. In Canada, the worse we're looking at is 3/4 percent. They're looking at default rates on housing of about 10/15 percent, whereas the major Canadian banks predict about .2 percent. I mean, the loan losses in the US are just incredible. They've been addicted to debt because to a great extent it's tax deductible in the United States, the interest costs, and they're hugely are over indebted, and they're in a post -- let's see, they're in a depression or a alcoholics recovery from being addicted to debt, and how long it's going to take for those problems to work through isn't quite certain. Some people predict it's going to take a long time. Others have said, well, they're alcoholics, they'll get back to borrowing money in a relatively short period of time because Americans are not going to abolish the interest deductibility of most of the debt that they borrow. So Americans have either got to get a grip with some serious policy decisions in terms of their tax structure and their spending because they can't keep spending, having deficits of 13 percent of GDP, but regardless of those American problems, the impact on Canada is relatively minimal. I mean, the Canadian dollar went up to 95/97 cents, not because of the US, but because of China and India, and the demand for commodities.

CHAIRMAN:

Q. Uh-hm. Mr. Johnson, I think you --

VICE-CHAIR WHALEN:

Q. I just --

CHAIRMAN:

Q. Oh, I'm sorry.

VICE-CHAIR WHALEN:

Q. I hesitated earlier because I wasn't sure if I could get my head around just framing the question. I'm just going to put it to you. I was reading through your evidence last night and the last three or four lines of your testimony where you highlighted the inconsistency or incongruity between Newfoundland Power's seemingly approaching a lower risk profile with more and more of these accounts that they're requesting, coupled with a higher ROE request, and, you know, you just said it seems inconsistent, but to what extent does the risk profile of the company come to play for you as an analyst sitting and looking at the numbers? Do you actually consider the actual risk profile of the utility that's before you, or is it done more on a global basis?

DR. BOOTH:

A. There's two sides to that. First of all, I've been sitting in hearings in Canada for a long time now, and what I see across Canada is Boards that are protective towards the utility. I see this in the frequency of rate reviews, I see this in the response to problems faced by the utility. So the utility has a problem, it comes to the Board, the Board sets up some deferral mechanism to help the utility. That's part of what I regard as the regulatory compact, that we lower the risk of the utility, we'll then allow the lower rates of return, and they finance more debt, and debt is tax deductible, so overall it lowers the rates. So the regulatory compact in Canada is relatively more debt, relatively lower ROEs, but almost a complete absence of risk. In fact, I've yet to see any risk affect a Canadian utility, and I know that sounds like an incredibly strong statement, but I've sat in regulatory hearings and heard witnesses say all of the risks that the utility faces. Sooner or later, some of these risks has to affect a Canadian utility somewhere, and Mr. Johnson put questions

towards Ms. McShane and she said, well, just because the risk hasn't materialized doesn't mean to say it's not there. Well, my perception is if the risk does materialize, utility comes before the Board, and the rate payers pay, and one good example of this is this -- the late fees charged in Ontario where it went to the Supreme Court, and the Supreme Court said this is illegal, it contradicts the Interest Rate Act, and as a result there was settlement. Did Union Gas and Consumers Gas pay the settlement; no, they just came before the OEB and they said pass it on to the rate payers, and the Consumers Association, the rate payers agreed with that. So when I see a risk materialize, first of all, I'd be a little bit surprised, and secondly, if I see that the rate payer -- sorry, if I see the utility bearing those costs, I'll be even more surprised because it's yet to happen in Canada. So this is -- when I look at utilities, the utilities wanted to get us to look at specific risks, and that's sort of a quagmire, because it's always a little bit specific to Newfoundland Power, things

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specific to Enbridge Gas, things specific to TransCanada. I look at what the capital markets look at, which is do they earn their allowed ROE. That's where the rubber hits the road, that's the sum effect of all of these risks, and the evidence is that the utilities across Canada earn their allowed ROEs, and they exceed them, and typically they exceed them by 50 to 100 basis points because of incentive agreements and traditionally under spending operations and maintenance expenses and things. So there's no short term risk. There may be some long term risk for some of the utilities. TransCanada Pipeline has got some risk because the main line from Alberta is -- unless something happens significantly through the western Canada sedimentary basin, the supply coming out of Western Canada may not be there to have the main line run full. In fact, it's not going to be there. So there are long term risks for some utilities that bear on the fair rate of return, and those long term risks the National Energy Board took into account in the TQM decision, but for a utility like Newfoundland Power, I don't think

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there's any long term risk, I don't think there's any problems in the utility recovering its rate base through its depreciation charges, and I don't see any evidence of any inability to earn its allowed rate of return. So on a risk basis, I don't see any risk attached to this utility. Almost all of the risk is capital market risk, which is how investors react to the shares of Canadian utilities, not the underlying business of financial risk, which is what you're responsible for.

VICE-CHAIR WHALEN:

Q. Thank you.

CHAIRMAN:

Q. Mr. Johnson.

MR. JOHNSON:

Q. Mr. Chairman, just one question on re-direct.

DR. LAURENCE BOOTH - RE-EXAMINATION BY MR. TOM JOHNSON:

MR. JOHNSON:

Q. I don't think we ever got to see what you were referring to in the Mercer Report. Is that CA-NP-26?

DR. BOOTH:

A. Yes, that's it. Unfortunately, I do all my

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typing and 26 became 25. If you scroll down a little bit --

MR. JOHNSON:

Q. Yeah, there's the table.

DR. BOOTH:

A. These are the underlying economic assumptions that Mercer uses to estimate the rate of return that the Newfoundland Power pension fund's going to earn, and they've got down equities, US and Canada, 8.5 percent, fixed income 4.4. So this isn't somebody -- an expert coming in on behalf of Newfoundland Power to tell you what the expected return on Canadian equities is. This is independent experts. Mercer goes around and they do exactly the same thing, right away across Canada, in evaluating pension funds, and they're using long run expected rates of return in the Canadian and US equity markets of 8.5 percent, which is 2.5 percent less than the ROE that Newfoundland Power is asking for, and I can't believe that Newfoundland Power is riskier than the US and the Canadian equity market as a whole.

MR. JOHNSON:

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Q. That's the only question I had.

CHAIRMAN:

Q. So they're out there ten years on this, are they? Is that what you --

DR. BOOTH:

A. Sorry?

CHAIRMAN:

Q. This 8 and a half -- when they say "long run", I mean, someone said there's no such thing as a long run, we're all going to be dead, but --

DR. BOOTH:

A. John Maynard Keynes, 1936.

CHAIRMAN:

Q. Yeah, but is this -- the 8.5, are they saying five/ten years?

DR. BOOTH:

A. Generally, they're talking about a long, long run, indefinite long run, because most defined benefit plans that they look at, particularly the Public Service ones, they're indefinite because you're always going to have the CPP, you're always going to have the RCMP Pension Plan, or Ontario Teachers, because you're constantly replacing these people. So the pension plan is indefinite. Now I would caution that these equity returns, they're are long run equity returns and they tend to be what we call compound rates or return, not geometric rates of return. At least, that's my guess. So the arithmetic rate of return consistent with the way that I estimate them is probably 1 percent or 1.5 percent higher than these, but then the fixed income isn't the long Canada fixed income, it's a blend of everything. So this isn't directly 100 percent comparable with the work that I'm doing. This I would just take as another reasonableness check. Getting up from 8. 5 percent is difficult, and it's the same with the Royal Bank's forecast, and the same with the TD forecast, it's -- you just don't see many people predicting long run equity returns much out of 8.5/9 percent.

CHAIRMAN:

Q. And that's been consistent with the history going back 40 or 50 --

DR. BOOTH:

A. That's consistent with history, and the fact is that it's a long run reversion to trend. You can't suddenly say, well, 80 years, all of

these professionals, whether they're Mercer, the Royal Bank, TD, surveys and investors, they've all got it wrong, suddenly there's going to be a seismic shift, they're wrong and we're now going to say 12/13 percent long run equity return. It's just -- Mercer did this relatively recently, and they're paid to determine the unfunded liability and the funding status of the pension. So their reputation is on the line when they do this.

CHAIRMAN:

Q. I think that's it. One question. We were trying to figure out what your accent is. Some say New Zealand, some say Australia, I say you're a Brit.

DR. BOOTH:

A. Australians I just treat as being transplanted Brits or transplanted London, anyway. I'm a Londoner by birth, but I've been in North America for longer than I would care to admit.

CHAIRMAN:

Q. Not east end London?

DR. BOOTH:

A. No, north London.

CHAIRMAN:

Q. Thank you very much. Do you want to take a break now or do you want to carry on?

KELLY, Q.C.:

Q. Well, we'll start with Mr. Cicchetti next, so it might be just as well since it's past quarter to, to take the break down and start fresh after the break.

CHAIRMAN:

Q. Okay. Is that okay?

MR. JOHNSON:

Q. That's fine.

CHAIRMAN:

Q. All right.

(RECESS)

(11:20 a.m.)

CHAIRMAN:

Q. Now before we go to our next witness, I was told there are some -

MS. GLYNN:

Q. We have a couple of filings.

CHAIRMAN:

Q. - procedural matters.

MS. GLYNN:

Q. Yes, Mr. Chair. The first is undertaking No. 3. Ms. McShane, yesterday, agreed to provide

a recalculation based on a smaller bond spread. So that has been submitted by Newfoundland Power. And we also have Exhibit MAC-1 which would be Mr. Cicchetti's resume.

CHAIRMAN:

Q. All right. So we're ready to proceed now with Mr.--I'm sorry, sir.

MR. CICCHETTI:

A. Cicchetti.

CHAIRMAN:

Q. Cicchetti, okay.

MR. MARK CICCHETTI, SWORN, EXAMINATION-IN-CHIEF BY MR. DANIEL SIMMONS

CHAIRMAN:

Q. Thank you. Mr. Simmons, over to you.

MR. SIMMONS:

Q. Mr. Cicchetti, you prepared a report dated August 2009 which comprises your pre-filed evidence. Do you adopt that report as your evidence at this hearing?

MR. CICCHETTI:

A. Yes.

MR. SIMMONS:

Q. And are there any updates or corrections to your report?

MR. CICCHETTI:
A. I have one correction to Schedule 8 of my testimony.
MR. SIMMONS:
Q. I'm sorry, which schedule is that?
MR. CICCHETTI:
A. MAC-8. In the column on the far right, the word "revenues" should be market capitalization.
MR. SIMMONS:
Q. Thank you. We've entered your CV in evidence, but can you give us a brief description of your background and qualifications, including your involvement in giving testimony in any other regulatory proceedings?
MR. CICCHETTI:
A. Certainly. I am a project manager with C.H. Guernsey & Company. I've been involved with the regulation of public utilities for approximately 27 years and have been involved in one form or another in hundreds of cases and have testified in at least 50 of those cases. This is my first time testifying in Canada. I am a former chief of finance for the Florida Public Service Commission and a

former president of the Society of Utility and Regulatory Financial Analysts, which is an organization whose sole and specific interest is in public utility cost of capital issues.
MR. SIMMONS:
Q. Thank you. Mr. Cicchetti, can you comment on the assumptions that you've made regarding current or prospective financial market conditions for the purpose of preparing your testimony for today?
MR. CICCHETTI:
A. Yes. I think Dr. Booth did a good job of explaining the conditions that led to the financial crisis and the history of interest rates and inflation and projections for interest rates and inflation and one area that I do have a disagreement with him is where we are currently economically. I believe Dr. Booth indicated he felt that we were in a normal recovery coming out of a recession and I don't think it's that simple, and I preface my comments with the understanding that the US economy and the Canadian economy are intricately intertwined and I think it's generally accepted that for significant

economic activity, particularly exports, to occur in Canada, there's going to have to be some meaningful recovery in the US.
There was tremendous amounts of stimulus that was applied in the first and second quarters and I think everyone expected that we would see some economic growth in the third and fourth quarter of this year, and it looks like we're going to have--the US is going to have about three percent growth in the third quarter and it's expected to decline somewhat to two and a half percent in the fourth quarter and the forecasts are for around two percent for the first half of next year, and I think a lot of economists feel is that about it, all we got for the bang for the buck, keeping in mind that this second round of stimulus occurred after a first round of stimulus that gave us the couple of quarters of minor economic growth.
In the US, approximately 70 percent of the economy is consumer spending, based on consumer spending, and I tend to agree with the comments of Ms. Perry and Ms. McShane that we're going to have to wait and see if the

consumer is going to be able to lead us out of this economy, and with that in mind, in the US, unemployment is approaching ten percent, which is very high, and there doesn't seem to be, on the horizon, reasons for that to come down. The housing market is still troubled. Housing starts unexpectedly declined in September. Foreclosures are rising and so it's hard to see how the consumer is going to have the income to pull us out of the significant downturn.
On top of that, the banking system is still fragile. Although we don't hear a lot of the headline-grabbing too big to fail banks being rescued, a lot of the smaller and mid size banks are failing and the FDIC is in the process of having to supplement their reserves in order to be able to deal with that and that has kept lending, in the US, low. So Dr. Booth mentioned the concerns about inflation and that also has to do with the amount of stimulus that's been providing the significant amounts of excess reserves in the banks, although they're not lending it. But the balancing act that they have to have is they

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have to be able to drain those reserves as interest rates pick up in order to keep from inflation becoming a problem, because inflation is a monetary phenomena and if you have more dollars chasing a set amount of goods, that's the definition of inflation. So they have a fine balancing act to be able to drain those out as economic activity picks up and so there is some concern about stagflation, which is a stagnant economy with inflation, which was experienced in the '70s, so my point being that I think there's a lot of things that are different from a standard recovery coming out of a recession. There's a lot of things that could potentially go wrong and layered on top of all of that is the fact that long-term government rates are low. If there's not a pick up in activity, maybe they will stay low and I think that relates to the issue that we have with regard to the automatic adjustment formula, and I'll talk about that when we get to the automatic adjustment formula.

