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<p>1 (9:00 a.m.)</p> <p>2 CHAIRMAN:</p> <p>3 Q. All right. Good morning, everybody. Any</p> <p>4 preliminary matters?</p> <p>5 KELLY, Q.C.</p> <p>6 Q. No, Mr. Chairman.</p> <p>7 CHAIRMAN:</p> <p>8 Q. I just got one, please.</p> <p>9 KELLY, Q.C.</p> <p>10 Q. You're up first.</p> <p>11 CHAIRMAN:</p> <p>12 Q. Yeah, well, you seen this cane I've been</p> <p>13 using. I got an appointment tomorrow morning</p> <p>14 at 8:15 with a orthopedic surgeon, and it's</p> <p>15 like getting to see God, apparently. So I</p> <p>16 don't know how long I'm going to be. So we</p> <p>17 were thinking maybe we'd start at 10:00, would</p> <p>18 that be all right?</p> <p>19 KELLY, Q.C.</p> <p>20 Q. Certainly, fine.</p> <p>21 CHAIRMAN:</p> <p>22 Q. You know, I may be sooner, but I don't want to</p> <p>23 keep people waiting, but if I miss this</p> <p>24 appointment, it's just as well for me to, you</p> <p>25 know, forget about it. I'll be crawling</p>	<p>1 capital asset pricing model itself and we'll</p> <p>2 talk a little bit about that, and I guess we</p> <p>3 can agree, there are three basic factors that</p> <p>4 go into the capital asset pricing model.</p> <p>5 There is the market risk premium, the beta,</p> <p>6 and then interest rate.</p> <p>7 DR. BOOTH:</p> <p>8 A. That's correct.</p> <p>9 KELLY, Q.C.</p> <p>10 Q. Okay. Now we'll talk first then about the</p> <p>11 market risk premium or the overall premium in</p> <p>12 the market. That's an area that obviously</p> <p>13 requires an exercise of judgment as well?</p> <p>14 DR. BOOTH:</p> <p>15 A. True. Judgment, as I say, constrained by the</p> <p>16 facts. We do have 80 years of history and we</p> <p>17 can't just throw that out.</p> <p>18 KELLY, Q.C.</p> <p>19 Q. I'll accept that, and so that we don't spend</p> <p>20 too much time, if I take you to Consent 18,</p> <p>21 the Chairman of the BCUC was asking you a week</p> <p>22 or so ago about the capital asset pricing</p> <p>23 model. I'll take you over to 721, just to set</p> <p>24 up his question.</p> <p>25 DR. BOOTH:</p>
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<p>1 around. So if that's acceptable, we can start</p> <p>2 at 10:00 tomorrow morning.</p> <p>3 KELLY, Q.C.</p> <p>4 Q. That's fine, Chairman.</p> <p>5 CHAIRMAN:</p> <p>6 Q. Okay, thank you very much. So I guess we're</p> <p>7 back to you, are we, sir?</p> <p>8 MR. LAURENCE BOOTH, RESUMES STAND, CROSS-EXAMINATION BY</p> <p>9 IAN KELLY, Q.C.</p> <p>10 KELLY, Q.C.</p> <p>11 Q. Yes, thank you, Mr. Chairman. I'll continue</p> <p>12 with Dr. Booth in just a moment. One of the</p> <p>13 things I've done is I've provided a handout</p> <p>14 and I don't know if Board counsel want to mark</p> <p>15 that first.</p> <p>16 MS. GLYNN:</p> <p>17 Q. We'll mark that as Consent No. 19.</p> <p>18 KELLY, Q.C.</p> <p>19 Q. 19. Now, Dr. Booth, I won't come to that</p> <p>20 right away, but when we finished up yesterday,</p> <p>21 Dr. Booth, we were looking at the various--</p> <p>22 some of the judgment factors that go into</p> <p>23 determining the cost of capital and into your</p> <p>24 analysis and evidence and we had talked about</p> <p>25 methodology and I want now to come to the</p>	<p>1 A. Yes.</p> <p>2 KELLY, Q.C.</p> <p>3 Q. Line 6 and 7 and 8, he gave you a quote from</p> <p>4 H.L. Mecken, "there is always an easy solution</p> <p>5 to every human problem, neat, plausible and</p> <p>6 wrong" and he asked you, I take it, it would</p> <p>7 not be your epitaph of CAPM, and you gave him</p> <p>8 a fairly lengthy answer, and I don't want to</p> <p>9 take you through all of it. I'll take you</p> <p>10 over just to page 722, to the top of the page.</p> <p>11 DR. BOOTH:</p> <p>12 A. Yes.</p> <p>13 KELLY, Q.C.</p> <p>14 Q. The point, "secondly you want to capture risk,</p> <p>15 and the CAPM captures that and it captures</p> <p>16 that in a really elegant way by saying what's</p> <p>17 the overall market risk premium, and all of</p> <p>18 our evidence is based upon judgment</p> <p>19 constrained by facts. The facts are the</p> <p>20 market risk premium five to six percent,</p> <p>21 conceivably seven percent." So we have a</p> <p>22 range of judgment of five to seven percent?</p> <p>23 DR. BOOTH:</p> <p>24 A. No, I said--I mean, the median in Canada is</p> <p>25 five percent or 5.1 percent. The median from</p>

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<p>1 the experts is six percent in the US. 2 Conceivably, it is possible, it's a slim 3 possibility it could be up at seven percent. 4 I did testify that around November, December 5 this year, I would have put the market risk 6 premium at about eight percent because the 7 markets were so skittish back in the fall that 8 I could easily believe that the market risk 9 premium at that point in time was eight 10 percent, because the market risk premium 11 varies with the business cycle and conditions 12 in the capital market. 13 KELLY, Q.C. 14 Q. So we got five to six, conceivably seven. 15 We'll take that to start, and part of your 16 analysis, as I understand it, comes from 17 Professor Fernandes' study that he did? 18 DR. BOOTH: 19 A. That's correct, I look at that as 20 confirmation. I directly estimate my own 21 market risk premium, which I've been doing for 22 a considerable period of time, and my estimate 23 is five percent. I look at the survey by 24 Fernandes and say, oh look, that's what my 25 colleagues have been saying, and I use that as</p>	<p>1 chief financial officers at institutions, 2 people like that? 3 DR. BOOTH: 4 A. He's done a survey of chief financial 5 officers, but he hasn't published it, but I 6 would guess that will be coming out soon. 7 KELLY, Q.C. 8 Q. Okay. 9 DR. BOOTH: 10 A. But my testimony does have evidence of the 11 market risk premium or expected rates of 12 return by the TD Bank, by the Royal Bank of 13 Canada, and it has evidence from Damodaran of 14 survey evidence in the United States to the 15 market risk premium. So that evidence is 16 already in my testimony. 17 KELLY, Q.C. 18 Q. So within that study and your testimony of 19 five to six, conceivably seven, you're at five 20 percent, correct? 21 DR. BOOTH: 22 A. That's correct. 23 KELLY, Q.C. 24 Q. And if I take you to the NP-CA-12, you used 25 4.5 percent in 2005 and the first time you</p>
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<p>1 a reasonableness check, and in fact, use that 2 to say, well, if my colleagues basically think 3 it's five percent, or the significant number 4 think it's either five or six, I use that to 5 say, well, look, I could be marginally low. 6 KELLY, Q.C. 7 Q. Okay. Now that was a study in 2008? 8 DR. BOOTH: 9 A. It was a study done in the spring of this 10 year, January and February. It was an e-mail 11 survey of finance professors around the world 12 asking them what they thought the market risk 13 premium was, if I remember correctly, 2008, 14 2007 and asked them whether they changed their 15 market risk premium over time, and it was - 16 KELLY, Q.C. 17 Q. Right, because in the table we had on the 18 screen yesterday, it shows market risk premium 19 used in 2008. 20 DR. BOOTH: 21 A. That's correct. 22 KELLY, Q.C. 23 Q. Okay, and that was a survey of finance or 24 finance professors, not a survey, for example, 25 of financial economists or bank economists or</p>	<p>1 used 5 percent was in January of 2007. So 2 somewhere in 2006, you increased your market 3 risk premium from 4.5 to 5 percent? 4 DR. BOOTH: 5 A. That's correct. 6 KELLY, Q.C. 7 Q. Okay, and the market risk premium changes over 8 time? 9 DR. BOOTH: 10 A. It changes - 11 KELLY, Q.C. 12 Q. As obviously it has in your estimation. 13 DR. BOOTH: 14 A. Well, absolutely. It's changed in the 15 estimation of every board that's used an 16 adjustment mechanism as well. It's changed 17 both what we would say was secularly or over 18 time since the early 1990s, as I explained in 19 my direct testimony, and then it does change 20 marginally over the business cycle. I think 21 it changed significantly probably last fall, 22 before the market condition stabilized. 23 KELLY, Q.C. 24 Q. And so we have you at five percent. We have a 25 range of five to six, conceivably seven. We</p>

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<p>1 have Ms. McShane at 6.75 and we have Mr. 2 Cicchetti who has done his analysis and he 3 gets a utility risk premium of 4.35 and he 4 seems to have a beta of about .6, .66, which 5 would you give you an inferred market risk 6 premium for him of somewhere in the 6.6 range? 7 DR. BOOTH: 8 A. I would accept that. I mean, I hadn't done 9 that backward analysis of his work. I suggest 10 you ask him that question. 11 KELLY, Q.C. 12 Q. I will indeed. I just want to establish out 13 of this discussion that there is a range. 14 You're currently at the bottom end of what you 15 concede the range to be and others have 16 different judgments as to where to be within 17 that range? 18 DR. BOOTH: 19 A. No, that's absolutely incorrect. 20 KELLY, Q.C. 21 Q. You don't agree with that? 22 DR. BOOTH: 23 A. I totally disagree with that, because as I 24 showed in Fernandes', where Fernandes showed 25 it's conceivably the market risk premium is</p>	<p>1 understanding is that's part of a new deferral 2 account for Newfoundland Power, and I asked 3 what they were using to--well, it looks like I 4 got the wrong reference here. 5 KELLY, Q.C. 6 Q. Dr. Booth, we'll get along a lot faster with 7 this if I put the questions and we kind of 8 focus on the question. I'm asking about the 9 market risk premium now and the question of 10 judgment, and is it therefore - 11 MR. JOHNSON: 12 Q. Mr. Chairman, I mean, there was a technical 13 malfunction in terms of the witness being able 14 to refer to it, and now Mr. Kelly uses that 15 excuse to move on before the witness can 16 actually support what it is he's saying in 17 response to Mr. Kelly's question. That's not 18 fair. 19 CHAIRMAN: 20 Q. I'd kind of like to hear what - 21 KELLY, Q.C. 22 Q. I'll - 23 CHAIRMAN: 24 Q. - Mr. Booth got to say on that matter, Mr. 25 Kelly. I don't -</p>
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<p>1 two percent. There's as many people who think 2 it's two or three percent as there is that 3 think it's seven percent. So when I say 4 conceivably, all I'm saying is well, there is 5 a slim possibility that it could be up at that 6 level of range, but all the historic evidence 7 is that it's five percent and based upon 8 historic evidence in Canada and the United 9 States, it's four and a half to five and a 10 half percent over the last 80 years. Most of 11 my colleagues think that it's five percent. 12 Almost as many think it's six percent, and I 13 mean, the other thing is that what are actual 14 professionals using, and here, I ask questions 15 for what does Mercer think, the people that 16 are valuing and providing the assumptions for 17 Newfoundland Power's pension? And I forgot to 18 mention this yesterday, but these people 19 aren't coming in here as expert witnesses. 20 They're valuing the Newfoundland Power pension 21 and--let's see. This was in the materials 22 that I was going to talk about yesterday, but 23 in response to CA-NP-25, I asked what were the 24 assumptions that Mercers were using to value 25 the Newfoundland Power pension, because my</p>	<p>1 KELLY, Q.C. 2 Q. Fine. 3 DR. BOOTH: 4 A. On page 15 of the Mercer report, the value of 5 the Newfoundland Power pension, and I seem to 6 have the wrong reference to the information 7 requests, but it's around about page 77 or 78 8 of my testimony. That analysis by Mercer, who 9 were basically valuing in the pension, they 10 came out with long run expected rates of 11 return of the Canadian and US equity markets 12 of 8.5 percent, and they estimated the fixed 13 income return of 4.4 percent, which means an 14 implied risk premium of 4.1 percent. Now 15 their fixed income wasn't particularly 16 Canadian, includes default risky bonds, so 17 that's probably above what we would look at as 18 the true return on Canadian bonds, and the 19 equities, it's difficult to say exactly where 20 they came up with--how they calculated the 8.5 21 percent, but their estimate is 4.1 percent, 22 and if Newfoundland Power said, "well, 23 Mercers, we're not going to use you. We're 24 going to use Ms. McShane instead to provide 25 estimates of the rates of returns in the</p>

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<p>1 Newfoundland Power pension," I suspect that</p> <p>2 with those estimates, there wouldn't be an</p> <p>3 unfunded liability in the pension plan. So</p> <p>4 these are experts in the financial markets.</p> <p>5 The Royal Bank of Canada's experts are</p> <p>6 experts. TD economics are experts. Damodaran</p> <p>7 survey of US investors are experts. They all</p> <p>8 come up with estimates of the market risk</p> <p>9 premium considerably lower than mine.</p> <p>10 KELLY, Q.C.</p> <p>11 Q. And out of that whole big answer, Dr. Booth,</p> <p>12 haven't we just established that there is a</p> <p>13 large element of judgment in what it should</p> <p>14 be? Now you've just given us an example of</p> <p>15 the people who think it should be below five.</p> <p>16 You're at five and others are above five.</p> <p>17 They're at 6.75 and conceivably seven.</p> <p>18 DR. BOOTH:</p> <p>19 A. Yes.</p> <p>20 KELLY, Q.C.</p> <p>21 Q. So there's an element of judgment in that</p> <p>22 determination?</p> <p>23 DR. BOOTH:</p> <p>24 A. There is an element of judgment, but as I've</p> <p>25 said, it's judgment constrained by the facts.</p>	<p>1 hired not to provide expert testimony to this</p> <p>2 Board in terms of the fair rate of return, but</p> <p>3 to provide expert support for valuing the</p> <p>4 Newfoundland pension plan.</p> <p>5 KELLY, Q.C.</p> <p>6 Q. That runs off a different interest rate,</p> <p>7 doesn't it?</p> <p>8 DR. BOOTH:</p> <p>9 A. No, what we've got here are just the long term</p> <p>10 expected rates of return, which is the asset</p> <p>11 performance on the asset side of the pension</p> <p>12 plan. You're referring to the way in which</p> <p>13 the pension plan's liabilities are valued,</p> <p>14 which is to use the long term corporate bond</p> <p>15 yield, which is laid down by the Canadian</p> <p>16 Institute of Actuaries.</p> <p>17 KELLY, Q.C.</p> <p>18 Q. Dr. Booth, the second element, because let's</p> <p>19 move on, otherwise we'll be here 'til</p> <p>20 Christmas. The second element that you have</p> <p>21 to look at in the capital asset pricing model</p> <p>22 is the beta, correct?</p> <p>23 DR. BOOTH:</p> <p>24 A. That's correct.</p> <p>25 KELLY, Q.C.</p>
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<p>1 When we look at the facts of what does Mercer</p> <p>2 think it is, professionals in pension</p> <p>3 valuation, what do investors think it is, what</p> <p>4 does private economic forecasters think it is,</p> <p>5 what do people not involved in this hearing</p> <p>6 think it is, they will come out at my estimate</p> <p>7 or lower than my estimate. You're referring</p> <p>8 to the upper end of a range which is provided</p> <p>9 by estimates on behalf of the company and</p> <p>10 behalf of the Board staff. But the objective,</p> <p>11 external evidence is that a market risk</p> <p>12 premium is less than my estimate. So you've</p> <p>13 got to say what are the facts out here and how</p> <p>14 do you weight them.</p> <p>15 KELLY, Q.C.</p> <p>16 Q. That seems to be a matter of disagreement, Dr.</p> <p>17 Booth. The next -</p> <p>18 DR. BOOTH:</p> <p>19 A. I don't think it's a matter of disagreement in</p> <p>20 terms of what Mercers, the professional</p> <p>21 actuaries hired by the company to value the</p> <p>22 pension fund, think the market risk premium</p> <p>23 is. That's objective evidence. It's here.</p> <p>24 It determines the unfunded pension liability</p> <p>25 of Newfoundland Power and these people were</p>	<p>1 Q. And the beta is the relative risk of</p> <p>2 comparable investments, comparable utility</p> <p>3 investments and that has to be looked at at an</p> <p>4 expected or forecast or future beta is what</p> <p>5 we're looking for, correct?</p> <p>6 DR. BOOTH:</p> <p>7 A. Correct.</p> <p>8 KELLY, Q.C.</p> <p>9 Q. And so there are a number of judgment elements</p> <p>10 in that, clearly. One is the determination of</p> <p>11 comparable securities?</p> <p>12 DR. BOOTH:</p> <p>13 A. That's correct.</p> <p>14 KELLY, Q.C.</p> <p>15 Q. Okay, and we're not necessarily looking for</p> <p>16 comparable operating companies, but companies</p> <p>17 with similar investment risk, agreed?</p> <p>18 DR. BOOTH:</p> <p>19 A. That's correct.</p> <p>20 KELLY, Q.C.</p> <p>21 Q. Okay. But the biggest part of the problem is</p> <p>22 in the use of the historical data, isn't it?</p> <p>23 Because what we're really looking for is the</p> <p>24 expectation going forward into the future and</p> <p>25 just looking at the raw data is problematic in</p>

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<p>1 itself, agreed?</p> <p>2 DR. BOOTH:</p> <p>3 A. No, I wouldn't say it's problematic. The raw</p> <p>4 data is what the raw data is. You look at the</p> <p>5 raw data and then you try and work out what's</p> <p>6 generated this raw data.</p> <p>7 KELLY, Q.C.</p> <p>8 Q. Okay.</p> <p>9 DR. BOOTH:</p> <p>10 A. That's where judgment and experience and</p> <p>11 expertise come in. As I said yesterday, the</p> <p>12 raw data, you can hire a statistician to</p> <p>13 calculate the raw numbers.</p> <p>14 KELLY, Q.C.</p> <p>15 Q. That's exactly my point. If we look at the</p> <p>16 raw data, then one has to exercise judgment as</p> <p>17 to what the expected beta is going to be?</p> <p>18 DR. BOOTH:</p> <p>19 A. That's correct.</p> <p>20 KELLY, Q.C.</p> <p>21 Q. Right. In fact, let's go to page 34 of your</p> <p>22 testimony, and you make the point -</p> <p>23 DR. BOOTH:</p> <p>24 A. Yes.</p> <p>25 KELLY, Q.C.</p>	<p>1 calculations. So if we take, for example, the</p> <p>2 last line, the 2008 beta, it's .26 over at the</p> <p>3 end of the line?</p> <p>4 DR. BOOTH:</p> <p>5 A. That's correct.</p> <p>6 KELLY, Q.C.</p> <p>7 Q. Okay.</p> <p>8 (9:15 a.m.)</p> <p>9 DR. BOOTH:</p> <p>10 A. That's just a simple average of the betas of</p> <p>11 the underlying companies.</p> <p>12 KELLY, Q.C.</p> <p>13 Q. For the five years?</p> <p>14 DR. BOOTH:</p> <p>15 A. Yeah.</p> <p>16 KELLY, Q.C.</p> <p>17 Q. Right, and so if we go back--if we just kind</p> <p>18 of go up that line, in order to get .5, for</p> <p>19 example, we've got to go back to 1998 that you</p> <p>20 could actually observe a mathematical</p> <p>21 calculation of .5 or so?</p> <p>22 DR. BOOTH:</p> <p>23 A. That's right. You've got to go back to before</p> <p>24 we had these two major stock market crashes,</p> <p>25 the internet bubble and what I might call the</p>
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<p>1 Q. - down through lines 12, 13, 14, 15 on that</p> <p>2 page, the second problem.</p> <p>3 DR. BOOTH:</p> <p>4 A. Yes.</p> <p>5 KELLY, Q.C.</p> <p>6 Q. Using actual betas, which are simply</p> <p>7 mechanical and you go on to the next couple of</p> <p>8 paragraphs to talk about the use of judgment</p> <p>9 and adjusted betas.</p> <p>10 DR. BOOTH:</p> <p>11 A. That's correct.</p> <p>12 KELLY, Q.C.</p> <p>13 Q. Okay, and if we go over to the table on the</p> <p>14 next page, you have in the far column a set of</p> <p>15 beta calculations, correct?</p> <p>16 DR. BOOTH:</p> <p>17 A. That's correct.</p> <p>18 KELLY, Q.C.</p> <p>19 Q. And the beta that you ultimately adopt as your</p> <p>20 judgment is a beta of .5?</p> <p>21 DR. BOOTH:</p> <p>22 A. That's correct.</p> <p>23 KELLY, Q.C.</p> <p>24 Q. Right, and so if we go over to the calculated</p> <p>25 betas, and I understand these are five-year</p>	<p>1 credit crisis crash of last year.</p> <p>2 KELLY, Q.C.</p> <p>3 Q. And if you look down between those two, we</p> <p>4 even have betas that are close to zero, and in</p> <p>5 one case, even a negative beta, which is kind</p> <p>6 of counter intuitive and would essentially be</p> <p>7 an investor expecting to lose money going</p> <p>8 forward.</p> <p>9 DR. BOOTH:</p> <p>10 A. That's right. These are actual historic</p> <p>11 estimates of the way in which the stock moved</p> <p>12 with the market and as I mentioned in my</p> <p>13 direct testimony, the betas go down whenever</p> <p>14 you get a major stock market crash because</p> <p>15 what happens then is the market crashes.</p> <p>16 Utilities don't crash, they're relatively</p> <p>17 stable, and you get one or two observations</p> <p>18 that indicate that these are what we expect</p> <p>19 them to be, defensive stocks, and that affects</p> <p>20 the estimate of the beta for the five years</p> <p>21 during which that observation is in the</p> <p>22 estimation period.</p> <p>23 KELLY, Q.C.</p> <p>24 Q. So the big -</p> <p>25 DR. BOOTH:</p>