MR. SIMMONS:

Q. Mr. Cicchetti, can you describe for us the

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methodologies that you've used in your cost of equity analysis and maybe tell us something about what you regard as being the strengths and weaknesses of those methodologies and the weights you've given to them and the results of your use of those?

MR. CICCHETTI:

A. What I'd like to do, Mr. Chairman and Commissioners, is explain the methodologies I used and why I used them and compare them to some of the other methodologies and then talk about the companies that I've selected and why I selected those companies and the recommendation that I reached.

The discounted cash flow formula, I think, is the most accurate theoretically correct direct method of measuring the required return on equity and I consider the DCF method to be similar to using the scalpel to perform surgery, whereas the other methodologies are similar to using butter knife, and the reason why I think that is there's not any controversy regarding the equation, the actual DCF formula. In fact, the formula, the discounted cash flow formula

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is the formula, the equation that you would use to calculate the cost of debt, and in that case, you know what your interest payments are going to be semi-annually as you go through time and that's contractual, as well as the repayment of principle. So you know what an underwriter or whoever bought the bonds pays for them and so you simply, through math, solve the equation to find out what discount rate equates those cash flows to the price that you receive for the debt, and so there's no doubt about that. That same model is used to discount the dividends for price of stock. The question then becomes is you don't have those contractual interest rate payments. You have dividends that are going to occur over time and so do you have a valid proxy for those dividend payments.

Now what I use in my model is a service that's called Value Line. They provide information for utilities and all other companies in other industries and it's particularly relevant for the utility industry because utilities are so dividend oriented, considered orphans, widows and orphan stocks,

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and utilities tend not to change their dividends very much. They're very predictable, at least over the next few years, and Value Line is not a sell-side analyst. They do not underwrite securities. They don't have the conflicts of interest that Dr. Booth was talking about. So in my analysis, I'm using those as a valid proxy of investor expectations. Value Line is in pretty much every library in the US. They sell subscriptions to individuals, as well as businesses. It's used extensively in universities and it's in every university library that I've ever seen and could imagine. So it's relatively widespread. They're well respected and they don't have those conflicts of interest. So I believe that it's a very good valid proxy and a good use and it makes the DCF method a very valid method for calculating the required return on equity, particularly for utilities.

Now we compare that to, let's say, the capital asset pricing model. The capital asset pricing model was derived from a formula that a Professor Markowitz came up with in the mid '50s on his portfolio theory, and what portfolio theory says is that you can minimize the risk of your portfolio through diversification, and the way you can judge that diversification is how does a stock affect the relevant risk of the portfolio and so that is how does that stock move with regard to the market versus how the other stocks move with regard to the market and when you put them altogether, how can you minimize your risk that can be diversified away? And that formula is beta or the relevant factor there is beta, and so it was then taken from that portfolio theory and a couple of professors, Sharpe, Lintner and Mark developed a capital asset pricing model which says we'll take beta and we'll use a number of assumptions and we'll then be able to compare the market return minus the risk free rate, multiply that times the beta, add that to the risk free rate and given these assumptions that we've made, we can determine the required return.

Now the problem is that model has been tested over time. It hasn't performed as

expected, still hasn't. One of the reasons being, some say, are the assumptions too limiting or alternatively, could it be that when you're looking at the market, you need to look at the returns on all human capital, real estate, stocks and generally the betas are calculated relative to the stock market, and I think in Dr. Booth's case, the Canadian stock market.

So there were a number of problems that were identified with beta. For one thing, what we're really looking for is the future beta that should be applied and it's calculated on historical information. So you cannot know the true beta. It can't be observed. There's been some other tests that show you can increase systematic risk and the beta will lower. That's counter to rational thought and so they say, well, there's a lot of question that has to do with beta. They tend to regress towards unity. That means they tend to regress towards one. So adjustments have to be made, and I think most of the witnesses and most of the academic studies agree that that adjustment has to be

made. Dr. Booth hasn't made that adjustment, but Ms. McShane has. The betas I use come out of Value Line. Value Line makes that adjustment and most of the major companies that report that information make that adjustment. But, the betas are unstable. There are four predictors and many empirical studies have shown that.

I was asked to, when I mentioned in my testimony that beta is fine in theory, but it tends to break down in practice, to cite some articles, and I just want to read one paragraph. One of the articles I cited was "The Capital Asset Pricing Model: Theory and Evidence." It's written by Eugene Fama and Kenneth French. Professor Fama is the McCormick distinguished service professor to finance at the Graduate School of Business at the University of Chicago, and Professor French is the high professor of finance at the Tuck School of Business at Dartmouth, and it's just a couple of sentences, but this was the concluding paragraph. "The CAPM, like Markowitz's portfolio model on which it is built, is nevertheless a theoretical tour de

force. We continue to teach the CAPM as an introduction to the fundamental concepts of portfolio theory and asset pricing to be built on by more complicated models like Merton's ICAPM. But we also warn students that despite its seductive simplicity, the CAPM's empirical problems probably invalidate its use in applications."

And so when you look at what you actually do in a capital asset pricing model, you're going to estimate, first of all, the beta and we saw in Dr. Booth's testimony, the betas recently are as low as zero and there's probably evidence in this hearing that they range all the way from a negative amount up to the .6 or .7 that Ms. McShane and I have used in our testimony, and I've addressed some of the theoretical problems with the beta. We then need a market return, a market risk premium, which is the expected market return, minus the risk free rate. Now the market return that's been used in a lot of Ms. McShane and Dr. Booth's testimony is based on earned returns in the market over some historical period of time. Now those aren't measuring required returns, which is the cost of equity. Those are averages of the earned returns. A company might earn two percent or 25 percent, but that doesn't mean that their required return was either two percent or 25 percent. That just happens to be what they've earned. So now we're taking that market return that was earned over some period of time and multiplying it by a beta which has some problems and then adding it to a risk free rate, which at this time has a certain amount of flight to quality implications that is holding down that risk free rate. So my point is, you can see where I would say that the DCF model is looking exactly at companies what investors are paying for their price of stock and expected cash flows versus a model that's taking a more macro look at the entire situation, and that's why I think the discounted cash flow is the most appropriate model to use.

Dr. Booth mentioned that the comparable earnings isn't even in an academic textbook as a means of calculating the required return, and I agree with him, so I won't address that

any further.

Finally, I would like to just address the automatic adjustment formula for a second. I need to talk about the comparable companies. The companies that I used, I tried to get as accurate a representation of Newfoundland Power as I could. If you want a publicly traded stock that's small, T & D related, doesn't have any non-regulated activities, there's none out there. I went through great pains to try and get stocks that I considered similar to the company in order to use in my analysis and in looking at them, there just weren't Canadian companies that were as accurate a sample as I believe the highly rated low-risk utilities that I used, electrics and gas, in my testimony, and I would refer back to the memo or the e-mail that Moody's sent yesterday and of the six companies they cited, although none are publicly traded, five are US companies and in the last paragraph or in the last sentence of the first paragraph, it says "however, I include O & R because Moody's views the business risk profile of gas LDCs to be

similar to, indeed generally somewhat lower, than that of electric T & Ds," and I've used a group of low risk LDCs in my analysis, both in a discounted cash flow analysis and a risk premium analysis. So I believe I've got companies that are as comparable as I can get in order to give you insight as to what the required rate of return is for the company.

And finally, with regard to the automatic adjustment formula, the required return on equity is not solely a function of the long-term government rate. There are other things that are involved in that. So I was surprised to hear this morning when Dr. Booth said he would like to see a one-to-one comparison for every basis point drop in a long term rate or increase, he'd like to see a one-and-one relationship with the return on equity for the company.

In the risk premium analysis I performed and I think what's generally accepted is risk premiums vary as interest rates vary. For example, when interest rates decrease ROEs tend to decrease less and so interest--risk premiums tend to increase as interest rates

decrease, and vice versa. As interest rates increase, the risk premium tends to narrow. One of the problems I see with the automatic adjustment formula is as you keep that constant 80 percent, the ROE's going down in the same proportion. It's not reducing less, but going down in the same proportion, so you get to a point, if you have a continued low, long-term Canadian rate, it's going to put pressure on the financial metrics, for example, of the utility because it's allowed return is being tied at least 80 percent to that long-term rate, and so although you may allow the company to be viable and not have its debt ratings reduced, I guess the question becomes do you want to allow them some financial flexibility.

There is risk, for example, you could have an event that occurs and if the company has had its allowed return kept very tight, such that its metrics are tight, it may have a little more trouble if it needed to raise capital if some catastrophe occurred, God forbid, than if it would have had a little bit more financial flexibility that would have been associated with, let's say, an ROE that was determined in a proceeding that more accurately reflected the true ROE versus the formula. So I'm saying the formula can work, but we have a financial crisis, for example, as we have, I think it just highlights the shortcomings of it, and you can have the same thing on the upper end, I think, and you can think of things in terms of both ways.

We talked about--or political pressure was discussed and I would imagine if, for some reason, we had some kind of--the crisis came about again or something occurred, the Federal Reserve in the US didn't get the stimulus out of the system enough such that there was inflation that somehow bled over in order for Canada to compete for funds, the long-term rate had to go up. If for some reason the long-term Canada rate went up and the formula also went up, you might have some political pressure that you didn't foresee at this time that may--you know, your hands have been bound. You don't have the discretion that you might have had had you not had the formula, and political winds can change quickly.

It was mentioned that Florida was having some problems in that regard and for, you know, the last 25-27 years that I've been involved, Florida was considered one of the best regulatory agencies in the US. We now have a governor who prior to being governor was an attorney general that represented the citizens actively before the Florida Commission. He has announced he's going to step down as governor and run for the US Senate. So he is, for lack of a better term, effectively campaigning while two of the largest utilities in Florida are in for significant rate increases. So sometimes political change can come in ways that you don't expect, and have implications that you didn't expect. So there's always that kind of risk that's hanging out there, and so those are a couple of the things that I wanted to highlight with regard to the automatic adjustment formula.

The analysis that I did for the natural gas companies over the last ten years indicated less sensitivity to a change in interest rates than 80 percent that's in this

current formula. If you held a hearing and reviewed similar relevant testimony, I would imagine you'd find something similar to that. So my point being, if you didn't want to do away with the formula, there may be things that you could do to adjust it that would make it work maybe a little better over the long term.

The final part of my testimony was some rebuttal of Ms. McShane and I would think the only main part of that was--and it would apply a certain extent to Dr. Booth--is when you're using historical information in your analysis, you're not using what's known as X antiforward looking information. So I would be careful when I was evaluating people's testimony to take that into consideration. This is not rocket science. You can look and use common sense to see what's going on. How well do the models reflect reality and how rational are the inputs that the witnesses have used? And with that, that concludes my summary.

MR. SIMMONS:

Q. Thank you, Mr. Cicchetti. I don't have any other questions for you.

CHAIRMAN:

Q. So who goes first now?

(11:45 a.m.)

KELLY, Q.C.

Q. I guess I do, Mr. Chairman.

CHAIRMAN:

Q. Okay.

MR. MARK CICCHETTI, CROSS-EXAMINATION BY IAN KELLY, Q.C.

KELLY, Q.C.

Q. I'm happy to proceed. Mr. Cicchetti, you've given us a good explanation of the DCF model. Can I get you to expand a little bit on the use of the American data? Like you're basing yours off of a group of utilities in the United States. Can you explain why--I take it you obviously view that transferable to Canada. Can I get you to explain why?

MR. CICCHETTI:

A. Well, right now, if you look at inflation forecasts for Canada, they're similar to the US. Forecasts for the long-term bond rates are similar. The single A utility rates have trended together for as long as I think we're looking at in this case. The same with the long-term government rates and the two economies are intricately related. The capital markets are intricately related. They're similar operating environments and when I say similar regulatory environments, what I mean is they both operate under cost of service regulation, for the most part, original cost regulation and so I think the main criteria is are the companies comparable to the company that you're trying to determine the required rate of return for. Just because they're US companies, I don't think makes them evil or requires any way the--all the things that you would consider for a required rate or a nominal rate to be applicable in the US, I believe are applicable in this case for Newfoundland Power.

KELLY, Q.C.

Q. And when you talk about a comparable company, I take it you're not talking about all of the same operating characteristics and precise same regulatory mechanisms, but at an investment--at an investors expectation level are they reasonably comparable? Is that--have I got the point correct?

MR. CICCHETTI:

A. Yes, and I heard a lot of discussion about that yesterday and the point that I would make in regard to that is you have total risk includes business risk and financial risk, and part of business risk is regulatory risk, and a significant part of regulatory risk involves the allowed rate of return that the company's going to earn. So Newfoundland Power, their operations wise, the business risk is very low. They have very supportive regulation. But when you look at their capital structure, having a little more leverage than would be on average in the US, although its high for Canada, and the allowed return, the net result is their financial metrics are somewhat lower, which in and of itself isn't necessarily bad, but it's that combination that makes up total risk that causes the company to have a bond rating similar, for example, to the ratings of the companies that I'm looking at. Had the company had similar equity ratios and similar allowed returns, I'm sure their bond rating or I believe their bond rating would be much higher. So it's a trade off.

KELLY, Q.C.

Q. So as long as we've got that comparability in investment risk, we can use the US companies without having to make further adjustment?

MR. CICCHETTI:

A. I believe so, and if there were Canadian companies that I could rely on, I would certainly do that. One of the problems is it doesn't appear that there is an industry here in Canada that looks at those type of forecasts and then the thought crossed my mind, it might not be a bad idea for someone to open a business that visited these companies, analyzed their prospects and made those kind of forecasts available.

KELLY, Q.C.

Q. Okay. Now I spent a fair bit of time with Dr. Booth talking about some of the difficulties with the capital asset pricing model and you've touched on those as well. So I don't want to go back there. But I think in fairness to the Board, I'd like you to give the Board some sense of what the difficulties are with the DCF model, because would you agree that there are difficulties with all the models?