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<p>1 A. As soon as that drops out of the estimation 2 period, you start getting the betas reverting 3 back to where they normally are, which is .4 4 or .5. 5 KELLY, Q.C. 6 Q. So the big challenge is figuring out what that 7 beta should be going forward and you 8 exercising your judgment, come up with a beta 9 of .5. Ms. McShane has a beta of .65 to .7. 10 DR. BOOTH: 11 A. She's clearly exercising a lot more judgment 12 than me, yes. 13 KELLY, Q.C. 14 Q. Okay, and if we look at Mr. Cicchetti, he uses 15 some value line analysis which has .66 to .69. 16 DR. BOOTH: 17 A. Well, he's not using judgment. He's using 18 mechanical formula which doesn't apply to 19 utility betas. 20 KELLY, Q.C. 21 Q. Okay. We're going to ask him a little bit 22 more about that, but there's a range of 23 judgment over what the appropriate beta is 24 going forward? 25 DR. BOOTH:</p>	<p>1 the data. Nobody argues that the data is not 2 the data. The question is how does one judge 3 it and what conclusions should one take out of 4 it on a go-forward basis. That's really the 5 issue, isn't it? 6 DR. BOOTH: 7 A. That's true. I'm explaining to you what this 8 data is because I sometimes get some lawyers 9 saying "oh, look at this number here, minus 10 .05. That number is silly," and I'm just 11 explaining that number is not silly. I know 12 exactly why that happened and anyone who 13 understands what's happened in the capital 14 markets over the last ten years will be able 15 to explain what's happened. 16 KELLY, Q.C. 17 Q. And the one thing we - 18 DR. BOOTH: 19 A. And going forward, just to answer that, you 20 keep coming back to going forward, going 21 forward, the fundamental question is do you 22 think we're going to get another internet 23 bubble? Are we going to get another Nortel 24 dragging the Canadian market up with it and 25 then crashing? Or conversely, are we going to</p>
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<p>1 A. Well, there's two things. There's mechanical 2 adjustment without any judgment and then 3 there's judgment, and what I'm using is 4 judgment. So I'm looking at the data and 5 saying, well, we can't discard this data. 6 This data actually tells us something. Data 7 is always useful, and you have to understand 8 why we got these betas. So I wouldn't go 9 through and say, look, I don't know anything 10 that's going on. I'm just going to 11 mechanically adjust these because I'm a 12 statistician and I don't know anything. I do 13 know something. I know that those betas went 14 down because of the crash of the internet 15 bubble and the fact that Nortel dragged the 16 market up and down, and I can see that the 17 betas are now going to go down for the next 18 couple of years because we've got this data 19 from basically September 2008 through this 20 year where the stock market went through a 21 vicious decline and then it's gone through a 22 recovery and the utilities have barely moved, 23 and that's what generates this very low beta. 24 KELLY, Q.C. 25 Q. And nobody argues that we shouldn't look at</p>	<p>1 have the Americans sort of severely damaging 2 their financial system again? And I'd have to 3 admit that in the past, I've said, look, we're 4 not--we've learned. We're not going to have 5 another internet bubble. So we're not going 6 to see betas down at .1, .2. Betas will 7 revert to their low run average, .4, .5, 8 something in that range, and then along comes 9 the credit crisis and we have another crisis 10 in the capital market. So what I will grant 11 you is that I'm assuming in my going forward 12 beta estimate that utilities will revert to 13 the normal sort of pattern of their betas, 14 consistent with not having another disaster in 15 the stock market. If we have another double 16 dip recession and we have another disaster in 17 the stock market, we're going to continue to 18 have betas down at .1-.2. 19 KELLY, Q.C. 20 Q. Which really wouldn't tell us then anything 21 about investor expectation? 22 DR. BOOTH: 23 A. Well, I think right now, investor 24 expectations, we're not going to have that 25 because the market has recovered and the</p>

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<p>1 economy has recovered and the Americans have</p> <p>2 fixed their financial system. So just as I</p> <p>3 indicated before, after the recovery from the</p> <p>4 internet bubble, we can see that beta is</p> <p>5 gradually increasing, which is what we would</p> <p>6 expect once we're out of a serious stock</p> <p>7 market crash like the internet bubble, and I</p> <p>8 fully expect after the experience of 2008, the</p> <p>9 beginning of 2009 washes out of the estimation</p> <p>10 period, the estimates of the beta will revert</p> <p>11 to the low run averages and that's all I'm</p> <p>12 assuming.</p> <p>13 KELLY, Q.C.</p> <p>14 Q. So the one thing we agree on is that the</p> <p>15 mathematical numbers are obviously too low and</p> <p>16 the question of judgment is what should they</p> <p>17 be as we look forward?</p> <p>18 DR. BOOTH:</p> <p>19 A. That is correct.</p> <p>20 KELLY, Q.C.</p> <p>21 Q. That's the question.</p> <p>22 DR. BOOTH:</p> <p>23 A. Judgment constrained by the facts.</p> <p>24 KELLY, Q.C.</p> <p>25 Q. Now the third item, and I don't want to spend</p>	<p>1 DR. BOOTH:</p> <p>2 A. That's correct. I would say it goes back</p> <p>3 again to Pierre Trudeau's remark as a smell</p> <p>4 test. You just don't mechanically come up</p> <p>5 with estimates. You come up with estimates</p> <p>6 and then you look at the big picture and you</p> <p>7 say, well look, does that make sense? And</p> <p>8 does that--is that a recommendation, are those</p> <p>9 numbers that I can live with in terms of a</p> <p>10 recommendation? Do I think that's fair and</p> <p>11 reasonable?</p> <p>12 KELLY, Q.C.</p> <p>13 Q. And so, at the end of the day, if you look at</p> <p>14 the capital asset pricing model, what you get</p> <p>15 out of it, if I can put this to you, is if you</p> <p>16 put in low inputs, you'll get out a low</p> <p>17 number, and the corollary is true. If you put</p> <p>18 in high inputs, you'll get out a high number.</p> <p>19 So the question ultimately is in the inputs</p> <p>20 going into the model, isn't it?</p> <p>21 DR. BOOTH:</p> <p>22 A. That's the same as everything. In computing</p> <p>23 we used to have a phrase "GIGO", garbage in,</p> <p>24 garbage out. If you put garbage numbers into</p> <p>25 any model, you're going to get garbage numbers</p>
Page 26	Page 28
<p>1 very long on this because I don't think we're</p> <p>2 really very far apart at all, is what the</p> <p>3 interest rate should be forecast for next</p> <p>4 year, correct?</p> <p>5 DR. BOOTH:</p> <p>6 A. That's correct.</p> <p>7 KELLY, Q.C.</p> <p>8 Q. That's CAPM requires that piece of information</p> <p>9 as well, and that requires an element of</p> <p>10 judgment and the two estimates are not</p> <p>11 particularly far apart on that, 425 and 450.</p> <p>12 DR. BOOTH:</p> <p>13 A. That's right. I think in the case of Kathy</p> <p>14 McShane and I, it's just simply a question</p> <p>15 that my testimony was filed three or four</p> <p>16 months after hers and the economy strengthened</p> <p>17 since then, and what happens is the economy</p> <p>18 strengthens, demand for credit goes up and</p> <p>19 interest rates tend to go up.</p> <p>20 KELLY, Q.C.</p> <p>21 Q. And then I suppose, Dr. Booth, there's an</p> <p>22 element of judgment in terms of the overall</p> <p>23 result. You look at the overall result out of</p> <p>24 the CAPM formula to determine whether that is</p> <p>25 appropriate?</p>	<p>1 out. If you don't understand what you're</p> <p>2 doing, you're going to get garbage numbers</p> <p>3 out. This is why when I teach this material,</p> <p>4 we never mention comparable earnings because</p> <p>5 that isn't in any textbook, it's not an</p> <p>6 acceptable measure of estimating fair rates</p> <p>7 return, but we do talk about discounted cash</p> <p>8 flow and we do talk about capital asset</p> <p>9 pricing model. They're the two basic methods</p> <p>10 for estimating fair rates of return. I get</p> <p>11 more problems with students estimating fair</p> <p>12 rate returns with DCF because the estimates</p> <p>13 are more prone to error. The capital asset</p> <p>14 pricing model, why most people like it is you</p> <p>15 can't be that far off, because you pick up the</p> <p>16 newspaper you can estimate the risk free rate,</p> <p>17 and the market risk free rate, we may sit here</p> <p>18 and say, well, conceivably it could be 2</p> <p>19 percent, conceivably it could be 7 percent,</p> <p>20 conceivably it could be 8 or 9 percent, but</p> <p>21 historic evidence constrains that. It says</p> <p>22 it's around 5 percent, 6 percent. So once you</p> <p>23 plug those numbers in, you take 5 or 6</p> <p>24 percent, you add the long term risk free rate,</p> <p>25 and you're at 9 or 10 percent for the market,</p>

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<p>1 and that's higher than Mercer estimates it, 2 but that's consistent with 80 years of capital 3 market history. So you've got to look at the 4 whole picture and say does it make sense, and 5 that's where there is an element of judgment, 6 but you can't come out and say that 7 Newfoundland Power needs 11 percent and it's 8 less risky than the market, which means the 9 market needs 30 and 40 percent going forward 10 because he's not compounding that forward, 11 nobody would be in the bond market, everybody 12 would be in the equity market. Those are 13 phenomenally high risk premiums and they've 14 never been experienced on a consistent basis. 15 KELLY, Q.C.: 16 Q. I want to talk a little bit next with you 17 about the buying markets and bond yields and 18 see what we can agree with there. You'll 19 agree with me that equity holders have a 20 greater risk than bond holders? 21 DR. BOOTH: 22 A. They're exposed to just about every risk, so 23 they weigh all of the risk that go into 24 determining a fair return. 25 KELLY, Q.C.:</p>	<p>1 DR. BOOTH: 2 A. Mainly held by institutions. There's been 3 attempts to try and broaden the market so 4 individuals can buy exchange rated funds that 5 consist of bonds, or they can buy bond mutual 6 funds. That's sort of an indirect investment. 7 It's very difficult for you or I to buy bonds. 8 KELLY, Q.C.: 9 Q. They're held by the pension funds and the life 10 insurance companies? 11 DR. BOOTH: 12 A. Mainly because those funds have got long lived 13 liabilities and they need long lived assets to 14 match those liabilities. 15 KELLY, Q.C.: 16 Q. Exactly the point. In fact, they're held by 17 those funds for long term long periods. 18 They're not normally bought and sold by the 19 life insurance companies or the pension funds? 20 DR. BOOTH: 21 A. That's right. That's why the bond market is 22 less liquid than the equity market, as a rule, 23 except for the Government of Canada bond 24 market. 25 KELLY, Q.C.:</p>
Page 30	Page 32
<p>1 Q. Right, whereas bond holders, and take, for 2 example, Newfoundland Power's bond holders, 3 are fully secured against the assets of the 4 enterprise? 5 DR. BOOTH: 6 A. That's right, Moody's upgraded them, yes. 7 KELLY, Q.C.: 8 Q. Now graded A. 9 DR. BOOTH: 10 A. Yes. 11 KELLY, Q.C.: 12 Q. And graded A by DBRS for some considerable 13 time. So over the last several years, since 14 2008, we'll agree that the spreads have 15 increased? 16 DR. BOOTH: 17 A. Absolutely. Every time we go through a 18 recession, spreads increase, and this time 19 with the crisis of last fall, they increased 20 to what I regard as record highs. 21 KELLY, Q.C.: 22 Q. And Newfoundland Power's bonds and the bonds 23 of other utility companies in Canada are 24 primarily held by pension funds and life 25 insurance companies?</p>	<p>1 Q. And you talked yesterday at some length about 2 your view of the liquidity crisis and the 3 forced sale of bonds. I put it to you there's 4 no indication that utility bonds in Canada 5 have been sold off by pension funds or life 6 insurance companies. In fact, it would be 7 quite the contrary to what they would need to 8 do for their own interests? 9 (9:30 a.m.) 10 DR. BOOTH: 11 A. I think it's fair to say that the major 12 institutions didn't sell off their bonds 13 because they were basically unionized. Those 14 bonds were there to match those liabilities. 15 Most of the trading in the bonds is done by 16 bond market mutual funds where they're trying 17 to sort of buy and sell in order to generate a 18 few extra points and beat the indexes, or 19 they're done by the short term traders, but 20 it's not done by the institutions. So I've 21 been asking -- every time there's a hearing 22 involving an investment dealer, somebody from 23 BMO or Royal Bank, I've asked them the same 24 question, can you provide me the data on the 25 trading for, say, Terasen Gas bonds or Gas</p>

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<p>1 Metro's bonds, and they constantly tell me the</p> <p>2 same thing, this is proprietary, we can't</p> <p>3 provide this data. So unless I get that data,</p> <p>4 you can't sort of actually make direct</p> <p>5 assessments on exactly what was sold off.</p> <p>6 KELLY, Q.C.:</p> <p>7 Q. So you have a theory as to what happened, but</p> <p>8 it's pretty clear that what didn't happen is</p> <p>9 Newfoundland Power's bonds didn't get sold or</p> <p>10 other utility bonds in Canada?</p> <p>11 DR. BOOTH:</p> <p>12 A. What Newfoundland Power would have is -- I'm</p> <p>13 not quite sure who the investment dealer is</p> <p>14 for Newfoundland Power, but Newfoundland</p> <p>15 Power, they would have an indicative yield</p> <p>16 because it doesn't trade that often. So all</p> <p>17 that would happen is if, for example, it was</p> <p>18 BMO, if I ask for data on yields on</p> <p>19 Newfoundland Power's long term debt, they'd</p> <p>20 provide indicative yields, and you then ask</p> <p>21 how many trades occurred in that, and the</p> <p>22 answer generally will be very few, but just to</p> <p>23 talk about my theory, it's not a theory. The</p> <p>24 fact is the Federal Reserve in the United</p> <p>25 States took huge efforts, and, in fact, I've</p>	<p>1 tried to sell 10 million dollars worth of</p> <p>2 Newfoundland Power's bonds, and they said,</p> <p>3 look, in this market, given how much</p> <p>4 liquidity, we would quote you this yield, but</p> <p>5 no transactions probably occurred of that.</p> <p>6 KELLY, Q.C.:</p> <p>7 Q. But you do know that Newfoundland Power issued</p> <p>8 bonds back in the spring with a spread of 275</p> <p>9 basis points?</p> <p>10 DR. BOOTH:</p> <p>11 A. That's right, and that spread is now down to</p> <p>12 160/170.</p> <p>13 KELLY, Q.C.:</p> <p>14 Q. About 187, if we look at Undertaking 2.</p> <p>15 DR. BOOTH:</p> <p>16 A. Okay, but when was that undertaking?</p> <p>17 KELLY, Q.C.:</p> <p>18 Q. Let's just pull it up.</p> <p>19 DR. BOOTH:</p> <p>20 A. Okay, because --</p> <p>21 KELLY, Q.C.:</p> <p>22 Q. Sorry, Undertaking 1, BMO indicative yield on</p> <p>23 October 2.</p> <p>24 DR. BOOTH:</p> <p>25 A. So this is pricing?</p>
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<p>1 got it in one of my exhibits, one of my</p> <p>2 appendices, I think it's "G", listing the</p> <p>3 tremendous efforts the United States went</p> <p>4 through to inject liquidity into its capital</p> <p>5 markets because liquidity disappeared last</p> <p>6 year. So what we're talking about is not my</p> <p>7 theory, we're talking about if you look at the</p> <p>8 Bank of Canada's bond sheet and all of the</p> <p>9 purchase agreements the bank went into to try</p> <p>10 and inject liquidity into the Canadian banks,</p> <p>11 and also to the US banking system. I mean,</p> <p>12 this wouldn't have happened if there wasn't a</p> <p>13 liquidity crisis last year.</p> <p>14 KELLY, Q.C.:</p> <p>15 Q. But the impact on bond yields, especially</p> <p>16 Newfoundland Power's bond yields, and other</p> <p>17 Canadian bond yields, is not a direct effect</p> <p>18 of the sale of those bonds by holders. At</p> <p>19 most, it's a "knock on" effect from other</p> <p>20 issues?</p> <p>21 DR. BOOTH:</p> <p>22 A. It's primarily a "knock on" effect, but as I</p> <p>23 said, trades didn't occur. They just said,</p> <p>24 well, I mean, what would be the indicative</p> <p>25 yield, what would be the price if somebody</p>	<p>1 KELLY, Q.C.:</p> <p>2 Q. Yes.</p> <p>3 DR. BOOTH:</p> <p>4 A. Okay, so, I mean, that's fine, I didn't</p> <p>5 realize --</p> <p>6 KELLY, Q.C.:</p> <p>7 Q. So about 187 basis points.</p> <p>8 DR. BOOTH:</p> <p>9 A. Okay, the -- I was using 160/170 because</p> <p>10 that's what Terasen Gas -- BMO's underwriter</p> <p>11 for Terasen Gas, they indicated Terasen Gas</p> <p>12 would be between 155 and 160.</p> <p>13 KELLY, Q.C.:</p> <p>14 Q. So if we look at that, they have come down</p> <p>15 from the high of a spread of 275, but I just</p> <p>16 want to pick up a comment that you made</p> <p>17 yesterday and just explore this with you for a</p> <p>18 minute. Can I take you over to page 142 of</p> <p>19 yesterday's testimony, and Mike can put it on</p> <p>20 the screen there for you. Do you have that,</p> <p>21 Dr. Booth?</p> <p>22 DR. BOOTH:</p> <p>23 A. Yes, I do.</p> <p>24 KELLY, Q.C.:</p> <p>25 Q. If I can take you down to -- pick it up about</p>

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<p>1 line 12, for example. You say, "The spreads 2 in the corporate bond market are getting down 3 to where we would expect them, given the 4 severity of this recession. They are still 5 marginally high. In my judgment, they are 6 still 15 to 20 basis points higher than I 7 would expect, given the state of the economy, 8 but they're not ridiculously high compared to 9 where they were three to six months ago", and 10 you're not saying that the spread is now down 11 to only 15 or 20 basis points, if I follow you 12 correctly. What you're saying is it's 15 or 13 20 basis points higher than where you expect 14 it to be?</p> <p>15 DR. BOOTH:</p> <p>16 A. Yes, and that's based upon not particularly 17 analysis of Newfoundland Power's bond, it's 18 based upon the Scotia Capital indices of A 19 bond yields, and normally the top out at 150 20 or so during a recession, and this time 21 they're still around about 160/170. So I 22 would say that there's still some uncertainty 23 in the market, there's still some resistance 24 to buying corporate debt, and the yields are 25 still higher than I would expect at this stage</p>	<p>1 DR. BOOTH:</p> <p>2 A. Because this is a normal cyclical behaviour.</p> <p>3 KELLY, Q.C.:</p> <p>4 Q. But compared to where we were when we were 5 last -- for example, in 2007, setting rates 6 into 2008 test year, spreads are now still 50 7 to 75 basis points higher than where they were 8 at that point in time?</p> <p>9 DR. BOOTH:</p> <p>10 A. That's right, because this is a cyclical 11 behaviour. I mean, spreads just go up and 12 down with the business cycle, and we're not at 13 the same stage in the business cycle now that 14 we were in 2005/2006. Believe me, I'd love to 15 be back in 2005/2006, and we'll get there in 16 another two or three years.</p> <p>17 KELLY, Q.C.:</p> <p>18 Q. Another two or three years is your estimation.</p> <p>19 DR. BOOTH:</p> <p>20 A. Yeah.</p> <p>21 KELLY, Q.C.:</p> <p>22 Q. That's interesting.</p> <p>23 DR. BOOTH:</p> <p>24 A. That's off the top of my head, but, I mean, 25 we're looking for next year will be a recovery</p>
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<p>1 in the business cycle.</p> <p>2 KELLY, Q.C.:</p> <p>3 Q. Right. So if I take you now over to the 4 company's evidence, page 313, and I take you 5 down to line 7 and 8, the credit spreads in 6 2007 were 1.40", in other words 140 basis 7 points, and 1.06 in 2005. So we still have 8 increased credit spreads over the previous 9 bond issue of in the order of 50 to 75 basis 10 points? Do we agree on that?</p> <p>11 DR. BOOTH:</p> <p>12 A. Yes, and I'd also point out, as I pointed out 13 in my direct, that 2005 and 2007 was pretty 14 much bracket at the top of the market when 15 there was huge liquidity and spreads were 16 basically low. If you go back to the last 17 time we had a recession, had a low down in 18 Canada -- technically, we didn't have a 19 recession, but basically 2001, 2002, 2003, 20 when spreads went up, then spreads for 21 Newfoundland Power's debt, I think, at that 22 time were not that much different from where 23 they are now.</p> <p>24 KELLY, Q.C.:</p> <p>25 Q. Right.</p>	<p>1 from a serious recession. The Bank of Canada 2 is predicting 4 or 5 percent growth into 2011. 3 So I would anticipate we'll be back to 4 euphoria, liquidity, and strong equity markets 5 in 2012/2013, and then the banks will make a 6 whole bunch of bad loans again, and we'll be 7 in another recession, 2016.</p> <p>8 KELLY, Q.C.:</p> <p>9 Q. Is it fair to say you have a fairly optimistic 10 view of getting out over the next two to three 11 years, if you think we'll be that far along in 12 two years, three years out?</p> <p>13 DR. BOOTH:</p> <p>14 A. Well, you just look at the past. We've 15 actually had recessions, and I keep telling 16 this to my students because if you graduate 17 during a recession, you're going to have a 18 tough time getting a job and the lifetime 19 impact on your earnings is huge, but we had a 20 recession in the early 70s, early 80s, early 21 90s, early 2000s, but what's remarkable is 22 that ten year cycle hasn't occurred this time. 23 This time we've had it earlier because of the 24 problems in the US sub-prime market destroying 25 big chunks of their financial system.</p>