MR. CICCHETTI:

A. Yes, and with the DCF, as Dr. Booth pointed out, you have to have an accurate for--a valid proxy for investor expectations. In my case, I'm using Value Line, which is the best. Now you can argue is Value Line an effective valid proxy for investor expectation. I say yes, and that's why I use it. I think, again, if you go back looking at how stable utility deadman's (phonetic) tend to be, they don't want to increase them until they know that they have earnings that can support an increase and they would rather cut off an arm than to decrease them. They're fairly stable and so in that regard, that is what I see as the biggest shortcoming.

Now those inputs can be manipulated by witnesses as well, and I think that goes back--I mean, I've used Value Line. You have other witnesses, I think you ought to average book value and earnings and dividends from this time period or this time period and another witness says, well, I think we ought to use the growth in the economy as the valid measure, and so it can become a big issue in the case and it can be confusing to the commissioners that are listening to that, and that's why I say you have to cut to the chase and say how rational are these inputs? What's the best way to do it?

KELLY, Q.C.

Q. So there are elements of judgment in the use of DCF models as well?

MR. CICCHETTI:

A. Absolutely.

KELLY, Q.C.

Q. Right, and what Ms. McShane, for example, has done is she's used a DCF model and she's used capital asset or equity risk premium model and looked at both methodologies and exercised judgment. Do you, in principle, have difficulty with that combined approach?

MR. CICCHETTI:

A. Not just as a combined approach. My problem has to do with looking at averaging beta that's historical and that's based on earned returns and not on required returns. What we're trying to get to is required returns.

KELLY, Q.C.

Q. Absolutely, okay. Now I just want to follow a couple of points up, if I could. Can I get you to go over to page 20 of your testimony?

MR. CICCHETTI:

A. I'm there.

KELLY, Q.C.

Q. And at the top of the page there, the first two paragraphs. Wait for Mike to get it up there. There you go. At line 421, you're talking about the comparison group with a Value Line beta of .69 and a little bit down further, at 426, the comparison group of natural gas distribution companies, because you got two electric utilities and natural gas, of .66. Would you just explain for the Board what that is, what that means, where it comes from?

MR. CICCHETTI:

A. Those are betas taken from Value Line and the definition of beta is the risk that it contributes to a well-diversified portfolio and that has to do with market returns. For example, the market overall would be considered one. These betas that are approximately .67 for a given change in the market, you would expect them to change two-thirds of that amount.

KELLY, Q.C.

Q. So they would be comparable to the betas that Ms. McShane's used in her testimony of .65 to .70?

MR. CICCHETTI:

A. Yes.

KELLY, Q.C.

Q. Okay. Can I follow up another point, which is I believe at page--the bottom of page 21, a little more technical here, in the DCF model, you look at dividends. Do you also factor in any growth amount in your model?

MR. CICCHETTI:

A. Yes.

KELLY, Q.C.

Q. Okay, just explain for the Board--you don't have to go very far with this--dividends and the growth and how that goes together in your DCF model.

MR. CICCHETTI:

A. As I indicated earlier, the relevant cash flows are the dividends that occur over time. We know what the dividend is today. With Value Line, they make explicit forecasts going out for four years. I've plugged those amounts into the model. For the years after that, I've used the same methodology that Dr. Booth referred to known as the sustainable growth method and that is you're going to use the retention rate of the company and the expected return on equity of the company to calculate, and that's basically the earnings minus the dividends divided by the earnings times the expected return on equity. So that's going to be the rate that you would expect the dividends to grow forward and it's basically an organic concept tied to the earnings of the company.

KELLY, Q.C.

Q. There's an element of judgment in the growth, but you've used it based upon the investor expectations from Value Line? Have I got that correct?

MR. CICCHETTI:

A. Yes.

KELLY, Q.C.

Q. Okay. Now beginning at the bottom of 21 and through page 22, I don't need to take you through the explanation, you explain, and I think we all agree why there needs to be an adjustment for market issuance costs, and I don't think there's any dispute over that factor. One of the things I'm just trying to understand is you've used five percent kind of going in and we're trying to understand what that means coming out the other end, because I take it to an answer that you've given, we can see this if we put up CA-PUB-16C. Just get this up for one second, CA-PUB-16. No, it should be CA-PUB. No. I'll just read you the question and answer, Mr. Cicchetti. You were asked--this was by the Consumer Advocate, "please confirm that the issue cost adjustment is based on US capital market experience" et cetera, and I won't read the whole question because the question is not that important. You said "confirmed. It is also noted that the issue cost adjustment recommended by Mr. Cicchetti is less than that recommended by Dr. Booth." Now Dr. Booth and Ms. McShane have each used 50 basis points, .50, and one of the things we're trying to understand is you've applied five percent to what and what would that equate at the end of the day to the

market risk premium?

MR. CICCHETTI:

A. It's applied to the price of the stock and it's approximately somewhere between 20 and 25 basis points and it seems, my understanding of what I've picked up is it's fairly standard here in Canada to use 50 basis points.

KELLY, Q.C.

Q. Right, and that's what I was trying to get at. So you've got about .2 to .25 in that, so about quarter of a percentage point less than -

MR. CICCHETTI:

A. Yeah, I've used five percent and it would be about a ten percent adjustment to make it similar to what Dr. Booth and Ms. McShane used.

(12:00 p.m.)

KELLY, Q.C.

Q. Okay. So we'd be short on your analysis, trying to put it into the more traditional Canadian model of about quarter of a percentage point, give or take?

MR. CICCHETTI:

A. Yes.

KELLY, Q.C.

Q. Okay, that's good, and does that also flow through to your equity risk premium analysis? If I take you over to page 24.

MR. CICCHETTI:

A. Yes, I made the same type of adjustment in that analysis.

KELLY, Q.C.

Q. So that is in your--what you've got built in that five percent flows into at the front end in that too?

MR. CICCHETTI:

A. Yes.

KELLY, Q.C.

Q. Because we weren't sure whether you had anything in that or whether you had what we now know to be say .2 or .25.

MR. CICCHETTI:

A. Yes, that's correct.

KELLY, Q.C.

Q. So if we wanted to adjust that, we'd need to add roughly quarter of a percentage point to that one as well?

MR. CICCHETTI:

A. If you wanted to do that.

KELLY, Q.C.

Q. Okay, and can I just ask you one last question? You end up with a utility risk premium of 4.35, if I take you to page 24, at line 518.

MR. CICCHETTI:

A. Yes.

KELLY, Q.C.

Q. See that?

MR. CICCHETTI:

A. Yes.

KELLY, Q.C.

Q. Okay, and we looked at the beta of .66. So if I take the beta and divide it into 4.35, I'd get an inferred market risk premium of about 6.6. So if I tried to equate where you are with kind of where Ms. McShane is, I then have to take off that 25 basis points roughly that you've got in for floatation costs because they add that on after, so I'd get roughly 6.6 minus the 2.--sorry, about quarter of a point. So I'd be down in about 6.4 as your inferred market risk premium?

MR. CICCHETTI:

A. That sounds reasonable, so I'd accept that,

subject to check.
KELLY, Q.C.
Q. Yeah, okay. I'm just trying to get a range of if we took your data and tried to put it into a CAPM model where your market risk premium would be. So it would be about, roughly about 6.4, give or take. Okay. Thank you, Mr. Cicchetti, those are my questions.
MR. MARK CICCHETTI, CROSS-EXAMINATION BY MR. THOMAS JOHNSON
MR. JOHNSON:
Q. Mr. Cicchetti, you can affirm for the record in this proceeding that not one of your recommendations flows out of an analysis of Canadian utilities, correct?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. Now you mentioned in your opening about your concerns about "we" getting out of the recession. You were talking about the United States, correct?
MR. CICCHETTI:
A. I was talking about United States and Canada.
MR. JOHNSON:

Q. Now you talked about the housing market still being troubled. That's a "we" for the United States, correct?
MR. CICCHETTI:
A. With the understanding that the two economies are intricately intertwined.
MR. JOHNSON:
Q. Do you have any knowledge of the housing market situation here in Canada?
MR. CICCHETTI:
A. Yes, and I don't mean to say that the housing market is as troubled in Canada as it is in the US. I'm only saying in order for the US economy to pull out of the situation that it's in, that's going to have to change and that has consequences for the Canadian economy.
MR. JOHNSON:
Q. You're saying you're not saying that the housing market in Canada is as troubled as what's in the United States, but what I'm asking you is do you have any information that the Canadian housing market is troubled?
MR. CICCHETTI:
A. No.
MR. JOHNSON:

Q. You referred to ten percent unemployment in the United States.
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. That's not the unemployment figure in Canada, correct?
MR. CICCHETTI:
A. Correct.
MR. JOHNSON:
Q. You referred to the fragility of banks. You're talking about American banks, correct?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. You heard the evidence of Dr. Booth who indicated that Canadian banks are worldwide regarded as being the strongest in the world. Do you have any reason to disagree with that?
MR. CICCHETTI:
A. Not at all.
MR. JOHNSON:
Q. Do you have likewise, sir, any reason to take issue with what the Bank of Canada's forecast inflation is, as set out in page 21 of Dr.

Booth's report?
MR. CICCHETTI:
A. No, I don't.
MR. JOHNSON:
Q. In fact, you would agree with it?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. You are also aware, from having sat through the testimony, that it has been years since a regulatory board in this country has accepted and given weight to a discounted cash flow analysis, correct?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. You've also sat through this hearing and you've heard Ms. McShane acknowledge that Canadian boards, to her extensive memory of their decisions in this country, have never accepted adjusted betas, correct?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. And I take it you will confirm that the Value

Line number, which we've called an adjusted beta, is no different, in essence, than what these Canadian regulatory boards have refused to acknowledge and accept, correct?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. That's right. Now you have indicated that DCF is a scalpel, right?

MR. CICCHETTI:

A. I made that analogy, yes.

MR. JOHNSON:

Q. Okay. How precise can this scalpel be when there are companies, Mr. Cicchetti, who are in your gas sample, and this is supposed to be a low risk comparator group, like South Jersey Industries? And we won't go there right away, but they say, at page two, "our growth comes from the robust growth and profitability of non-utility activities, along with reliable steady growth of our utility. To illustrate this point, our non-utility businesses in 2004 contributed 27 percent to South Jersey Industries' earnings in 2004, compared with 42 percent contribution to economic earnings in

2008," and their corporate documentation, again for the record at Tab 3, says at page four that one of their corporate goals is to execute from a low to moderate risk platform. Is that the scalpel you're talking about?

MR. CICCHETTI:

A. Yes. I think there's a couple of important points that need to be made. One is you're looking at the overall investment risk characteristics of the business, which includes both financial risk and business risk, and the ratings that fall from that process and the groups of companies that I used have an overall profile of total risk similar to that of Newfoundland Power. Additionally, a lot of the non-regulated businesses that the LDCs are and in the US formerly were regulated business, for example, gas transportation and storage, and so they are in the same relevant line of business and I think they are very good proxies for the company.

MR. JOHNSON:

Q. But Mr. Cicchetti, how can a company that derives, what was it, 40 percent of earnings

from a non-regulated business which they're trying to go from low risk to a medium risk platform, how in heaven's name can that be compared to Newfoundland Power without stretching credulity?

MR. CICCHETTI:

A. They have similar overall risk characteristics, total risk. I think if we went through this same process with the Canadian utilities that Dr. Booth used, I think you would find similar non-regulated operations.

MR. JOHNSON:

Q. To that extent?

MR. CICCHETTI:

A. Well, we're talking about one company, and there's going to be, I think it's been brought up many times, differences. You're not going to find companies that are exactly like Newfoundland Power that you can create a group. So you have to use your judgment and look at what you believe is a relevant comparable group.

MR. JOHNSON:

Q. Did you use your judgment and actually analyze

the 10K returns of South Jersey Industries and say "yes, I think that's a good proxy for Newfoundland Power"?

MR. CICCHETTI:

A. Yes. I've been through the 10Ks of these companies many times over the years and I'm aware--I get other investment reports that are associated with these companies and I think they are valid proxies if you look overall at equity ratio, Value Line safety rank, bond ratings, and the bond ratings are going to take all those things into consideration. It's not like the bond rating companies aren't aware of all of that, and they have similar bond ratings to Newfoundland Power and on top, and also you have to recognize that the financial metrics of the company are somewhat less than these companies, but taken overall as a whole, I believe they're very good proxies.

MR. JOHNSON:

Q. Now, Mr. Cicchetti, you've also acknowledged, do you not, that the bond rating is not intended to be an indicator of investor--equity investor expectations, is it?

MR. CICCHETTI:
A. No, but it's a relevant measure of risk.
MR. JOHNSON:
Q. Okay, but it's not, in your--in your analysis, how do you--how does one make its way into your comparable proxy group?
MR. CICCHETTI:
A. I'm going to analyze various aspects of business and financial risk for companies that are in the same or similar industries that have similar business and financial risks. For example, regulated natural gas companies, regulated electric companies of similar size to the company being studied and general overall knowledge of the industry in general.
MR. JOHNSON:
Q. Well how did you consider then what regulatory support these different companies had?
MR. CICCHETTI:
A. Well, regulatory support is one factor in the analysis and I think Moody's pointed out, and did it well, that the regulatory support here is phenomenal and I agree with that. It's just that you have to look at everything as a whole.