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<p>1 Normally, I would have expected a recession in</p> <p>2 another year or two years time, given the sort</p> <p>3 of basically a ten year cycle in the business</p> <p>4 cycle.</p> <p>5 KELLY, Q.C.:</p> <p>6 Q. Dr. Booth, I want to come back briefly to a</p> <p>7 question we talked about yesterday, which is</p> <p>8 US data, and let me take you back to Consent</p> <p>9 18, the BCUC transcript. I'll take you to</p> <p>10 page 634.</p> <p>11 DR. BOOTH:</p> <p>12 A. Yes.</p> <p>13 KELLY, Q.C.:</p> <p>14 Q. And if I take you down beginning at line 15 --</p> <p>15 even start down at line 17, "You've not</p> <p>16 followed US utilities because you don't</p> <p>17 consider them to be relevant". Your answer,</p> <p>18 "That's correct". The comment you made</p> <p>19 yesterday, "I've been dragged into looking at</p> <p>20 US utilities because US witnesses constantly</p> <p>21 bring them in as proxies", and the question,</p> <p>22 "Have you ever appeared as an expert witness</p> <p>23 in the US regulatory proceeding relating to a</p> <p>24 public utility", and answer, "No". Both those</p> <p>25 answers still correct?</p>	<p>1 this is deferral account. That's the context</p> <p>2 in which I don't feel that at the moment I</p> <p>3 have the expertise to testify on unique risks</p> <p>4 exposed to US utilities.</p> <p>5 KELLY, Q.C.:</p> <p>6 Q. Okay. Dr. Booth, I'm going to move on next to</p> <p>7 another question. This deals with a series of</p> <p>8 questions. This deals with the Automatic</p> <p>9 Adjustment Mechanism.</p> <p>10 DR. BOOTH:</p> <p>11 A. Yes.</p> <p>12 KELLY, Q.C.:</p> <p>13 Q. Now in 1998, in the Board's Order, the Board</p> <p>14 expressed the view that there could be changes</p> <p>15 in financial market conditions which would</p> <p>16 suggest that the formula is not accurately</p> <p>17 reflecting the appropriate return on equity,</p> <p>18 in which case it would be reviewed, and I take</p> <p>19 it from your evidence that there is agreement</p> <p>20 that that occurred last year, spring of this</p> <p>21 year?</p> <p>22 DR. BOOTH:</p> <p>23 A. I can -- my evidence is, and I've testified to</p> <p>24 this, I can fully understand why, given the</p> <p>25 depth of the problems we had last fall, why</p>
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<p>1 DR. BOOTH:</p> <p>2 A. That's correct. I've got no desire to appear</p> <p>3 in the United States as a witness. I've got a</p> <p>4 day job and I do enough in Canada to basically</p> <p>5 keep me busy, so -- and as I said, I'm</p> <p>6 starting to look at the US simply because we</p> <p>7 have so many US witnesses coming in to provide</p> <p>8 testimony in Canada, and I just don't think</p> <p>9 that's appropriate. You have to look at their</p> <p>10 evidence; otherwise, it goes uncontested. So</p> <p>11 I'm looking at US utilities more and more</p> <p>12 because it's necessary. If we keep bringing</p> <p>13 US witnesses into Canada, somebody has to sort</p> <p>14 of make sure their testimony is actually</p> <p>15 correct.</p> <p>16 KELLY, Q.C.:</p> <p>17 Q. But you're not following the US utilities per</p> <p>18 se, are you?</p> <p>19 DR. BOOTH:</p> <p>20 A. I'm not following them in the sense that if</p> <p>21 you took me through the questions that Mr.</p> <p>22 Johnson took Ms. McShane in terms of what's</p> <p>23 Duke Power doing, or what's AGL doing, then I</p> <p>24 wouldn't be able to answer and say, well, look</p> <p>25 their regulated business is this, this, or</p>	<p>1 the utilities would say, well, this is just --</p> <p>2 I see change in what's happening in the</p> <p>3 markets, we want to be reviewed, and as I</p> <p>4 testified for the Terasen Gas before the BCUC,</p> <p>5 and it's in my testimony here, the crisis last</p> <p>6 fall was the worse we've seen in 71 years and</p> <p>7 when you severely damage the financial system,</p> <p>8 you damage the whole economy, and that's what</p> <p>9 precipitated the Great Depression, it</p> <p>10 precipitated analogies with the Great</p> <p>11 Depression too last fall, and I can fully</p> <p>12 understand why in that situation why the</p> <p>13 utilities would say this is a seismic change</p> <p>14 in the markets, let's see whether the</p> <p>15 Automatic Adjustment Mechanism and the ROE is</p> <p>16 still fair. So I can understand why the</p> <p>17 utilities did that.</p> <p>18 KELLY, Q.C.:</p> <p>19 Q. And with spreads, for example, back in the</p> <p>20 spring of 275 basis points, you don't disagree</p> <p>21 that it's appropriate to review the operation</p> <p>22 of the formula going forward?</p> <p>23 DR. BOOTH:</p> <p>24 A. I can understand why they do it -- they did</p> <p>25 it. By the spring, you could see that the</p>

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1 markets were healing, and you could see, for
 2 example, the equity market hit its low March
 3 9th, and we already saw that the US banks, the
 4 American Government had already basically said
 5 we're guaranteeing the big 19 US banks, we're
 6 not going to allow them to fail, whereas there
 7 was still a suspicion that CitiBank and Bank
 8 of America would go bankrupt and these two
 9 control 20 percent of the US banking market.
 10 So if you allow those to go bankrupt, heaven
 11 knows what would have happened to the US
 12 financial system.

13 KELLY, Q.C.:
 14 Q. In your evidence, you've used some pretty
 15 strong language, as you did yesterday, the
 16 most serious recession, for example, since
 17 1982. I won't take you through all the
 18 references.

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

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

11 (9:45 a.m.)
 12 KELLY, Q.C.:
 13 Q. Can I take you to NP-CA-19. If I take you
 14 down to lines 19 and 20, you say, "The
 15 conditions that existed in the capital market
 16 from September 2008 to March 2009 could not be
 17 regarded as normal". So during that period at
 18 least, we'd agree that we had appropriate
 19 period to trigger the appropriate review by
 20 the Board?

21 DR. BOOTH:
 22 A. Yes, I can understand why the utilities would
 23 request that, and my understanding is if the
 24 utilities request a hearing and they feel that
 25 the allowed rate of return is not reasonable,

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1 then most Boards will call a hearing.
 2 KELLY, Q.C.:
 3 Q. And if we look across the country, the
 4 National Energy Board has already now
 5 discontinued the use of its Automatic
 6 Adjustment Formula?

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

19 KELLY, Q.C.:
 20 Q. So NEB has discontinued its formula, and the
 21 formulas are under review in British Columbia,
 22 Alberta, and Ontario?

23 DR. BOOTH:
 24 A. Alberta, it's a normal hearing because it was
 25 five years since the 2003 generic, with the

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1 2004 decision. So my understanding is that
 2 was basically just to review the formula, but
 3 clearly the --

4 KELLY, Q.C.:
 5 Q. But the question is the operation of the
 6 formula, whether to continue it will be part
 7 of that -- is part of that process?

8 DR. BOOTH:
 9 A. Clearly I think that became part of the
 10 process as the financial market meltdown
 11 continued, and the BCUC clearly had a request
 12 by Terasen to discontinue the formula for a
 13 period of time and to then reconsider the
 14 formula in the future. The Ontario Energy
 15 Board had a letter, I think it was January,
 16 and they had a technical conference, not a
 17 hearing --

18 KELLY, Q.C.:
 19 Q. Just recently?

20 DR. BOOTH:
 21 A. A couple of weeks ago.

22 KELLY, Q.C.:
 23 Q. Eight weeks ago, right.

24 DR. BOOTH:
 25 A. And they're wedded to the formula. They not

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<p>1 going to change the risk premium method for 2 the ROE formula for the Ontario utilities, but 3 they wanted to know whether it still continues 4 to be valid and whether they should change any 5 of the parameters, and that's really a 6 technical conference to think about changing 7 it. I don't know whether the OEB would just 8 unilaterally change it without a hearing, but 9 having said that, they imposed it unilaterally 10 without a hearing.</p> <p>11 KELLY, Q.C.: 12 Q. They kind of started the process. Where it 13 goes remains to be seen?</p> <p>14 DR. BOOTH: 15 A. That's correct.</p> <p>16 KELLY, Q.C.: 17 Q. We agree on that much.</p> <p>18 DR. BOOTH: 19 A. And the Regie in Quebec, they had a hearing 20 into Gas Metropolitan, GMI, and they -- Gas 21 Metro, the parent company owns half of TQM, 22 and they applied for a change in the 23 regulatory status to move to a network 24 approach, similar to that adopted by the 25 National Energy Board for TQM.</p>	<p>1 sort of methodology, and, for example, if we 2 had back in the spring the 275 basis point 3 spread, twice that would be 550, which would 4 be significantly above the risk premium from 5 the formula.</p> <p>6 DR. BOOTH: 7 A. That's right. As I said, what I was trying to 8 think of was a way of separating the normal 9 cyclical behaviour in spreads from abnormal 10 behaviour in spreads. So I wouldn't want to 11 trigger a hearing simply because spreads had 12 gone from 80 to 150 because that's what you 13 would expect when you go into a recession, 14 that's entirely predictable. So I was trying 15 to think of a way of triggering a hearing when 16 you get a unpredictable change in spreads, and 17 clearly what we had in the fall and in the 18 spring were spreads well beyond what would be 19 regarded as normal for that stage in the 20 business cycle.</p> <p>21 KELLY, Q.C.: 22 Q. And, Dr. Booth, currently we looked at 23 Undertaking #1 with a spread at 187. So if I 24 took that and multiplied it by two, I'd have 25 374, correct?</p>
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<p>1 KELLY, Q.C.: 2 Q. And if we -- just one last area just to 3 explore on this a little bit. I take you to 4 Consent 18 again, over to page 688.</p> <p>5 DR. BOOTH: 6 A. Yes.</p> <p>7 KELLY, Q.C.: 8 Q. And if I take you down to line 15.</p> <p>9 DR. BOOTH: 10 A. Yes.</p> <p>11 KELLY, Q.C.: 12 Q. This was a proposal which, I gather, you had 13 put forward in British Columbia. You would 14 support a trigger for a review of the BCUC ROE 15 formula if the formula generated a utility 16 risk premium less than twice the current 17 spread on TGI, which is Terasen, long term 18 debt over equivalent maturity long Canada 19 bonds.</p> <p>20 DR. BOOTH: 21 A. Yes. This was actually proposed by ATCO in 22 the generic hearing in 2003 before the -- what 23 was then the Alberta Energy Utilities Board.</p> <p>24 KELLY, Q.C.: 25 Q. So if we took that and we applied that same</p>	<p>1 DR. BOOTH: 2 A. Yes.</p> <p>3 KELLY, Q.C.: 4 Q. 375, round figures, and your proposed ROE is 5 775, with 450 as the interest rate, which 6 would give you a risk premium of 325. So even 7 on your analysis versus the current spread, 8 even on that basis, we would still be over 9 this formula trigger point. Do you agree --</p> <p>10 DR. BOOTH: 11 A. I may be dreaming, Mr. Kelly, but I think 12 we're in a hearing talking about fair ROE 13 right at the moment.</p> <p>14 KELLY, Q.C.: 15 Q. Exactly. So we're not quarrelling over the 16 fact that the formula operation needs to be 17 reviewed by the Board, I take it?</p> <p>18 DR. BOOTH: 19 A. No. I think -- I mean, my trigger, just to 20 put it in context, was relative to the BCUC 21 formula. So that spread was what was 22 suggested by ATCO, and I could understand why 23 it would be reasonable in the context of the 24 ROE adjustment formulas, but I entirely agree, 25 and as I've said repeatedly, that we've had</p>

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

21 KELLY, Q.C.:

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

23 CHAIRMAN:

24 Q. Mr. Simmons.

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

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1 MR. SIMMONS:

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

15 DR. BOOTH:

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

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

6 MR. SIMMONS:

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

16 DR. BOOTH:

17 A. That's correct.

18 MR. SIMMONS:

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

1 Formula has to be reconsidered?

2 DR. BOOTH:

3 A. There is a big difference. My view would be
 4 that from September to March, as I indicated
 5 yesterday, we were in a situation of
 6 uncertainty. We simply didn't know whether
 7 the US Government was going to allow CitiBank,
 8 Bank of America, and a whole series of other
 9 US banks that were in serious financial
 10 trouble to go bankrupt, and the process --
 11 there was so much uncertainty that we saw
 12 these record high spreads in the bond market,
 13 we saw the Canadian dollar drop from a premium
 14 down to 77 cents at one point, a significant
 15 drop in the value of the Canadian dollar. We
 16 saw the Canadian Government intervene to
 17 generate liquidity into the markets. The US
 18 Government, as I've said, have taken herculean
 19 efforts, both on the part of the Treasury in
 20 terms of the programs they introduced, and on
 21 behalf of the Federal Reserve. At that point,
 22 this was by far and away the biggest financial
 23 crisis that we have had for 70 years. So if
 24 that's doesn't trigger -- if that doesn't
 25 justify utility asking for a hearing, it's

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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

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

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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.

8 (10:00 a.m.)

9 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?

21 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

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.

17 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.

24 DR. BOOTH:

A. That's correct.

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<p>1 MR. SIMMONS:</p> <p>2 Q. Did I understand that correctly?</p> <p>3 DR. BOOTH:</p> <p>4 A. Yeah.</p> <p>5 MR. SIMMONS:</p> <p>6 Q. We've heard from Ms. McShane, and I think</p> <p>7 we'll hear from Mr. Cicchetti as well, that</p> <p>8 they have some other views on what the</p> <p>9 appropriate factor is to use other than the .8</p> <p>10 or the 80 percent, and I wonder if you have</p> <p>11 any current views on whether you foresee any</p> <p>12 need to look at adjusting that 80 percent</p> <p>13 factor in the future, assuming the Automatic</p> <p>14 Adjustment Formula continues to be used after</p> <p>15 2010?</p> <p>16 DR. BOOTH:</p> <p>17 A. If the formula were to be rebased, I would now</p> <p>18 use an adjustment for it probably closer to 1,</p> <p>19 and the reason for --</p> <p>20 MR. SIMMONS:</p> <p>21 Q. And why would you do that?</p> <p>22 DR. BOOTH:</p> <p>23 A. Well, the reason for doing that is that when</p> <p>24 the formula was introduced in '93, '94, the</p> <p>25 big problem was the long Canada bond yield,</p>	<p>1 around 4 to 6 percent, somewhere in that</p> <p>2 range. So the adjustment formula worked</p> <p>3 because of a structural change primarily in</p> <p>4 the finances of the Government of Canada, the</p> <p>5 tax structure in Canada, the rate of</p> <p>6 inflation, most of those changes have worked</p> <p>7 their way through. I don't see there being</p> <p>8 huge potential for tax reductions in Canada.</p> <p>9 I think we've stripped out most of the</p> <p>10 excesses in Government spending, and I don't</p> <p>11 see any ground swell of public opinion for</p> <p>12 further tax reductions or further program</p> <p>13 cuts. I don't see the rate of inflation</p> <p>14 getting out of control. I think the</p> <p>15 Government has done a very good job in terms</p> <p>16 of fiscal stimulus, of limiting the amount of</p> <p>17 fiscal stimulus Canada, and stretching it out</p> <p>18 over multiple time periods. In fact, if the</p> <p>19 truth be told, you look at the Government</p> <p>20 budget deficit, very little of it is</p> <p>21 structural spending, unlike in the United</p> <p>22 States. So I see the Government of Canada</p> <p>23 returning to a surplus over a three to four</p> <p>24 year period because most of it is what we call</p> <p>25 automatic stabilizers that fluctuate with</p>
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<p>1 not the equity market, but the long Canada</p> <p>2 bond yield, because we had long Canada yields</p> <p>3 of 9.25 percent, and because we had 6 percent</p> <p>4 inflation, we had huge Government deficits.</p> <p>5 So we had a problem that expected inflation</p> <p>6 gets factored into the long term Canada bond</p> <p>7 yield, plus the uncertainty about exactly what</p> <p>8 the Government is going to do, whether it's</p> <p>9 just going to inflate its way out of the</p> <p>10 deficit, or whether it's going to tackle the</p> <p>11 deficit issues. The Government took the right</p> <p>12 approach. We had tough medicine in Canada in</p> <p>13 several years, so we missed out on a lot of</p> <p>14 the prosperity in the early and mid 90s that</p> <p>15 the rest of the world experienced, but we're</p> <p>16 benefiting from that now because the inflation</p> <p>17 premium has gone out of long term Canada bond</p> <p>18 yields, the Bank of Canada now has credibility</p> <p>19 in the capital markets to stick to 1 to 3</p> <p>20 percent inflation, and as a result, we've</p> <p>21 reaped the rewards, and one of those rewards</p> <p>22 is low interest rates, low capital market</p> <p>23 opportunity cost in Canada, and as long as the</p> <p>24 Bank of Canada sticks to 1 to 3 percent, long</p> <p>25 Canada bond yields are going to fluctuate</p>	<p>1 business cycle. So that's a long answer,</p> <p>2 saying that the justification for .8, .75,</p> <p>3 that we used fifteen years ago was based upon</p> <p>4 capital market conditions where most of that</p> <p>5 is now out of the system. We're now down to a</p> <p>6 system where the rate of inflation</p> <p>7 incorporated into bond yields is 1.5/ 2</p> <p>8 percent, and I don't see that changing very</p> <p>9 much. There's not a lot of risk in terms of</p> <p>10 Government financing, the way there was 15</p> <p>11 years ago, because we've had structural</p> <p>12 surpluses for the last ten years, and I expect</p> <p>13 that to return. So if there is an adjustment,</p> <p>14 it's more likely to be 1 to 1 now. It's</p> <p>15 difficult to see why it should continue to be</p> <p>16 .75 to .8. There's no reason for it to be . 5</p> <p>17 at all. If you work through the arithmetic of</p> <p>18 a utility that on average, say, has a beta of</p> <p>19 .5, if you use an adjustment of .5, and apply</p> <p>20 the market risk premium, it perfectly offsets</p> <p>21 a change in the long Canada bond yield, and as</p> <p>22 a result, the overall expected return on the</p> <p>23 market is constant, which means we can throw</p> <p>24 all the risk premium models out the window.</p> <p>25 That argument I put before the NEB, the BCUC,</p>

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<p>1 the Manitoba PUB, consistently for the last 2 fifteen years, and no Board has accepted an 3 adjustment of .5 because it doesn't make any 4 sense whatsoever. It flies in the face of 5 financial theory, and it flies in the face of 6 commonsense. The equity markets are totally 7 unresponsive to Canada bond yields, and as a 8 result, it just doesn't make any sense. So I 9 think when I put that evidence, myself and my 10 late colleague, Dr. Berkowitz, before the NEB, 11 the Manitoba PUB, and the BCUC, we recommended 12 .8, other witnesses recommended 1, the company 13 witnesses generally recommended .5, and I 14 guess the NEB just split the difference and 15 came up with .75, and that's proven to be 16 remarkably correct.</p> <p>17 MR. SIMMONS: 18 Q. The effect of using a factor of 1 instead of 19 .8 or some lower factor, if I understand 20 correctly, that would mean that between 21 general rate applications and between test 22 years, the potential for customer rates to 23 change would actually be higher with that 24 higher factor than it is if a lower factor is 25 used?</p>	<p>1 into the ROE Adjustment Formula, came out with 2 an ROE and then fixed it for the next ten 3 years, I'd be perfectly happy with that. What 4 it would mean is the ROE will be slightly over 5 during bad years and slightly under during 6 good years, but over the full business cycle, 7 it will average out. As I indicated in my 8 direct testimony, I've got no problems with 9 doing that. I think it's marginally generous 10 to the company both to have an adjustment 11 mechanism or to fix the yield, but over the -- 12 everything will average out over the business 13 cycle. So if you wanted to put in place 8.5 14 percent, fix it for the next ten years, 15 subject to dramatic changes in the capital 16 markets, I'll be happy with that. If you 17 wanted a 1 to 1 adjustment, I'll be happy with 18 that. If you wanted a .8 adjustment, I'll be 19 happy with that because it basically averages 20 out over the business cycle. What I would not 21 be happy with is cherry picking, saying, well, 22 we'll have this adjustment during these bad 23 years and then when the good years come along, 24 we'll throw it away and we'll just take the 25 higher ROE. You've got to be consistent over</p>
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<p>1 DR. BOOTH: 2 A. That's correct. The -- I've been asked in the 3 past about this. My view is as long -- and 4 I've said this several times, as long as the 5 Bank of Canada commits to 1 to 3 percent 6 inflation, and you believe that because the 7 capital markets believe that, then basically 8 the long Canada bond yield will average out 9 the same over the business cycle. So you will 10 have lower rates as the rates when you have a 11 recession, the way we just had it, and you'll 12 have high rates the way that we had in 2005 13 and 2006 when there's pressure for capital, 14 and as a result capital costs go up. So there 15 will be variations over the business cycle, 16 but it will average out at about 5 percent or 17 so, 5.25, 5.50 for the long Canada bond yield. 18 So I'm personally indifferent to whether you 19 fix the ROE for a five to ten year period at, 20 say, 8.5 percent, consistent with, say, the 21 5.25 percent long term Canada bond yield. So 22 if Ms. McShane says that 5.25 percent is the 23 long term Canada bond yield, I have no 24 objection to that. It might be 5.5, but 25 that's about right. So if you just put that</p>	<p>1 the business cycle.</p> <p>2 MR. SIMMONS: 3 Q. So there would seem maybe to be two approaches 4 that can be taken in the long run to how the 5 Automatic Adjustment Formula would be used. 6 One would be to try to structure the formula 7 to make it reflect actual rates in the market 8 that the company is affected by as closely as 9 possible, which would promote matching the 10 cost of producing power to the rates paid by 11 consumers at the time that they pay their 12 rates. The other approach would be not to 13 worry about that so much and rely on the long 14 term fluctuations in the business cycle and 15 the symmetry to produce a fair return for the 16 company and fair rates for the consumers of 17 the power?</p> <p>18 DR. BOOTH: 19 A. That's right. When you take out a mortgage, 20 you can either take a five year mortgage at a 21 fixed rate or you can take a one year mortgage 22 and then get all the uncertainty in one year 23 rates. They're both fair. So it's perfectly 24 fair to have a rate that resets every year on 25 capital market conditions. It's also</p>