MR. JOHNSON:
Q. In terms of the Canadian companies that you looked at, but at the end of the day really didn't do anything with, what--did you look at their filings to see if they could be comparable?
MR. CICCHETTI:
A. I looked at various investment research reports.
MR. JOHNSON:
Q. Did you look at Gas Metro?
MR. CICCHETTI:
A. If it wasn't publicly traded, I didn't look at it. I can't remember the names of all the companies that I looked at, but I did look at everyone that I could find, looked at their annual reports and looked at investment rating reports.
MR. JOHNSON:
Q. So you can't--do you know if--you don't know if Gas Metro is publicly traded, do you?
MR. CICCHETTI:
A. I can't remember the names of all the companies off the top of my head.
MR. JOHNSON:

Q. How about Emera? Did you look at Emera?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. Okay. They're publicly traded?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. They own Nova Scotia Power?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. Okay, and did you look at their 10K filing?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. Okay, but they -
MR. CICCHETTI:
A. No, I looked at their annual report.
MR. JOHNSON:
Q. Okay, but how come they didn't make it into the group?
MR. CICCHETTI:
A. They're very large. They were larger than--I was looking at small cap and mid cap

companies.
MR. JOHNSON:
Q. Mr. Cicchetti, if we could, just to go back and we'll join up with this again. You referred to the idea that betas go to one as being conventional wisdom, accepted theory. Is that right?
MR. CICCHETTI:
A. Generally speaking, yes.
MR. JOHNSON:
Q. Okay. Are you familiar with the report or the study that Dr. Booth cites at Footnote 10, page 38 of his evidence?
MR. SIMMONS:
Q. I'm sorry, did you say footnote 10 on page 38?
MR. JOHNSON:
Q. Yes.
MR. SIMMONS:
Q. We see footnotes 11, 12 and 13 on page 38.
MR. JOHNSON:
Q. Oh, page 11.
MR. SIMMONS:
Q. Footnote 11?
MR. JOHNSON:
Q. Footnote 11. He cites Gombola and Kahl, "Time

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Series Properties of Utility Betas" who comes to the exact same conclusions as he does. Are you familiar with that study?

MR. CICCHETTI:

A. I'm familiar with the conclusions.

MR. JOHNSON:

Q. Yeah, and this Fama French model that you spoke of, has that been applied in Canada, to your knowledge?

MR. CICCHETTI:

A. I don't know if it has or if it hasn't.

MR. JOHNSON:

Q. I guess we agree on one thing for sure and that's comparable earnings has no place before this Board. Is that your advice to the Board?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. Yeah. Do you have any experience with an automatic adjustment formula?

MR. CICCHETTI:

A. I don't know exactly how to answer that. In Florida, we developed what's known as a leverage formula. We have many small water and waste water utilities that can't afford

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utility cost of capital expert witnesses to come in for rate proceedings. Many of them are just subdivisions, water and waste water utilities for subdivisions. So in order to deal with that situation, we developed a formula that based on the theories of Madiglioni and Miller that the overall cost of capital would remain the same as you varied the leverage in the capital structure and correspondingly varied the allowed return associated with that leverage. How it works is each year the staff of the Florida Commission will update the cost of equity analysis that would get plugged into that formula and then companies can choose whether or not they want to rely on the results of that formula based on their capital structure or they can hire a witness and I can't remember the last time that a small water or waste water utility decided that they didn't want to rely on the formula.

MR. JOHNSON:

Q. So that's your experience with formulas of this type?

MR. CICCHETTI:

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A. Yes.

MR. JOHNSON:

Q. Okay, and you refer, at page three of your evidence, on line 66, that you reviewed the status of the power markets in Canada and the United States, the characteristics of Newfoundland Power and examined the related business and financial risks that are important to investors. What are the business and financial risks that are important to investors?

MR. CICCHETTI:

A. Those are on my schedules that lay out the investment risk characteristics.

MR. JOHNSON:

Q. Would things like fuel protection be important to investors?

MR. CICCHETTI:

A. Yes, as I discussed in my description of business risk, those would be the kinds of things that would affect the company.

MR. JOHNSON:

Q. Yeah. There might be investors out there who really are not all that familiar with a company's bond rating, for instance, correct?

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MR. CICCHETTI:

A. Correct.

MR. JOHNSON:

Q. And they would look to see does this company earn its allowed return? Would that be fair for an investor to take that on board?

MR. CICCHETTI:

A. I understand your point generally. I just wonder if someone couldn't understand the bond rating, could they understand the difference between allowed returns and earned returns for a public utility, but generally speaking, I could see maybe one would understand one and not the other. That's possible.

MR. JOHNSON:

Q. But would an equity investor feel safer in a supportive regulatory environment than in one that is not as supportive?

MR. CICCHETTI:

A. I would assume so, yes.

MR. JOHNSON:

Q. Yeah. Would they feel more comfortable in an environment where a utility has the ability to make applications to establish accounts outside of a general rate application?

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MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. Yeah, and would they feel more comfort, less risk if they had their energy supply cost variances covered off in an account?
MR. CICCHETTI:
A. I would assume so.
MR. JOHNSON:
Q. Yeah, and similarly, if they had pension expense variances covered off in an account, they would relatively that this is less risky than a utility that did not have those protections, correct?
MR. CICCHETTI:
A. I think that's a fair assumption.
MR. JOHNSON:
Q. Yeah, that would be the equity investor. His or her mind would work like that, wouldn't it?
MR. CICCHETTI:
A. Those would be some of the things that they would take into consideration, yes.
MR. JOHNSON:
Q. Yeah. You've indicated that it's a stand-alone approach that a regulatory board must

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keep its eye on when looking at what the return should be for a regulated utility?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. Okay, and you mentioned at page nine of your report that many operating utilities--this is at line 201. "Many operating utilities are subsidiaries of larger conglomerate corporations that have both regulated and higher non-risk regulations. The stand-alone approach to utility regulation recognizes that the reasonable and prudent cost associated with the provision of utility service should be based on the cost that would be incurred if the utility was an independent stand-alone entity." What implication is there if the holding company has higher non-risk -- higher risk of non-regulated operations and that utility becomes part of a proxy sample when we're trying to establish the fair rate of return for a wholly regulated company?
MR. CICCHETTI:
A. Again, you would have to look at the entire business risk and financial risk and total

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risk. The answer to your question is would the non-regulated operations tend to increase the required return? Yes, they would.
MR. JOHNSON:
Q. Yeah.
MR. CICCHETTI:
A. Would it be a meaningful amount? That's disputable.
MR. JOHNSON:
Q. Well, what judgment should be--what's the cutoff percentage of non-regulated income in order to make you comfortable that the proxy group is not overstating what the fair return would be?
MR. CICCHETTI:
A. It would depend. It would depend on the utility, but if you were to exclude all publicly traded utility companies that had non-regulated operations, I don't know that you would be left with any to compare to.
MR. JOHNSON:
Q. I could grant you that, but what I'm interested in knowing is--because you've got to look at it from where I'm sitting. I'm representing customers, because we've talked

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about investor expectations and I'm thinking about the customer who's on the other side of this equation, and if they were to be told that we are going to look to a proxy group to determine what the fair return for Newfoundland Power is, they may not have a problem with that. But if you were then to say to them "yeah, the proxy group now is going to contain companies that get a fair chunk of their earnings from non-regulated higher risk activity," what do you think they'd say?
MR. CICCHETTI:
A. I can understand your point. I guess my point would be some non-regulated operations are more risky than others. For example, with the case of regulated natural gas companies whose operations previously were regulated and then in the United States they became non-regulated transportation and storage of gas, for example, that might not be much riskier than the regulated operations overall.
MR. JOHNSON:
Q. But Mr. Cicchetti, if you have a holding company that has, as part of its corporate

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structure, a company that's out competing and hustling and getting -- generating great returns, doesn't that represent a problem from the point of view of the customer whose rates are going to be including a return on equity for the utility company when the utility company is totally regulated and doesn't have that competitive influence?

MR. CICCHETTI:

A. Well, I guess, I'd get back to the point is it a meaningful amount? In the cases of the companies I chose, I don't think it has that much of an impact. If the Board was concerned about that to a significant extent, I say the required return is calculated within a range. They could take that into consideration when they're making their determination.

MR. JOHNSON:

Q. So what would be the--what would be a rule of thumb that you would use to say, look, if that has more than X percent of non-regulated income, I think you're going to have to think about an adjustment of some sort?

MR. CICCHETTI:

A. I don't think there is a rule of thumb.

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MR. JOHNSON:

Q. No? How much unregulated income would you--would one of these subsidiaries or one of these holding companies have to have for Mark Cicchetti to say "oops, I think that that company no longer should be in that sample"?

MR. CICCHETTI:

A. Well, it would depend on what the non-regulated income was coming from. If it's an industry that's not much risk and it's not substantial and I don't know exactly--I would have to look at it to say is this substantial for this round of business, I would have to make that determination, but generally speaking, these are considered regulated utilities. If they become somewhat more non-regulated, they'd become a company that's in a different industry. These are generally regulated electric and gas utilities.

MR. JOHNSON:

Q. Well, if--I guess the upshot is that there is a risk, depending upon the choice of the proxy group, of overestimating the fair return on equity, isn't there?

MR. CICCHETTI:

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A. It can be.

MR. JOHNSON:

Q. And how does that risk arise?

MR. CICCHETTI:

A. Through investment and non-regulated operations affecting the overall cost of capital to a meaningful amount.

MR. JOHNSON:

Q. Now you recommend that the Board not apply any adjustments to the numbers that flow out of your DCF tests, right?

MR. CICCHETTI:

A. Correct.

MR. JOHNSON:

Q. Take them at face value and say, Board, that's fair for Newfoundland Power. Have I got you correct?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. We've had some discussion, as you know, about the introduction of the pension expense variant deferral account, and you were here for that testimony?

MR. CICCHETTI:

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A. I believe I was here for a good portion of it.

MR. JOHNSON:

Q. And you can recall the testimony about how much money would have gone into that variance account in past years had it been in operation?

MR. CICCHETTI:

A. I don't remember the details. I wasn't involved particularly with that issue, so I wasn't paying close attention to it.

MR. JOHNSON:

Q. In your judgment, Mr. Cicchetti, would an introduction of a new deferral account, like a PEVDA, lessen the risk of a utility?

MR. CICCHETTI:

A. It's hard to say. I mean, I guess there is a point of diminishing returns. Once you say, you know, this--we're going to give certain amount of credit for supportive regulation, you know, does it incrementally keep increasing every time something happens or is it just in general considered supportive?

MR. JOHNSON:

Q. Well, let's put it this way. Let's turn it around. Let's say the Board says, "look, guys, you got the energy supply cost variance. You got rate stabilization. You got the municipal tax adjustment. We're going to take off one of these now." Would that influence the risk of the utility?

MR. CICCHETTI:

A. Well, I think you'd have to see how much it increases the variability of their earnings and try to measure the risk impact and I don't know that without having taken a closer at it exactly how that would impact investors overall perception of the quality of regulation.

(12:30 p.m.)

MR. JOHNSON:

Q. A deferred account usually helps cut down on volatility in earnings, doesn't it?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. And cutting down on volatility in earnings is a risk reducer, isn't it?

MR. CICCHETTI:

A. Yes. I'm just getting back to the point of what is the extent of it and how does that

relative to the total amount.

MR. JOHNSON:

Q. So if the Board feels that the amount is material enough not to be diminimus, they could be safe in concluding that the company has been made less risky?

MR. CICCHETTI:

A. If they had reason to believe that it has in fact reduced the risk in the eyes of the investor, then I wouldn't disagree with that.

MR. JOHNSON:

Q. Right. Now you've indicated that Newfoundland Power, at page 14, faces very little competition, as it is an isolated geographic location. You've also pointed to the fact that it serves 85 percent of the customers on the island of Newfoundland and that the customers mix is primarily residential and commercial, so there is virtually no risk associated with customer concentration as it doesn't have any industrial customers, and in your sample, Mr. Cicchetti, have you seen any utility that protected from competition?

MR. CICCHETTI:

A. No.

MR. JOHNSON:

Q. And you also go on to say "because the customer base is stable, capital expenditures and a need to raise capital are expected to be relatively modest into the future." I've gone through the 10Ks on these companies and I've seen examples of fairly robust capital expenditure plans. Have you seen any where the rate base was so stable and the need to raise capital was expected to be so relatively modest going into the foreseeable future?

MR. CICCHETTI:

A. No. I just would again emphasize you need to look at the entire picture.

MR. JOHNSON:

Q. Yeah. Now you have said, and we've already talked around this a bit, on page 17 of your report, at line 364, you've indicated that--well, it starts up at line 362. "Consequently, determining a valid proxy for investor expectations regarding the expected cash flows of a stock, the expected dividends, is the most important and often most contentious issue in determining the cost of equity using the DCF formula." And I think

that's really what these binders are all about. I mean, that's--why is it the most contentious?

MR. CICCHETTI:

A. Because there is no--you cannot know what all investors think at any point in time. So you have to find the proxy for investor expectations, and so with regard to the growth in the dividends of a stock, you need to come up with a valid proxy.

MR. JOHNSON:

Q. And so you've seen battlegrounds, battles fought in hearings, have you, about the appropriate proxy groups?

MR. CICCHETTI:

A. About the appropriate growth rate for dividends of a stock, yes.

MR. JOHNSON:

Q. No, but I thought your line said "consequently, determining a valid proxy for investor expectations." So you're not saying the battleground is the selection of the companies, are you?

MR. CICCHETTI:

A. No.

MR. JOHNSON:
Q. Okay. In terms of your proxy groups that you use, have you used these proxy groups a lot?
MR. CICCHETTI:
A. I've used local gas distribution companies and tried to put together a group that's similar to whatever group I'm looking at, the same with electrics, and I don't think I've used the exact same groups prior.
MR. JOHNSON:
Q. I think you gave a response to an RFI that in the last two years you've used it.
MR. CICCHETTI:
A. I used the same methodology.
MR. JOHNSON:
Q. No, you indicated that you used the same groups. So the question that was posed was CA-PUB-14. I think this is where the miscommunication is. The question was "can Mr. Cicchetti provide copies of all testimony presented by him over the last"--this is PUB-14 -- CA-PUB-14F. "Can Mr. Cicchetti provide copies of all testimony presented by him over the last two years and indicate the tests that he performed and the sample of firms that he

used? It would be sufficient to indicate that all his evidence over the last two years is based on the same techniques and samples presented in this hearing if that's the case." And what you've indicated is that, and you're right, you've used similar analysis in your testimony over the last two years, but this is the first time using this proxy group.
MR. CICCHETTI:
A. Of all the companies, yes.
MR. JOHNSON:
Q. Okay, and when did you construct this proxy group?
MR. CICCHETTI:
A. I believe it was some time in July or August.
MR. JOHNSON:
Q. Okay. So in fairness, Mr. Cicchetti, you don't have a long working knowledge of these companies?
MR. CICCHETTI:
A. Oh, I do.
MR. JOHNSON:
Q. Have you used, in the last two years, your sample, let's say at Schedule MAC-7, which is your comparable gas companies?