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<p>1 perfectly fair to take out a fixed rate over</p> <p>2 the same time period. So I think both of</p> <p>3 those are fair. Personally, I think the best</p> <p>4 thing for rate payers, and also for the</p> <p>5 company, is to fix it over a period of time,</p> <p>6 so you don't take all of the volatility in</p> <p>7 capital markets threw into rates, which is why</p> <p>8 I'm perfectly happy to fix the adjustment</p> <p>9 mechanism and keep it where it is at the</p> <p>10 moment, or I'm perfectly happy to have a fixed</p> <p>11 rate based upon Ms. McShane's estimate of the</p> <p>12 average or long term Canada bond yield of 5.25</p> <p>13 percent, because that's where it's been for</p> <p>14 the last eight or nine years. Long Canada</p> <p>15 bond yields have been around 4 or 5 percent.</p> <p>16 So whether you adjust by .8 or 1, the change</p> <p>17 in the ROE has been relatively small.</p> <p>18 MR. SIMMONS:</p> <p>19 Q. I had a couple of questions for you about the</p> <p>20 DCF method, which you didn't use directly as a</p> <p>21 means of returning ROE here, but it did form</p> <p>22 part of your risk premium analysis, if I</p> <p>23 understand correctly?</p> <p>24 DR. BOOTH:</p> <p>25 A. It formed part of my reasonableness check</p>	<p>1 was there data available, but these were pure</p> <p>2 regulated utilities. So no problems involved</p> <p>3 in looking at firms involved in a merchant</p> <p>4 power function and other things. I also at</p> <p>5 that time tried to look at a sample of gas and</p> <p>6 electric companies, and at that time we had</p> <p>7 Maritime Electric, which was a traded company</p> <p>8 which was a pure electric company. We had</p> <p>9 Consumers Gas in Ontario with, I think, a</p> <p>10 15/20 percent public float that you could</p> <p>11 actually use to value. You had Trans Alta</p> <p>12 out in Alberta which at that time was still an</p> <p>13 integrated electric utility in generation,</p> <p>14 distribution, and transmission. So we had a</p> <p>15 number of utilities in the gas and electric</p> <p>16 field that were close to being pure utilities.</p> <p>17 So you could actually estimate what is the</p> <p>18 stop price for this stream of dividends, and</p> <p>19 you could look at the growth rates, and one of</p> <p>20 the nice features at that time was that</p> <p>21 inflation was a significant factor, and why I</p> <p>22 say that was nice is because most growth is</p> <p>23 generated by inflation. If the economy is</p> <p>24 inflating at 10 percent per year, you've got</p> <p>25 10 percent built in almost to the growth rate.</p>
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<p>1 after I came up with my estimates.</p> <p>2 MR. SIMMONS:</p> <p>3 Q. Right, and you said in your evidence yesterday</p> <p>4 that you did use the DCF method in the past,</p> <p>5 but you stopped using it in the 1990s because</p> <p>6 there had increasingly been problems with it,</p> <p>7 and I wonder can you tell me a little more</p> <p>8 about what the problems were that you</p> <p>9 encountered with using that method here in</p> <p>10 Canada and why you discontinued using it?</p> <p>11 DR. BOOTH:</p> <p>12 A. I used to use two samples of firms. One</p> <p>13 telephone sample, because at the time in the</p> <p>14 80s and 90s, the local telephone companies</p> <p>15 were still subject to rate of return</p> <p>16 regulation, and we were lucky in Canada, we</p> <p>17 had Island Telephone in PEI, we had</p> <p>18 Newfoundland Telephone, we had Maritimes Tel,</p> <p>19 we had Quebec Tel, we had BC Tel, and for a</p> <p>20 time we had AGT, which became Telus.</p> <p>21 MR. SIMMONS:</p> <p>22 Q. So there was data available to use the method?</p> <p>23 (10:15 a.m.)</p> <p>24 DR. BOOTH:</p> <p>25 A. There was data available, yeah, and not only</p>	<p>1 So at that time we could estimate the growth</p> <p>2 rates looking at rates of inflation, and we</p> <p>3 could look at real growth, and to estimate a</p> <p>4 DCF estimate. We did it that way, my late</p> <p>5 colleague and I, and other people did it the</p> <p>6 same way. So we had the data, we had the</p> <p>7 companies, and we could correctly estimate</p> <p>8 these opportunity costs. The Ontario Energy</p> <p>9 Board rejected DCF in part because Consumers</p> <p>10 Gas, the public float was bought out by</p> <p>11 Enbridge, and then Unicom that owns Union Gas</p> <p>12 became part of the west coast system, so you</p> <p>13 didn't have directly observable prices for the</p> <p>14 utilities that were being regulated in Canada.</p> <p>15 That, plus a lot of problems in estimating the</p> <p>16 growth rates, caused their demise in Canada.</p> <p>17 In the United States, it's more prevalent.</p> <p>18 The reason for that is they have growth</p> <p>19 estimates from analysts, and the only problem</p> <p>20 that I'm sure Mr. Cicchetti will get into is</p> <p>21 the fact that we know those growth estimates</p> <p>22 are biased because analysts -- these analyst's</p> <p>23 growth estimates come from sell side analysts,</p> <p>24 so they're basically selling the stock or</p> <p>25 promoting the stock, and we know there's an</p>

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<p>1 optimism bias in these growth estimates in the</p> <p>2 United States. Ms. McShane has accepted that</p> <p>3 in the past. So any estimates coming from DCF</p> <p>4 estimates based upon growth estimates from</p> <p>5 analysts, we have to adjust them downwards</p> <p>6 because we know that they're biased high.</p> <p>7 MR. SIMMONS:</p> <p>8 Q. So your reasons for not using the DCF method</p> <p>9 now, and not having used it since 1990, are</p> <p>10 twofold. One is that you lost the Canadian</p> <p>11 data that you would have used from comparable</p> <p>12 Canadian companies to input into the formula,</p> <p>13 and you are unwilling to go to American</p> <p>14 comparable companies, in part, because you</p> <p>15 didn't trust the reliability of the forecast</p> <p>16 data that was available for those companies?</p> <p>17 DR. BOOTH:</p> <p>18 A. Well, I wouldn't say me, I don't think anybody</p> <p>19 trusts the reliability of sell side analysts</p> <p>20 in the United States. They're under a huge</p> <p>21 conflict of interest, and all of the academic</p> <p>22 evidence indicates that they're biased high.</p> <p>23 MR. SIMMONS:</p> <p>24 Q. So those are the reasons, it wasn't anything</p> <p>25 about the methodology per se that you</p>	<p>1 percent. So we look at those DCF estimates</p> <p>2 because that's intrinsically what you get out of</p> <p>3 investing in stock, you get dividends, you get</p> <p>4 capital gains, and they come from the</p> <p>5 underlying profitability in the system. So I</p> <p>6 use it as a check, but a lot of the estimates</p> <p>7 from investment banks come totally from D/P +</p> <p>8 G, dividend yield plus growth.</p> <p>9 MR. SIMMONS:</p> <p>10 Q. You've already answered quite a few questions</p> <p>11 on your capital asset method calculations, but</p> <p>12 I read in your report that you used a couple</p> <p>13 different methods there; two variations, a two</p> <p>14 stage method, in addition to the more direct</p> <p>15 calculation to determine the results of that,</p> <p>16 and you've been questioned a good bit about</p> <p>17 the determination of the beta factor, and the</p> <p>18 element of judgment that goes into that. In</p> <p>19 your two stage approach, I see you refer to a</p> <p>20 factor that you call a "gamma".</p> <p>21 DR. BOOTH:</p> <p>22 A. Yes.</p> <p>23 MR. SIMMONS:</p> <p>24 Q. And would the same considerations apply to the</p> <p>25 determination of gamma, in that you do look to</p>
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<p>1 considered inappropriate, and if you had the</p> <p>2 data you needed, you would probably still use</p> <p>3 the DCF method approach, would you?</p> <p>4 DR. BOOTH:</p> <p>5 A. Absolutely. In fact, I still use the DCF</p> <p>6 method in the way that people like TD and the</p> <p>7 Royal Bank and the big investment banks use</p> <p>8 it, which is to say they look at the forecast</p> <p>9 growth and they look at top down analysis of</p> <p>10 looking at where we are in the economy, what's</p> <p>11 the economic growth, what are the reasonable</p> <p>12 estimates for top level profit growth, and</p> <p>13 then they reconcile that with bottom up</p> <p>14 analyst forecast. They look at the dividends</p> <p>15 yield and they say what's a reasonable equity</p> <p>16 cost for the market as a whole, and that's</p> <p>17 DCF, plus the overall growth in profits in the</p> <p>18 economy. So I do that because that's -- it's</p> <p>19 a check. It's sort of saying, well, if you've</p> <p>20 only got 2 percent inflation and the economy</p> <p>21 is growing at 3 or 4 percent tops, you've got</p> <p>22 5 or 6 percent growth in the economy overall.</p> <p>23 So it's difficult then to say, well, in</p> <p>24 aggregate, profits can grow at 10 percent</p> <p>25 forever when the economy can only grow 5 to 6</p>	<p>1 evidence, but you also bring an element of</p> <p>2 judgment into the determination of that factor</p> <p>3 in that test?</p> <p>4 DR. BOOTH:</p> <p>5 A. That's correct. Ms. McShane, I think,</p> <p>6 estimates the interest sensitivity to</p> <p>7 utilities of .52. I use .5. It obviously</p> <p>8 varies with the amount of interest rate</p> <p>9 uncertainty in the economy. During periods</p> <p>10 when interest rates were really violently</p> <p>11 going up and down, the sensitivity differs</p> <p>12 because all of these coefficients are</p> <p>13 basically how sensitive is the stock price to</p> <p>14 a change in some underlying risk factor. If</p> <p>15 that underlying risk factor doesn't change</p> <p>16 during the estimation period, then you can't</p> <p>17 estimate accurately a sensitivity coefficient</p> <p>18 very well.</p> <p>19 MR. SIMMONS:</p> <p>20 Q. And using both of those methods, you came up</p> <p>21 with a 7 percent number that you used?</p> <p>22 DR. BOOTH:</p> <p>23 A. Yeah.</p> <p>24 MR. SIMMONS:</p> <p>25 Q. Which you further adjusted to account for</p>

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<p>1 floatation costs and a margin of error, 2 resulting in 7.75 percent? 3 DR. BOOTH: 4 A. That's correct. 5 MR. SIMMONS: 6 Q. Which was your recommendation, and if I 7 understand the last step in the process you 8 use is smell test to see if that number looks 9 right? 10 DR. BOOTH: 11 A. Sure. 12 MR. SIMMONS: 13 Q. What do you do when it doesn't? 14 DR. BOOTH: 15 A. I go back and I look at why doesn't the 16 numbers look right, and if I was just to not 17 use my judgment and just be a statistician and 18 just use the realized risk premium, say, since 19 1956 and come up with 2 percent, and I was 20 plugging that into, say, the capital asset 21 pricing model, the way it's supposed to be 22 used in non-regulated -- here using the 23 treasury bill yield, then we've got 25 basis 24 points plus 2 percent, and then you come up 25 with nonsense numbers. So that's a smell test</p>	<p>1 fair return. 2 MR. SIMMONS: 3 Q. So those are the things you would have to 4 consider when you use your smell test and see 5 if the final result looks reasonable, given 6 all these underlying factors and what you know 7 about the markets and the economy, but when 8 the number fails, what do you do? Do you go 9 back and adjust factors that you've used in 10 order to work through the processes of the 11 different methodologies again to come up with 12 different numbers, or do you just say at the 13 end of your report "this is an unreasonable 14 number and instead of 5, I think it should be 15 6"? 16 DR. BOOTH: 17 A. I do the same thing as if a builder builds a 18 house and the house falls down. He says, 19 "Wow, why did the house fall down, I'll go and 20 investigate why the house fell down", and 21 exactly the same when I come up with 22 estimates, I will go through and say, well, 23 look, given the long run experience in the 24 market, given the level of interest rates, 25 judgment constrained by the facts, you go back</p>
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<p>1 when you sort of look at it and you say, well, 2 look, I'm doing what they did on all these 3 empirical tests, I'm coming up with 2.5 4 percent, if I add in 50 basis points, would I 5 recommend 3 percent for an allowed rate of 6 return; the answer is obviously nonsense, 7 that's the smell test. You look at it and you 8 say that's not reasonable. So you have to 9 look at it in the context of understanding 10 where we are in the business cycle, and I've 11 said that repeatedly over the last day and a 12 half, but it distresses me sometimes when 13 people produce estimates and there's no 14 discussion of the economy or the financial 15 markets because all of this comes from the 16 state of the economy. The key driving fair 17 rates return is the expected rate of 18 inflation, and when we have expected rate of 19 inflation down 2 percent, we're not going to 20 have the same allowed rates of return as we 21 had 15/20 years ago when the rate of inflation 22 was 5/6 percent. I mean, that would defy 23 logic. So you have to understand the state of 24 the economy and then you have to understand 25 what's driven your estimates that go into the</p>	<p>1 and you look and say, well, why has the beta 2 been .1. So I don't believe in just reporting 3 numbers and saying these are the numbers. I 4 believe in looking at the numbers and 5 understanding what generated those numbers. 6 MR. SIMMONS: 7 Q. So you can't go back and change the underlying 8 data that you've used, what you can change is 9 either the methodology that you've used or the 10 judgment that you've exercised? Those are the 11 two elements that are within your control when 12 it comes to using your methodologies and 13 working out a final number, right? 14 DR. BOOTH: 15 A. To some extent, that's true. I think it's -- 16 I have some Boards say can't we just throw out 17 2008, let's just pretend it didn't happen, and 18 as a result we didn't suffer a 38 percent drop 19 in the Canadian market, and as a result our 20 historic risk premium estimates are higher, 21 and my answer to that is, no, you can't do 22 that, you just can't throw out data that you 23 don't like, you have to go back and understand 24 what drove that data and understand whether 25 the underlying economic situation is going to</p>