MR. CICCHETTI:
A. Now looking at just the gas companies, it's possible that I've used those, depending on the company that we're looking at, it may include some or some may drop in and out. Just the gas companies, it's possible that I've used just that group in past testimony.
MR. JOHNSON:
Q. And so would--this has--you would have used a list much like this in, let's say the last two years, three years?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. Okay, testifying, giving evidence?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. Okay, and what companies would you have relied on that sample to give evidence in respect of?
MR. CICCHETTI:
A. I think at one time or another, maybe all of them, maybe one or two that would have dropped out. I'd have to double check.
MR. JOHNSON:

Q. No, but what company's rate hearing were you involved in where you used this sample?
MR. CICCHETTI:
A. I'd have to double check.
MR. JOHNSON:
Q. Could you provide an undertaking to provide that information?
MR. CICCHETTI:
A. Certainly.
MR. JOHNSON:
Q. Say the last three years.
MR. CICCHETTI:
A. Okay.
MR. JOHNSON:
Q. And similarly -
MR. CICCHETTI:
A. And you want those same--it would be have testified in another case using those same companies in an LDC index?
MR. JOHNSON:
Q. Same or substantially the same. And would you be able to do the same in respect of your comparative--comparable electric companies in Schedule MAC-8?
MR. CICCHETTI:

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A. Certainly.

MR. JOHNSON:

Q. Thank you. So the assumption then, to the extent that these have been used in same or substantially the same content, is that these companies are of similar risk to Newfoundland Power?

MR. CICCHETTI:

A. Yes, I believe so. These are very low risk and I would refer again to the e-mail from Moody's, the line I cited, "however I include O & R because Moody's views the business risk profile of gas LDCs to be similar to, indeed, generally somewhat lower than that of electric T & Ds."

MR. JOHNSON:

Q. No, but just to be clear, so there's no misunderstanding, you're saying that the evidence that you've been involved in for other utilities, those other utilities where you used these samples would be similar in risk to Newfoundland Power?

MR. CICCHETTI:

A. Oh, those other utilities?

MR. JOHNSON:

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Q. Yeah, the cases you were involved in involving these other utilities where you relied on these samples.

MR. CICCHETTI:

A. I'm not sure. I would have to double check.

MR. JOHNSON:

Q. Because that's the critical piece, right, that you know, to confirm the actual company that you used these samples for.

MR. CICCHETTI:

A. Well, I might have used them in terms of determining a risk premium for a sample of low risk natural gas companies.

MR. JOHNSON:

Q. Well, let's--we'll get a confirmation of what they were used for. Now you indicated in your comparable companies analysis, starting at page 18, that you examined the companies listed by Value Line as the Canadian energy industry--I'm looking at line 389-390 of your testimony, and I take it, then you go on to say that you also examined Enbridge, however none of the Canadian companies that you examined were similar to Newfoundland Power and had long-term analyst forecast for growth

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earnings, return on equity and dividends, and were you able to get value--on how many of these were you able to Value Line ratings?

MR. CICCHETTI:

A. I think about three.

MR. JOHNSON:

Q. About three. Which ones?

MR. CICCHETTI:

A. I believe it was TransCanada, TransAlta and Enbridge.

MR. JOHNSON:

Q. And what were their Value Line ratings?

MR. CICCHETTI:

A. I believe the safety ratings were three, the betas four. I believe -

MR. JOHNSON:

Q. The safety rating being Newfoundland Power would be what safety rating?

MR. CICCHETTI:

A. One.

MR. JOHNSON:

Q. One, being the safest?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

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Q. And TransCanada would be?

MR. CICCHETTI:

A. I'd have to check, but I think one of the three would have qualified just on the basis of the safety rank and the others were riskier on the basis of the safety rank.

MR. JOHNSON:

Q. And riskier, not less than three?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. Okay. Would you undertake to provide the definition of three under the Value Line methodology?

MR. CICCHETTI:

A. It's a relative ranking from one to five, based on their financial strength rating and their price stability rating, and in their materials, they recommend that conservative investors stay with an investment or safety rank of one or two.

MR. JOHNSON:

Q. But isn't there a descriptor for what rank three means?

MR. CICCHETTI:

A. If there is, I can't recall it.
MR. JOHNSON:
Q. Just would rank one be highest safety?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. And would you agree with me that the definition for that, "these stocks as a group, the safest, most stable and least risky investments relative to the Value Line universe"?
MR. CICCHETTI:
A. Yes, that sounds familiar.
MR. JOHNSON:
Q. Sound familiar?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. And rank two would be above average and would you agree that the descriptor is "these stocks, as a group, are safer and less risky than most"?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:

Q. And for three, the descriptor is "average. These stocks, as a group, are of average risk and safety."
MR. CICCHETTI:
A. That sounds right.
MR. JOHNSON:
Q. And TransAlta, are you aware of the fact they don't have non-regulated businesses?
MR. CICCHETTI:
A. Yes, they're a pipeline company.
MR. JOHNSON:
Q. Yeah. Now in respect of the Value Line rankings, you had to be one or two to make it into your proxy group?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. And I understand that, going over to page 20, that the Value Line safety ranking average was 1.67 for your electric utility companies.
MR. CICCHETTI:
A. Correct.
MR. JOHNSON:
Q. Okay, and do you know who were the ones and who were the twos?

MR. CICCHETTI:
A. Yes, they're listed.
MR. JOHNSON:
Q. Okay, and that's listed in your report, okay, and then of course, that will be there as well for your natural gas distribution comparables?
MR. CICCHETTI:
A. Yes.
(12:45 p.m.)
MR. JOHNSON:
Q. Now you indicate in your report that, at page 19, that "regarding the use of natural gas distribution companies," and I'm looking at line 407, "regarding the use of natural gas distribution companies as proxies for Newfoundland Power, it should be noted it is helpful to have results from a different by similar industry to verify the reasonableness of cost of equity results."
MR. CICCHETTI:
A. Yes, that's what it says.
MR. JOHNSON:
Q. But Mr. Cicchetti, you'll confirm that you didn't use these companies to verify the reasonable cost of equity results. You used

it to ground your entire risk premium analysis, didn't you?
MR. CICCHETTI:
A. Yes, that's, I guess, a matter of semantics.
MR. JOHNSON:
Q. Okay.
MR. CICCHETTI:
A. I was speaking in general, not specifically, to the analysis in this report.
MR. JOHNSON:
Q. Now you indicated as well, at the bottom of page 19, that in your screening process, you used small or mid cap companies, and what was the thinking there?
MR. CICCHETTI:
A. That that approximates the size of the company and I wanted to exclude large cap companies. I try to get as accurate a proxy group as I can and so I tried to stay close, in terms of size.
MR. JOHNSON:
Q. And what would be the problem with having medium to large cap companies?
MR. CICCHETTI:
A. Well, as I said, Newfoundland Power is not a

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large cap company. They're approximately 890 million dollars of regulated assets. I would assume if they were market traded, they'd be somewhere in the mid cap range, small. I mean, they're kind of on the border line there.

MR. JOHNSON:

Q. But I mean, we know--you know, we know that they're not large cap, but for that matter, we know as well that they're not a US natural gas utility. So what I'm getting at is why would you exclude medium-large cap from the point of view of the accuracy of your analysis?

MR. CICCHETTI:

A. I did not exclude mid cap. I relied on small and mid cap. I excluded large cap to try and get away from the types of things that affect large companies that wouldn't affect a company the size of Newfoundland Power.

MR. JOHNSON:

Q. What type of things would they be?

MR. CICCHETTI:

A. Well, smaller companies have unique characteristics. I mean, they don't have the same service territory size, the same access

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to the capital markets that the large capital companies have. There's just some inherent differences, so -

MR. JOHNSON:

Q. But you're telling me about the differences, but I want to know--who cares if there's differences in those? You know what I'm saying? What's the point of the differences?

MR. CICCHETTI:

A. The point is to get a comparison group that is similar to Newfoundland Power and Newfoundland Power, in my opinion, in terms of size, is small to mid cap size. They're a regulated utility, electric utility. We look at their equity ratio, their safety rank, and just the importance of it is to try and get a group of comparable companies similar to the company that you're looking at.

MR. JOHNSON:

Q. I'd also note that you screened or looked for companies at least, at page--line 416 on the same page, that were not currently involved in a merger, and now a company being involved in a merger, they'd still have their S & P ranking, wouldn't they, and their Value Line

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ranking, right?

MR. CICCHETTI:

A. Correct.

MR. JOHNSON:

Q. And so that tells me that there is a different equity investor expectation for a company that might be in a merger situation.

MR. CICCHETTI:

A. What I have found in calculating required rates of return for companies, when you see one that's in a merger, my experience has been because of the changes in stock prices, you get anomalous results and so I prefer to remove companies that are involved in a merger when I'm doing a comparison analysis.

MR. JOHNSON:

Q. Now your risk premium analysis is really--I mean, we just had DCF DCF in your report, right? I mean, we're seeing DCF applied basically twice?

MR. CICCHETTI:

A. No, I consider it a risk premium analysis.

MR. JOHNSON:

Q. But totally driven by--the only thing that's different is now we're going to talk about the

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risk free rate?

MR. CICCHETTI:

A. Well, not only that, you're looking over an extended period of time and you're using required rates of return to do that.

MR. JOHNSON:

Q. And you indicated to Mr. Kelly's questions what your risk premium would end up being if you--your 435 is what the utility equity risk premium is, right?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. But the equity risk premium for the market that you would take out of that is significantly higher?

MR. CICCHETTI:

A. If you work through the math under those assumptions, I believe, subject to check, that's the answer that you would get.

MR. JOHNSON:

Q. Up around Ms. McShane?

MR. CICCHETTI:

A. That appears to be the case, yes.

MR. JOHNSON:

Q. Mr. Cicchetti, regarding your gas and electric samples, which have a safety ranking of one and two, according to Value Line, these then result in your DCF estimates in MAC-11 and MAC-10, right?

MR. CICCHETTI:

A. Those are the companies I used to make the calculations, yes.

MR. JOHNSON:

Q. Yeah, and could you provide, as an undertaking, an equivalent table for only those utilities with a safety ranking of one?

MR. CICCHETTI:

A. Certainly.

MR. JOHNSON:

Q. Thank you. Mr. Cicchetti, if I could, in fact, turn you now to South Jersey Industries?

MS. GLYNN:

Q. South Jersey will be Consent No. 20.

MR. JOHNSON:

Q. At Tab 1 again, we see a description of what South Jersey Industries is.

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. "An energy services holding company, provides a variety of energy-related products and services through its five wholly owned subsidiaries," et cetera. I would like just to confirm for the record what I put to you earlier, that at Tab 3, which is the 2008 annual report to shareholders, at page four, in the left-hand column.

MR. CICCHETTI:

A. Okay.

MR. JOHNSON:

Q. That this particular company has indicated, as part of its financial overview, that one of its goals is to--the third bullet down, is to execute from a low to moderate risk platform?

MR. CICCHETTI:

A. That's what it says.

MR. JOHNSON:

Q. No indication that Newfoundland Power is seeking to execute from a low to moderate risk platform, is there?

MR. CICCHETTI:

A. I'm not exactly sure what that means, what context they're saying that, but I'm not aware of the company in any shape or form,

Newfoundland Power moving from a low to moderate risk platform.

MR. JOHNSON:

Q. They'd be very low risk, Newfoundland Power, wouldn't they?

MR. CICCHETTI:

A. Well, they're equivalent to, for example, the group of companies that I've used in my analysis when you look at total risk perspective.

MR. JOHNSON:

Q. If you could just go back to the bottom of page two in this letter to shareholders? On the left-hand column where they say "growth and income. Yesterday, today and tomorrow" and under "yesterday" in the second paragraph, you see that?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. "Our success comes from the robust growth and profitability of our non-utility activities, along with the reliable steady growth of our utility. To illustrate this point, our non-utility businesses contributed 27 percent to

SJI's earnings in 2004, compared with a 42 percent contribution to economic earnings in 2008. This change occurred despite utility net income increasing from 31.5 million to 39.4 million during that time." See that?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. But, and you look up under performance highlights, again on the left-hand side, you see what they say about their performance highlights? "Dividend growth over the past three years was 28.4 percent. Equity of capitalization improved 7.9 percentage points to 47.4." Do you think their dividend growth had anything to do with the significant earnings from the non-utility side of the business?

MR. CICCHETTI:

A. It's possible.

MR. JOHNSON:

Q. I put to you, sir, that it's more than possible. It's obvious.

MR. CICCHETTI:

A. Well, I don't know that they specifically raised their dividend because they had two good years with regard to non-utility, non-regulated investment. I don't know that for certain.

MR. JOHNSON:

Q. Could we turn to CH Energy Group Inc.?

MS. GLYNN:

Q. CH Energy will be Consent No. 20--21, sorry.

MR. JOHNSON:

Q. Tab 1, under the business description, Mr. Cicchetti, CH Energy Group is the holding company of Central Hudson Gas and Electric, Central Hudson, it's known as, and Central Hudson Enterprises Corporation. Central Hudson, the regulated electric and natural gas subsidiary has one wholly owned subsidiary, Phoenix Development Inc. CHEC, the parent company of CH Energy Group's unregulated business segments has two wholly owned subsidiaries, Griffith Energy. Would non-regulated be a significant part of CH Energy Group?

MR. CICCHETTI:

A. Well, I think if you look at the following page, 1 of 3, it has in the middle on the

right hand side a little chart called "Business Segment", and I think right there will tell you exactly how it relates.

MR. JOHNSON:

Q. And what does that chart say to you?

MR. CICCHETTI:

A. It looks like a fairly significant portion.

MR. JOHNSON:

Q. Just turn, Mr. Cicchetti, to Tab 4, and in particular now, for the record, we're at the SEC filing, the 10K, page 41 of 367.

MR. CICCHETTI:

A. Can you repeat that, please?

MR. JOHNSON:

Q. Tab 4, page 41 of 367. Do you see the five year summary of consolidated operations and selected financial data?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. And you see in 2008 -- I take it that both electric and natural gas, they're regulated here?

MR. CICCHETTI:

A. I believe so, yes.

MR. JOHNSON:

Q. Right. So electric, 608 million, was it; yeah. Natural gas, 189 million. Competitive business subsidiaries, $535,144,000.00.

MR. CICCHETTI:

A. Yes, and that would relate to the amount of gas that they have to purchase.

MR. JOHNSON:

Q. Yeah. So the person who is looking to invest in CH Energy Group, they have an eye not just on the utility operations, they have a big eye on the competitive business subsidiaries, don't they?

MR. CICCHETTI:

A. Right, except I would point out that when you're looking at sales, and you're purchasing gas to flow through your pipeline or your transportation or storage, that's going to be a rather significant number, but it's pretty much just a pass through.

MR. JOHNSON:

Q. Aren't we agreed, though, that in terms of the overall earnings of this company, that non-regulated is very significant?

MR. CICCHETTI:

A. Again going back, if you look at just sales and you're talking about gas pass through, if you'll look on the left hand side -- well, it's a good portion.

(1:00 PM)

MR. JOHNSON:

Q. Turn to page 65 of Tab 4. You see a description of a proceeding in front of the regulator for the petition of Central Hudson Gas and Electric, they petitioned apparently for authority to defer certain gas expenses for the year, and the background apparently is that in 2007, Central Hudson filed a petition with the regulator seeking approval to defer certain incremental and material non-labour gas expenses that were incurred during rate year one, but were not included in rates under the 2006 rate plan, and this indicates under notable activity that the PSC denied Central Hudson's request, noting that while Central Hudson satisfied the standards for demonstrating the expense items were incremental, and Central Hudson hadn't earned its allowed rate of return, the PSC did not view the expense items as material and extraordinary in nature. So the shareholders in Central Hudson were told by the regulator to pick that up, right?

MR. CICCHETTI:

A. That's what it says.

MR. JOHNSON:

Q. Have you got any experience or any knowledge that something like that has happened with Newfoundland Power in this jurisdiction?

MR. CICCHETTI:

A. Not to my knowledge.

MR. JOHNSON:

Q. Could it happen in this jurisdiction, to your knowledge?

MR. CICCHETTI:

A. I don't think it's impossible that it could happen. I don't think it's likely. I have no reason to believe it would be likely, but it's not out of the realm of possibility.

MR. JOHNSON:

Q. Would an equity investor have a consideration like that in mind?

MR. CICCHETTI:

A. Certainly.

MR. JOHNSON:

Q. Let's look to MGE Inc.

MS. GLYNN:

Q. MGE is Consent #22.

MR. JOHNSON:

Q. There's a fairly convenient description at page 21 of these materials at the corporate profile.

MR. CICCHETTI:

A. Tab 3?

MR. JOHNSON:

Q. I don't have a tab, for whatever reason. I've just got -- the first cover of mine just deals with celebrating 100 years of delivering dividends to you.

MR. SIMMONS:

Q. That's Tab 3.

KELLY, Q.C.:

Q. Which page?

MR. JOHNSON:

Q. Page 21. On the left hand column, corporate profile, MG Energy Inc. is the parent company of Madison Gas and Electric, and its divisions which serve natural gas and electric customers in south central and western Wisconsin.

MR. CICCHETTI:

A. I'm sorry, Mr. Johnson, I don't appear to have that same --

MR. JOHNSON:

Q. Oh, I'm sorry. I'm looking at page 21.

KELLY, Q.C.:

Q. There's another page 21 before the one you're looking at. You're looking for the one that's got the map on it probably.

MR. HAYES:

Q. It's in the 10K. It's another document.

MR. JOHNSON:

Q. It's in the 10K? Yeah, for some reason I don't have a tab in mine. Page 21 on the bottom right.

MR. CICCHETTI:

A. I believe I have it.

MR. JOHNSON:

Q. So we've covered MGE and its divisions, and they also own assets. MG Power owns assets in the West Campus Cogen facility in Madison, Wisconsin, and the Elm Road Coal Plant under construction at Oak Creek. MGE Transco Investment owns interest in the American Transmission Company through its members, MGE and MGE Energy. MGE Construct provides

construction services for building new generation facilities. Central Wisconsin Development Corp. promotes business growth in MGE's service area, and MAGAEL holds title to properties acquired. Now you see up at the top right there's a description of MGE Electric Services have generation and distribution, 137,000 customers, population of 292,000. Now if you look at page 8 -- so you'd have to go back a little bit. No, that's wrong, you've got to go further into the 10K, I'm sorry. At the bottom of page 7, they talk about electric utility operations. They say at the very last line, "Electric revenues for 2008, 2007, and 2006, were comprised of the following", and then you go over to the next page, and you see, Mr. Cicchetti, residential, 33.9 percent, commercial, 54 percent, industrial 6 percent, public authorities, including the UW, 9.2 percent, with 100 percent. Now if you were an equity investor, Mr. Cicchetti, would you prefer this profile or Newfoundland Power's?

MR. CICCHETTI:

A. I would have to look at the entire picture, and I don't know that just because they have 54 commercial, it would make one better or worse than the other.

MR. JOHNSON:

Q. Okay, well, let's be specific about this. If we were talking about comparing Newfoundland Power's situation as to where it derives its electric revenues versus MG - this particular utility, where it gets its revenues, which one would be safer?

MR. CICCHETTI:

A. If you looked at that sole one item, then the commercial concentration would make this company more risky relative to Newfoundland Power, on that one particular item.

MR. JOHNSON:

Q. Yeah, I grant you, and why would that be?

MR. CICCHETTI:

A. Commercial would be more volatile, more susceptible to downturns in the economy, depending on how concentrated they were. Residential is considered the least risky to serve.

MR. JOHNSON:

Q. And that's -- residential being less risky,

that's accepted conventional wisdom, isn't it?

MR. CICCHETTI:

A. I would think so, yes.

MR. JOHNSON:

Q. Just like it's accepted conventional wisdom that T & D is less risky than companies that have generation?

MR. CICCHETTI:

A. Generally speaking, yes.

MR. JOHNSON:

Q. Why would that be?

MR. CICCHETTI:

A. It just has to do -- if you run generation, you are subject to a much greater capital investment, more susceptible to something going wrong, higher operating costs than if you were just a wires company and it's just passing through cost of transmission and distribution.

MR. JOHNSON:

Q. Just look to the top of page nine regarding fuel supply and generation, and you will see "MGE satisfies its customers electric demand with internal generation and purchase power. During the years ending December 31st, 2008,

2007, and 2006, MGE's electric energy delivery requirements were satisfied by the following sources". You see that their purchase power is 39.2 percent. They generate coal, with coal nearly 52 percent. Natural gas, 6 percent. The rest is fairly negligible. Now if you were an equity investor, I take it, it follows from our discussion a moment ago that Newfoundland Power's profile is considerably less risky than this one?

MR. CICCHETTI:

A. To the extent that they're a wires company, transmission and distribution, versus a company that is generation, generally speaking, yes, but again, you know, each company is going to have its differences and you need to look at the entire picture.

MR. JOHNSON:

Q. Yes, but the devil is in the details, isn't it, because after a while these differences start mounting up and they start affecting the overall picture?

MR. CICCHETTI:

A. Well, that's why you have to look at the overall picture.

MR. JOHNSON:

Q. That's right. Let's look at page 18. Now at the very top, they put out in their 10K in bold letters, "We face risk for the recovery of fuel and purchase power cost when they exceed the base rate established in MGE's current rate structure". Now, Mr. Cicchetti, I won't leave it at that because that would leave a false impression, but I do want to take you to page 56 where this is explained a bit more. You see regulatory recovery risk, and I'll just read it, "MGE's electric operations burn natural gas in several of its peak power plants or as supplemental fuel as several coal-fired plants, and in many cases the cost to purchase power is tied to the cost of natural gas. MGE bears significant regulatory risk for the recovery of such fuel and purchase power cost when costs are higher than the base rate established in its current rate structure". The next paragraph says, "As noted above in commodity price risk, the electric operations of MGE operate under a "Fuel Rules" adjustment clause for fuel and purchase power costs associated with the

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generation and delivery of electricity. This clause establishes a base rate for fuel purchase power. MGE is subject to a "Fuel Rules" bandwidth of -2 percent to +2 percent. MGE may be required to refund the customers if the "Fuel Rule" cost fall outside the lower end of the range, i.e. -2 percent, and it would be allowed to request a surcharge if the "Fuel Rule" cost exceed the upper end of the range, _+2 percent. MGE assumes the risks and benefits of variances that are within the 2 percent bandwidth. For 2009, fuel and purchase power costs included in MGE's base fuel rates are 123.2 million". Now that means that this company is at risk within that band, correct?

MR. CICCHETTI:
A. But I'm sure -- I've assumed they would hedge that risk.

MR. JOHNSON:
Q. Yeah. Does Newfoundland Power have a similar risk?

MR. CICCHETTI:
A. No, but again there's going to be individual differences between these companies, and you

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have to look at the entire picture, and with regards to looking at the entire picture, looking at bond ratings, and the other things that we've talked about, these group of companies are similar in risk to Newfoundland Power.

MR. JOHNSON:
Q. Well, Mr. Cicchetti, let me ask you a simple question. It appears to me that MGE, if they're at risk for 2 percent of the fuel rate, that's 2 and some million dollars based on 123.2 million, correct?

MR. CICCHETTI:
A. Sounds right.

MR. JOHNSON:
Q. Right. Do you think an equity investor would prefer the risky profile or the less risky profile? What would be the less risky, that's a better way to put it, Newfoundland Power's or this one?

MR. CICCHETTI:
A. Well, if you want to look at one particular item --

MR. JOHNSON:
Q. Yeah, I want to look at one particular item?

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MR. CICCHETTI:
A. Obviously, reasonable risk, investors are risk adverse, and would choose for a given return, less risk, rather than more risk, but you keep looking a specifics associated with business risk, and in order to evaluate a company as comparable, you have to include business risk and financial risk, and with regard to regulatory risk, you have to look at the allowed returns, the capital structure, the financial metrics that fall out there, and all of that gets wrapped up to a great extent in the bond rating, and so on that basis, these are comparable. I mean, you can beat this to death, but it's not going to change the fact that you have to look at the overall investment risk characteristics, and, yes, there are specific business risk items associated with Newfoundland Power that are less risky than a lot of these companies, but all in all, they're similar.

MR. JOHNSON:
Q. That's why a lot of these companies, I take it, would be getting a higher ROE? Could be, right?

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MR. CICCHETTI:
A. An allowed return is one thing, but what we're calculating using the DCF formula and the comparable companies, is the required return. They may have an higher allowed return, but that stop price and the expected return is being factored in to the equation and producing a required return, such that if you then apply that required return to that company, you would expect that company to earn that return and their marketable ratio to come down accordingly. So just because these companies might have higher allowed returns doesn't change the nature of how you calculate the required return.

MR. JOHNSON:
Q. Sounds rather mechanical to me, Mr. Cicchetti.

MR. CICCHETTI:
A. It's a matter of math.

MR. JOHNSON:
Q. Wouldn't you think -- wouldn't you think that a management team, okay -- just think about MGE, the management team at MGE. They're at risk for a couple of million bucks, right? So what do you --

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MR. CICCHETTI:
A. Well, depending --
MR. JOHNSON:
Q. What do you think that they would do? Would you expect that they'd put in strategies to minimize that risk?
MR. CICCHETTI:
A. Certainly.
MR. JOHNSON:
Q. Yeah, and so they'd try to manage the risk, and would you agree with me that they ought to be compensated for having to manage that risk?
MR. CICCHETTI:
A. It's part of their job.
MR. JOHNSON:
Q. No, no, but, in fairness, if a leadership team in a company is at risk for a couple of million bucks and they're managing that risk for the benefit of the shareholder, they should get compensated for that in the ROE, shouldn't they?
MR. CICCHETTI:
A. I'm not sure I follow you. I don't think that's the case. I mean, they're there to run the company and they get a salary for running

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the company, and if hedging fuel cost is part of their job, I don't understand how --
MR. JOHNSON:
Q. Let's put it this way, would it be fair -- you take company "A" and company "B", and they are identical, okay, except company "A" is at risk for fuel costs, okay. Should company "B", who is not at risk for fuel cost, expect the same return on equity, other things being equal?
MR. CICCHETTI:
A. Again now you're looking at one particular item and trying to draw a conclusion from it. We've already accepted the fact that Newfoundland Power has certain clauses that on that basis allow them to be less risky in those particular areas, and experience supportive regulation. That is being taken into account in coming up with their bond rating, coming up with their financial profile, but to try and specifically look at one particular thing with this company versus another thing with another company, they're going to have a job, which is why you look at a group, and you have to look at the overall picture, which includes total risk, which

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includes business risk, and financial risk in determining whether or not they're comparable to Newfoundland Power.
MR. JOHNSON:
Q. Just go down the page of page 18, operating risk, "We are affected by weather, which affects customer demand, and can affect the operation of our facilities. The demand for electric and gas is affected by weather. Very warm and very cold temperatures, especially for prolonged periods, can dramatically increase the demand for electricity for cooling and heating respectively. Our electric revenues are sensitive to the summer cooling season, and to a lesser extent, the winter heating season". If, as it appears, this company is affected by weather and it doesn't have it normalized, so it's earnings are not protected from it, and we add that, should -- other things being equal, should they expect that they should be rewarded for that in their ROE as opposed to a company that doesn't have such protection, or are we back to you've got to look at the credit rating?
MR. CICCHETTI:

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A. You have to look at the overall picture.
MR. JOHNSON:
Q. And the overall picture is encapsulated in the credit rating, is it?
MR. CICCHETTI:
A. That's one aspect of it, and certainly in evaluating their credit rating, Moody's and Standard and Poor's, and DBRS, or whoever, is going to consider those type of items.
MR. JOHNSON:
Q. Well, why do we waste all this time of talking about company's business risks, and regulatory risks? Why don't we just say, look, you've got this credit rating, this is what you get?
MR. CICCHETTI:
A. Mr. Johnson, I have people wondering why we're going through this particular exercise. I could just say that there are differences between the companies, and if you go through these 10Ks, you will find these types of disclosures and disclaimers for various issues for all the different companies. It's a part of the nature of the regulated electric and natural gas business.
MR. JOHNSON:

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Q. You see, the problem I have, and you've already agreed earlier, is that you were not able to identify one as less risky than Newfoundland Power, and I'm wondering if that be the case, how it would be fair to customers to lets just forget about that, it is what it is, all of them don't have the same protections as Newfoundland Power, but let's get on with it and apply this model.

MR. CICCHETTI:

A. Well, again you have to look at Newfoundland Power's allowed return, their equity ratio, how that translates into their financial metrics, and I think that's about the clearest way that I can say. Sure there are things on the regulatory side and the business risk side that are very favourable for them, but you have to look at the entire picture and see how do these compare, and when we look at the investment risk characteristics that I've presented, I think -- it's my opinion they are comparable overall.

MR. JOHNSON:

Q. I take it we'd have no disagreement at all that the median -- the median utility in the

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United States versus the median utility in Canada, Canada would have a higher credit rating on the whole than the United States, right?

MR. CICCHETTI:

A. I think that's fact, yes.

MR. JOHNSON:

Q. And just the bottom of page 32, the very last paragraph refers to MGE's GCIM. I think this gets explained in the context of the paragraph. "Under MGE's GCIM, if actual gas commodities saving and capacity release revenues are above or below a benchmark as set by the PSCW, then MGE's gas sales service customers and shareholders share in any increased cost or savings per percentages set by the PSCW". So it's not all put over on the customer, it's a shared issue, isn't it?

MR. CICCHETTI:

A. I think that's an incentive mechanism.

MR. JOHNSON:

Q. That's right, and what's the saying in capitalism, "No risk, no reward", right, and how do equity investors get rewarded?

MR. CICCHETTI:

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A. They're compensated for the risk that they incur.

MR. JOHNSON:

Q. With a return on equity, correct?

MR. CICCHETTI:

A. Correct.

MR. JOHNSON:

Q. Wisconsin Energy.

MS. GLYNN:

Q. Wisconsin Energy is Consent 23.

(1:30 p.m.)

MR. JOHNSON:

Q. Again there's a business description at Tab 1, "Wisconsin Energy Corporation is a diversified holding company. The company conducts its operations primarily in two operating segments; a utility energy segment and a non-utility energy segment. The company's primary subsidiaries include Wisconsin Electric Power Company, known as Wisconsin Electric, Wisconsin Gas LLC, known as Wisconsin Gas, Edison Sault Electric Company, and WE Power LLC, WE Power. The company's utility energy segment consists of Wisconsin Electric, Wisconsin Gas, and Edison Sault. Its non-

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utility segment consists primarily of WE Power". Now if I could turn you to Tab 2, page 5 of 15, you see under utility, this company's utility operations are clearly electricity generation, distribution, and sales. So they are obviously a generator. If you turn to Tab 3, and now we're into the 10K, there's a description of a utility energy segment and their non-utility energy segment. That's just for the record, it just confirms the previous descriptions from the initial business profile, and if you could just look to page 12, Mr. Cicchetti, the installed capacity by fuel types, this would be a fairly sizeable generator of electricity, I take it, a total of 5,593 megawatts?

MR. CICCHETTI:

A. Yes, that's what it says.

MR. JOHNSON:

Q. And page 13 at the bottom, they refer to their coal-filed generation. They say under coal supply, "We diversify the coal supply for our power plants by purchasing coal from mines in Wyoming and Colorado, as well as from various other western mines. During 2009, 100 percent

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of our projected coal requirements of 11.6 million tons are under contracts, which are not tied to 2009 market pricing fluctuations". So then does that look to you like they're at risk for the price of coal?

MR. CICCHETTI:

A. I'm not sure. It could be that they're under contracts that are at a set price and not based on the market price.

MR. JOHNSON:

Q. Let's look over to the next page on coal deliveries because this is certainly more clear. They've got to get the coal to their generating units, and the second paragraph states, "Certain of our coal transportation contracts contain fuel cost adjustments that are tied to the cost of fuel utilized by the locomotives. The PSCW has approved a program that allows us to hedge up to 75 percent of our potential fuel for electric generation in order to help manage our risk of higher delivered cost of coal. The costs of this program are included in our fuel and purchase power costs". Now as I read that, they're allowed to hedge up to 75 percent, they don't

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have a guaranteed recovery of the coal transportation costs, do they?

MR. CICCHETTI:

A. That appears to be what it says.

MR. JOHNSON:

Q. Yeah. So they're at risk and management is paid and the investor in that company is paid to manage it, right?

MR. CICCHETTI:

A. Well, I'm not sure what the details of that particular contract are, but I don't know that that, in and of itself, is something that has increased the risk that an investor might consider on average, in general. That's one - these are pretty standard, for the most part, parts of being in the electric generation business.

MR. JOHNSON:

Q. In the United States. That's where you're going with that, right?

MR. CICCHETTI:

A. No, I mean, I -- there are electricities generated in Canada also, and these are the kind of things that have to be dealt with if you're going to generate electricity.

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MR. JOHNSON:

Q. Do you know that for a fact, or is that just what you think?

MR. CICCHETTI:

A. I'm just making a statement in general.

MR. JOHNSON:

Q. Yes, so that's just what you think, that's not tied to a fact, that's your impression?

MR. CICCHETTI:

A. Correct.

MR. JOHNSON:

Q. And under natural gas-fired generation, third paragraph down, "The PSCW has approved a program that allows us to hedge up to 75 percent of our estimated gas usage for electric generation in order to help manage our natural gas price risk. The costs of this program are included in our fuel and purchase power costs". Similar again, right?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. Just go to page 17. Just for the record, it's a further description at the bottom of their electric hedging programs.

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CHAIRMAN:

Q. Mr. Johnson, could you tell us how much longer are you going to be? Do you have any -- I mean, I'm not trying to --

MR. JOHNSON:

Q. No, I know. I would think probably half hour.

CHAIRMAN:

Q. Okay. So will we keep going and hopefully finish up today?

MR. JOHNSON:

Q. That would be perfect with me.

CHAIRMAN:

Q. Everybody agree to that?

KELLY, Q.C.:

Q. Mr. Chair, I don't know if there's anyone who would benefit from a five minute break I'm fine to carry on.

CHAIRMAN:

Q. Does anybody want to take a short break?

MR. CICCHETTI:

A. Mr. Chairman, I would. I don't think it'll take me five minutes.

CHAIRMAN:

Q. We'll resume when Mr. Cicchetti returns.

(RECESS)

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CHAIRMAN:
Q. All right, as they said in World War I, once more into breach.
MR. JOHNSON:
Q. Thank you. Mr. Cicchetti, when we left off, we were at the bottom of page 16 discussing Wisconsin Energy at Tab 3 and I was just identifying for the purposes of the record some details about electric hedging programs which I think we've already covered. I would then turn to page 17 which gives this particular utility's breakdown of operating revenues by class. And at the top, you'll see "Residential - 977,000,000; small commercial industrial - 890,000,000; and large commercial industrial - 659,000,000. So again, in keeping with our previous discussions, this would not be on a stand-alone basis as ideal as Newfoundland Power's situation?
MR. CICCHETTI:
A. With all the previous disclaimers, yes.
(1:45 a.m.)
MR. JOHNSON:
Q. And the previous disclaimers meaning you can't take one thing and, yeah, okay. And then at

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page 18, under "Competition", they indicate, I don't know to what extent competition is an issue there, Mr. Cicchetti, but there's a paragraph that says "Competition in varying degrees exists between natural gas and other forms of energy available to customers. A number of large commercial industrial customers are duel fuel customers that are equipped to switch between natural gas and alternative fuels, but they are allowed to offer lower priced gas sales and transportation services to these customers. So would that be something that would be typical in the U.S. environment?
MR. CICCHETTI:
A. Fairly typical, yes.
MR. JOHNSON:
Q. And would that be a risk to earnings for such a utility?
MR. CICCHETTI:
A. Certainly.
MR. JOHNSON:
Q. Yes. Page 41 deals with corporate developments and this is where you get into the non-utility. At the second paragraph,

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around halfway down, they start by saying "Our non-utility energy segment primarily consists of WE Power. WE Power is principally engaged in the engineering, construction and development of electric power generating facilities for long-term lease." And then, Mr. Cicchetti, they go over on page 43 to say, to state what the results of operations are regards consolidated earnings. And you will see that this outfit has utility energy earnings of 581.9 million, but significant non-utility energy earnings of 89.3 million dollars and there's a corporate and other, which I take from that took a loss. So that would be a fairly material amount of non-regulated earnings for this company?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. And again, that would be a riskier profile to Newfoundland Power, I guess it goes without saying.
MR. CICCHETTI:
A. The question would be how much riskier.
MR. JOHNSON:

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Q. But riskier, nevertheless.
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. And then at the bottom of page 43, utility energy segment contribution to operating income, they note 2008 verses 2007 that the utility energy segment contributed 581 million as we've seen, but then they go on to say "during '08, we experienced less favourable weather in the summer months which decreased electric sales. In addition, our fuel and purchase power cost increased primarily as a result of the Power Purchase Agreement entered into." So again at risk for purchase power and weather.
MR. CICCHETTI:
A. Again, the standard disclaimers apply.
MR. JOHNSON:
Q. Response. Again, an area where Newfoundland Power is considerably less risky.
MR. CICCHETTI:
A. With the standard disclaimer, yes.
MR. JOHNSON:
Q. If we could turn to Allette.

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MS. GLYNN:

Q. And that would be Consent No. 24.

MR. JOHNSON:

Q. Tab 2--no actually--yeah, Tab 2 is fine, page 3 of 14. This again is the Dow Jones Company report description. Allette provides energy services in the upper mid west and has real estate holdings in Florida that operates in two segments, regulated operations and investments and other. Under regulated, that's Minnesota Power and Superior Water, light and power company, as well as an investment in American Transmission Company, a Wisconsin based regulated utility, and it goes on and talks about Florida real estate, et cetera. If you turn to Tab 1 at page 1 of 2, it gives--it talks about large industrial customers. "Minnesota Power sells a high percentage of its electric power to large industrial facilities. Eleven of our customers require ten megawatts or more of generating capacity. Among these are four Taconite products, four papermills and two petroleum pipeline companies. Taconite is an iron bearing rock important as a raw material

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source for steel." Now some of these industries have been hit in your country, Mr. Cicchetti, I take it?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. And hit hard.

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. And if you go to page 7 of Tab 3, again it gives a breakdown of electric sales and customers, and you can see residential, 9 percent; commercial, 12 percent; industrial, 57 percent. If you're a shareholder, would you be more nervous there than Newfoundland?

MR. CICCHETTI:

A. That's one aspect of the business risk that's different than Newfoundland, yes.

MR. JOHNSON:

Q. And just above that table we have a split between regulated operations and non. And I see in terms of operating revenue, at least, 89--what's that, 89 million, is it, for regulated operations; 11 million for

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investments. But then we go on to see earlier in 2007 in '06 that non-regulated operations were 14 percent and 17 percent, so even a bit more.

MR. CICCHETTI:

A. I'm not sure I follow that.

MR. JOHNSON:

Q. Oh, I'm sorry, if you just go across the table, I was referring to 2007 and 2006.

MR. CICCHETTI:

A. Oh, okay.

MR. JOHNSON:

Q. Do you see that?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. Now at page 8, this comes back to the Taconite and industrial facilities, you'll see they have a table there showing industrial customer electric sales in 2008 and out of the industrial, 64 percent is Taconite; 22 percent paper, pulp and wood products and pipelines. Now, in the paragraph just below that, Mr. Cicchetti, it talks about how beginning in the fall of 2008 world-wide steel producers began

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to dramatically cut steel production in response to reduced demand driven by the world credit situation. And so, that's not good, is it?

MR. CICCHETTI:

A. No, but again you have to look at that in relation to all the other aspects of the company and if it's still considered overall a low risk company.

MR. JOHNSON:

Q. Now at page 32 of this tab under "outlook", they say "Allete has committed to earning a financial return that rewards our shareholders, allows for re-investment in our businesses and sustains growth. Minnesota Power's industrial customers are facing weak conditions in the market for their products and have and may continue to reduce the amount of energy they use. We will work to see this released energy in the wholesale market and believe that our ability to produce energy at low cost will be a competitive advantage." So they've got no guarantees here if the Taconite people can't use the power, right?

MR. CICCHETTI:

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A. Yeah, but there are no guarantees for anyone, including Newfoundland Power.

MR. JOHNSON:

Q. Newfoundland Power doesn't have a single industrial customer, though, does it?

MR. CICCHETTI:

A. But it's not a guaranteed return.

MR. JOHNSON:

Q. Page 34--oh, I'm sorry, page 32 under "Regulated Operations". "Minnesota Power expects significant rate base growth over the next several years as it continues its program to comply with renewable energy requirements and environmental mandates." Again, a distinction from Newfoundland Power that's much more moderate in rate base growth, correct?

MR. CICCHETTI:

A. Yes, again one of many distinctions.

MR. JOHNSON:

Q. Could we turn to OGE.

MS. GLYNN:

Q. OGE Energy will be Consent No. 25.

MR. JOHNSON:

Q. Tab 2 gives a description of OGE, an energy

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services provider offering physical delivery and related services for both electricity and natural gas, primarily in the south, central United States. Company conducts its activities through four business segments, electric utility, natural gas transportation and storage, natural gas gathering and processing, et cetera. And they also reference Enogex which is engaged in the business of gathering process and transporting and storing of natural gas. Are you familiar with Enogex?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. Are they a big outfit?

MR. CICCHETTI:

A. Relative to OGE, if you look at sales, all the gas that they transport through their system and that's going to make it look like a larger portion, but that's just a pass through.

MR. JOHNSON:

Q. Okay, well just--we'll come to it in a second, if we go to Tab 3, we'll get a closer look at Oklahoma Gas and Electric Company, the

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utility. Are you there?

MR. CICCHETTI:

A. Yes.

MR. JOHNSON:

Q. Okay. "Regulated electric utility, 773, 000 customers, generating capacity, 6800 megawatts, nine power plants, two wind farms, fuel 68 percent coal, 30 percent natural gas, two percent wind." And you see a description of Enogex, LLC, the non-regulated. And then in terms of this contribution of non-regulated, just refer you to page 10 under "Financial Performance".

MS. GLYNN:

Q. Under Tab 4?

(2:00 p.m.)

MR. JOHNSON:

Q. Under Tab 4, I'm sorry, yes. Mr. Cicchetti, what do these figures tell us about the importance of Enogex to this OGE Energy Corp?

MR. CICCHETTI:

A. It's a relatively large portion, but it's natural gas transportation and distribution, which is the business that OGE is in, other than that this happens to be an unregulated

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portion. I wouldn't consider the risk to be substantially greater than the regulated operations, other than from regulation, regulation in and of itself makes the company less risky overall.

MR. JOHNSON:

Q. What was the Enogex's return on equity in 2008?

MR. CICCHETTI:

A. 24.9 percent.

MR. JOHNSON:

Q. 2007?

MR. CICCHETTI:

A. 21.9 percent.

MR. JOHNSON:

Q. 2006?

MR. CICCHETTI:

A. 26.2 percent.

MR. JOHNSON:

Q. Okay, how about Oklahoma Gas & Electric, what was its return on equity average in '08, '07 and '06?

MR. CICCHETTI:

A. 9.3 percent. We are representing them in their rate case.

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MR. JOHNSON:
Q. You are representing -
MR. CICCHETTI:
A. Our company is, yes.
MR. JOHNSON:
Q. And how about '07?
MR. CICCHETTI:
A. 12.0 percent.
MR. JOHNSON:
Q. So the shareholders in OGE, I think it's fair to say, with Enogex 393 million in gross margin on revenues in 2008, compared to Oklahoma Gas & Electric Company's gross margin on revenue--or I should say the operating income of Enogex of 185 million in '08, compared to 143 million--I'm sorry, I should be looking at the net income line. Net income 91 million for Enogex in '08 and net income of 143 million for Oklahoma Gas & Electric Company. So, I mean, let's face it, the investors in OGE Energ Corp are getting quite a lift from the non-regulated side?
MR. CICCHETTI:
A. Yes, and those operations are transportation and storage of natural gas. It's not that

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much difference, in the past, recent past, how it was regulated.
MR. JOHNSON:
Q. But what does that--how should that make me feel better?
MR. CICCHETTI:
A. You'd have to look at the entire operations of the company, how much riskier is this non-regulated line of business? It's not materially that much riskier, it's part of the natural gas energy business.
MR. JOHNSON:
Q. But wouldn't it affect the equity investors' expectation as to what the return is going to be from OGE Energy Corp verses what the return should be to a shareholder of Newfoundland Power?
MR. CICCHETTI:
A. I'm sure it comes into consideration, yes.
MR. JOHNSON:
Q. How?
MR. CICCHETTI:
A. Well they're re-evaluating the entire company. I'm sure that 24.9 percent has gotten someone's attention.

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MR. JOHNSON:
Q. It would get your attention, wouldn't it?
MR. CICCHETTI:
A. Certainly.
MR. JOHNSON:
Q. Yeah. Page 16, just for the record is another breakdown on the bottom left-hand column of operating income or loss by business segment and it's set out again there for '08, '07 and '06. And if I look at--your company is doing a rate case for this regulated utility?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. Page 16 on the bottom, it looks to me like OGE, OG&E is at risk for weather, would that be right?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. Just compare OGE's--what you know about their regulatory mechanisms compared to what you found out about Newfoundland Power?
MR. CICCHETTI:
A. I would say it's, OG&E has good regulation,

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but this is exceptional regulation.
MR. JOHNSON:
Q. Yeah, exceptional regulation. And how about the deferral accounts that OGE has and the protections it has compared to Newfoundland Power?
MR. CICCHETTI:
A. They have some, but not to, as a percentage extent, so I don't have to go on, I'll just say all my previously stated disclaimers apply.
MR. JOHNSON:
Q. Finally I'll just go over the Alliant Energy and then I'll call it a day.
MS. GLYNN:
Q. Alliant will be Consent No. 26.
MR. JOHNSON:
Q. Tab 1, again gives a description of Alliant Energy operating as a regulated investor owned public utility holding company. "The company's primary focus is to provide regulated electricity and natural gas service to approximately one million electric, and approximately 400,000 natural gas customers in the mid west through its two public utilities

subsidiaries." It goes on to give further descriptions there, but I just would like to turn to Tab 4 and page 2, which again gives the sales mix of the regulated entity. Are you there, Mr. Cicchetti?

MR. CICCHETTI:
A. Did you say page 4?
MR. JOHNSON:
Q. I'm sorry, Tab 4, page 2.
MR. CICCHETTI:
A. I'm there.
MR. JOHNSON:
Q. And they're giving the company at a glance, who we are, and you'll see their electric sales mix, 40 percent industrial; 24 percent residential; 20 percent commercial and 15 percent for resale. They only have 25 percent purchase power, the rest they generate, well actually no, they purchase nuclear at 17 percent. I see at page, the same tab, F5, there's a reference to a special arrangement that companies have in the United States under a tax--under the Economic Stimulus Act, page F5 under Regulatory Developments. February, 2008, the Economic Stimulus Act of 2008 was

enacted which allows a 50 percent bonus tax depreciation deduction for certain property that is acquired or constructed in '08, that would be a part of the stimulus.
MR. CICCHETTI:
A. It appears to be so, yes.
MR. JOHNSON:
Q. Mr. Cicchetti, you will confirm for the record that not withstanding that market--that there's market integration, as we've heard between Canada and the United States, that that, that you have confirmed in response to CA-PUB-15, that that does not mean--and I'm referring to 15(c), where we asked you the question, can Mr. Cicchetti confirm that market integration simply means that capital can flow freely between two markets, but that dose not mean that the rate of inflation or risk is the same. If not, please provide, et cetera. And your answer to that was confirmed, right?
MR. CICCHETTI:
A. Yes, and as I pointed out, reviewing the inflation projections for the two countries, they are very similar.

MR. JOHNSON:
Q. You accept Dr. Booth's evidence as regards the inflation forecast for Canada, don't you?
MR. CICCHETTI:
A. Yes.
MR. JOHNSON:
Q. Yes. But the long-Canada bond yields are lower than the risk free rate in the United States?
MR. CICCHETTI:
A. They're fairly close. Right now, I think as of yesterday, the U.S. long rate was about 4. 2 and the long-term Canada rate was between 3. 95 and 4 or might have been--yes, at about 3.95.
MR. JOHNSON:
Q. Did I see in your evidence or was it in your evidence or was it in reply to an RFI that you took issue with the fact that there has been a recognized difference between the risk premium in Canada verses the United States?
MR. CICCHETTI:
A. I'm not sure what you're referring to.
MR. JOHNSON:
Q. If you could refresh my thinking, I think you said that there was no empirical evidence that

that was the case, is that ringing a bell now?
MR. CICCHETTI:
A. That doesn't ring a bell.
MR. JOHNSON:
Q. No?
MR. CICCHETTI:
A. There may have been some technical issue why I might not have agreed with the question, if that's what it was, it just doesn't ring a bell.
MR. JOHNSON:
Q. Those are my questions, Mr. Cicchetti, thank you.
MR. CICCHETTI:
A. Thank you.
CHAIRMAN:
Q. Okay, I guess--do you have to ask?
VICE-CHAIR WHALEN:
Q. No, I don't have any questions.
CHAIRMAN:
Q. Back to you then.
MR. SIMMONS:
Q Thank you, Mr. Chairman. Mr. Cicchetti, you've been asked to give an undertaking to do a recalculation of schedules MAC 10 and 11

using only the companies you have identified that have a safety rank of 1. And can I just ask you to look first at schedule MAC 8, which shows a group of those companies and I'm going to 8 because 8 is the one where the safety ranking is shown.

MR. CICCHETTI:

A. I'm there.

MR. SIMMONS:

Q. And on this particular one, if you just use the companies that have a safety ranking of one, you're going to reduce your selection from, I think it's nine companies down to three. And I'm must curious as to whether reducing your sample of companies that much would have any impact, positive, negative, neutral, on the usefulness of the information that's obtained in the table?

MR. CICCHETTI:

A. It's possible, I don't--I'm not anticipating any problem, but I can just make that calculation for those three and provide it.

MR. SIMMONS:

Q. Okay, and if you look at MAC No. 9, it would be the same question, the number of companies

and the sample of comparable gas companies would go from six to three.

MR. CICCHETTI:

A. Yeah, I certainly feel more comfortable having more because if there's any particular anomaly between that happens to get washed out when you use a group of companies, that's a benefit of using a group, but I'm not anticipating any particular problem.

MR. SIMMONS:

Q. Okay, if I could bring you back to MAC 8 then please, there are S&P bond ratings here that you've used in this table. Do you know or can you tell me how these bond ratings compare to the Moody's bond rating for Newfoundland Power?

MR. CICCHETTI:

A. They're similar.

MR. SIMMONS:

Q. Okay, there's a range of readings used here ranging from BBB+ up to AA- and at the time you prepared your report, the Moody's bond rating for Newfoundland Power was what?

MR. CICCHETTI:

A. It had actually changed, by the time--when I

did the calculations, they hadn't had their upgrade yet, and so at the time that was a BBB 1 for the company and an A from DBRS.

MR. SIMMONS:

Q. Is it possible to approximate what the general range of S&P bond rating that would be equivalent to?

MR. CICCHETTI:

A. For the companies that I'm going to pull out that are just 1?

MR. SIMMONS:

Q. Yes, for the Newfoundland Power bond rating, which is the closer to among these ratings on the S&P bond rating here?

MR. CICCHETTI:

A. It's going to be above, it's going to be approximately A+.

MR. SIMMONS:

Q. And one of the companies that you've just answered question on was MGE Energy Inc., and it was pointed out to you a number specific features of that company which, when compared to the corresponding feature of Newfoundland Power, you agreed suggested that for that feature, Newfoundland Power appeared to be a

risker company than MGE Energy Inc.

MR. JOHNSON:

Q. No, the other way.

MR. SIMMONS:

Q. Correct, Newfoundland Power is a less riskier company than MGE Energy Inc., thank you. The safety rank for MG Energy Inc. is 1. Is there a safety rank available from the same rating agency for Newfoundland Power?

MR. CICCHETTI:

A. No.

MR. SIMMONS:

Q. The bond rating for MGE Energy is AA-, how does that compare to the equivalent, Moody's bond rating for Newfoundland Power?

MR. CICCHETTI:

A. That's higher and I would just point out I hoped that what I said to Mr. Johnson was on those specific items that he pointed out, they might have been relatively risky, but overall, I mean when you look at MGE this way, they have a higher bond rating.

MR. SIMMONS:

Q. And do you know whether Standard and Poors in their methodology would have looked at the type of factors that were pointed out to you for MGE Energy when determining that bond rating?

MR. CICCHETTI:

A. Yes, I'm fairly certain that they have.

MR. SIMMONS:

Q. Thank you, I have no other questions, Mr. Chairman.

CHAIRMAN:

Q. Well, I guess that concludes today and it's not necessary, therefore, to sit tomorrow, I believe we've agreed. So we're back next Tuesday, is it?

MS. GLYNN:

Q. No, Monday, Mr. Chairman.

CHAIRMAN:

Q. Monday, is it?

MS. GLYNN:

Q. Company witnesses are Monday.

CHAIRMAN:

Q. Okay, I want to thank our two cost of capital witnesses and the third one -

MR. JOHNSON:

Q. He had to leave, Mr. Chairman.

CHAIRMAN:

Q. He's gone, but I think the quality of your presentation is exceptional and has given the Board much food for thought.

MR. CICCHETTI:

A. Thank you, Mr. Chairman.

CHAIRMAN:

Q. So with that, we will adjourn until Monday morning at 9:00.

Upon concluding at 2:15 p.m.

CERTIFICATE

I, Judy Moss, hereby certify that the foregoing is a true and correct transcript in the matter of Newfoundland Power's 2010 General Rate Application heard on the 22nd day of October, A.D., 2009 before Commissioners of the Public Utilities Board, Prince Charles Building, St. John's, Newfoundland and Labrador and was transcribed by me to the best of my ability by means of a sound apparatus.

Dated at St. John's, Newfoundland and Labrador this 22nd day of October, A.D., 2009.

Judy Moss

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