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<p>1 persist into the future. So I would regard</p> <p>2 2008 as an aberrant year, but we happen to</p> <p>3 have these aberrant years every certain period</p> <p>4 of time. Hopefully, it'll be another 70 years</p> <p>5 before the US destroys its financial system</p> <p>6 again, but I don't think it's going to happen</p> <p>7 in the foreseeable future.</p> <p>8 MR. SIMMONS:</p> <p>9 Q. I just want to be clear that I understand what</p> <p>10 you're saying, is that if the end result</p> <p>11 number you get is in your judgment</p> <p>12 unreasonable, what would you then do? Would</p> <p>13 you either review your choice of methodology</p> <p>14 or the way you've used it, or would you review</p> <p>15 the judgment you've used for the inputs into</p> <p>16 that methodology?</p> <p>17 DR. BOOTH:</p> <p>18 A. Well, I don't review the judgment in the sense</p> <p>19 that I'm using judgment all the way through</p> <p>20 the process. I'm looking at the data that's</p> <p>21 coming out and I'm trying to understand it,</p> <p>22 and do I place a lot of weight on the betas</p> <p>23 from last year; no, because I know that</p> <p>24 they're driven by the stock market crash last</p> <p>25 year, and the fact that whenever the stock</p>	<p>1 the capacity of the utility to borrow on its</p> <p>2 credit standing, its credit rating, its credit</p> <p>3 metrics, and those factors?</p> <p>4 DR. BOOTH:</p> <p>5 A. Yes. The critical thing is we can look at the</p> <p>6 fair rate of return, and we have to look at</p> <p>7 whether those costs are fair and reasonable.</p> <p>8 We then have to look at whether or not the</p> <p>9 firm, the utility, can actually raise capital</p> <p>10 and provide service. Normally, any fair</p> <p>11 return of return comes out, it's going to</p> <p>12 imply that the utility's financial integrity</p> <p>13 is preserved and it can continue to raise</p> <p>14 capital. In some cases, that's not the case,</p> <p>15 and it's not the case usually because the firm</p> <p>16 has got a very high embedded cost of debt, and</p> <p>17 usually it's because it's a small firm, and as</p> <p>18 a result that embedded -- high embedded cost</p> <p>19 of debt is not going to be rolled away very</p> <p>20 quickly by refinancing at lower interest</p> <p>21 rates. So if there's restrictions in the bond</p> <p>22 contract, for example, as there traditionally</p> <p>23 are for a lot of Canadian utilities, a two</p> <p>24 times interest rate restriction, has to cover</p> <p>25 the interest twice in EBIT, then sometimes it</p>
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<p>1 market crashes, betas go down because</p> <p>2 utilities are defensive stocks. So the</p> <p>3 question is, I then look forward and say where</p> <p>4 are we in the business cycle and what's likely</p> <p>5 to happen. So I'm constantly looking at the</p> <p>6 statistics. It's not as if a number comes out</p> <p>7 and I say, well, that's a nonsense number. I</p> <p>8 sort of have a pretty good idea what the data</p> <p>9 is going to tell me, given the fact that I'm</p> <p>10 constantly watching what's happening in the</p> <p>11 economy and have been for the last ten or</p> <p>12 fifteen years. I mean, I can predict the</p> <p>13 market risk premium results are going to go up</p> <p>14 next year; why, because we've had a 50 percent</p> <p>15 recovery in the stock market since March, and</p> <p>16 2009 will be a good year for the equity</p> <p>17 market, 2010 will be better possibly, and as a</p> <p>18 result the historic estimates are going to go</p> <p>19 up. Do I put a lot of faith in those year to</p> <p>20 year fluctuations; no.</p> <p>21 MR. SIMMONS:</p> <p>22 Q. Only one other question. When you complete</p> <p>23 your ROE analysis and your recommendation, is</p> <p>24 any part of what you do then to consider the</p> <p>25 impact that that recommendation would have on</p>	<p>1 means that the firm can't raise capital. In</p> <p>2 fact, this has been a perennial problem for</p> <p>3 Enbridge Gas distribution in Ontario, it's</p> <p>4 currently a minor problem for Terasen Gas,</p> <p>5 both of which are very close to the two times</p> <p>6 interest coverage ratio. Particularly for</p> <p>7 Enbridge when it got volatile earnings, partly</p> <p>8 volatile earnings, as a result of weather. It</p> <p>9 doesn't have a weather normalization account.</p> <p>10 So sometimes Enbridge has been restricted from</p> <p>11 issuing long term debt because it can't meet</p> <p>12 the new issue test. So in those cases, you</p> <p>13 look at it and you say, well, if the equity</p> <p>14 return is fair, how can we cope with this</p> <p>15 problem of maintaining financial integrity,</p> <p>16 access, raising capital to provide financing,</p> <p>17 and the answer to that is not to reward the</p> <p>18 equity holders because these concerns</p> <p>19 generally got nothing to do with the equity</p> <p>20 holders. So you don't give the equity holders</p> <p>21 a bonus return simply because of temporary</p> <p>22 financial access problems. What you do there</p> <p>23 is you look at the ability of the firm to</p> <p>24 raise short term debt, and in the case of</p> <p>25 Newfoundland, that's not problem because</p>

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<p>1 they've got extensive short term credit</p> <p>2 facilities, and, in fact, according to</p> <p>3 Moody's, they've just had the material adverse</p> <p>4 conditions clause removed from their credit</p> <p>5 line. So that means they can do what small</p> <p>6 utilities or smaller utilities generally do,</p> <p>7 which is borrow short term, and wait to refund</p> <p>8 when the market conditions are appropriate.</p> <p>9 Generally in those conditions, I look to see</p> <p>10 the availability of the short term capital,</p> <p>11 and if there's a persistent problem, and this</p> <p>12 is what I recommended before the Ontario</p> <p>13 Energy Board, the traditional solution is</p> <p>14 preferred shares. You use preferred shares on</p> <p>15 a temporary basis because preferred shares</p> <p>16 boost the interest coverage ratio, allows the</p> <p>17 firm better access to financial markets, and</p> <p>18 doesn't reward the equity holders, and I've</p> <p>19 constantly said for the last ten years you</p> <p>20 don't reward the equity holders for problems</p> <p>21 in the bond market in terms of coverage ratios</p> <p>22 and access in financial markets, because those</p> <p>23 are just technical restrictions and nothing to</p> <p>24 do with the fair rate of return standard.</p> <p>25 MR. SIMMONS:</p>	<p>1 quarter because of the cash for clunkers that</p> <p>2 was part of the Obama package, basically</p> <p>3 giving Americans money to buy new cars to</p> <p>4 replace their old gas guzzlers. So that</p> <p>5 stimulated some demand during the summer. I</p> <p>6 think the problem --</p> <p>7 CHAIRMAN:</p> <p>8 Q. That's pretty phoney, though, isn't it?</p> <p>9 DR. BOOTH:</p> <p>10 A. It is pretty phoney. It's a temporary</p> <p>11 stimulus, but you've got to remember the vast</p> <p>12 bulk of Obama stimulus package hasn't gone</p> <p>13 into effect, just as half of the 20 billion of</p> <p>14 our deficit stimulus package hasn't gone into</p> <p>15 effect yet. It's all infrastructure spending</p> <p>16 that basically still has got to be spent, and</p> <p>17 there is a significant body of people in the</p> <p>18 United States that believe, given these lags,</p> <p>19 all of this Government spending will come on</p> <p>20 stream just as the impact of interest rates</p> <p>21 will start rebounding the US economy, and as a</p> <p>22 result, there's people in the United States</p> <p>23 actually afraid of inflation, which I regard</p> <p>24 as rather sort of hysterical. I just don't</p> <p>25 see any economic basis for that, but there's a</p>
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<p>1 Q. Thank you, Dr. Booth, I don't have any other</p> <p>2 questions.</p> <p>3 (10:30 a.m.)</p> <p>4 CHAIRMAN:</p> <p>5 Q. Do you have any?</p> <p>6 VICE-CHAIR WHALEN:</p> <p>7 Q. I don't have any questions. Thank you.</p> <p>8 CHAIRMAN:</p> <p>9 Q. So it's your position that the economy is in</p> <p>10 recovery, whether it's a "V" shape recovery or</p> <p>11 a "U" shape, we're on our way back?</p> <p>12 DR. BOOTH:</p> <p>13 A. We're definitely on the way back. Unless</p> <p>14 every private forecaster, and the Government</p> <p>15 of Canada, and the Bank of Canada, have got it</p> <p>16 totally wrong, we're definitely on the way</p> <p>17 back. The results will come out, third</p> <p>18 quarter of this year we will economic growth,</p> <p>19 and as I indicated, France and Germany had</p> <p>20 economic growth in the second quarter.</p> <p>21 CHAIRMAN:</p> <p>22 Q. What about in the US?</p> <p>23 DR. BOOTH:</p> <p>24 A. The US has got more problems. The US</p> <p>25 definitely had some stimulus in the third</p>	<p>1 lot of commentators in the United States who</p> <p>2 are worried about inflationary pressures in</p> <p>3 the United States. These normally only come</p> <p>4 about because of a strong economy, but they're</p> <p>5 worried about it because somehow the US</p> <p>6 Government deficit, if the stimulus isn't</p> <p>7 taken away as the economy recovers, you get</p> <p>8 inflation. Then if the economy recovers, it's</p> <p>9 going to have a big stimulus for Canada as</p> <p>10 well.</p> <p>11 CHAIRMAN:</p> <p>12 Q. So you don't think it's possible for the</p> <p>13 United States to further debauch the dollar?</p> <p>14 DR. BOOTH:</p> <p>15 A. Their dollar?</p> <p>16 CHAIRMAN:</p> <p>17 Q. Yeah.</p> <p>18 DR. BOOTH:</p> <p>19 A. Canadian dollar is going to be the premium to</p> <p>20 the US dollar very, very soon, and if -- I</p> <p>21 mean, you can make these forecasts, but</p> <p>22 forecasts are almost always wrong in the sense</p> <p>23 that -- macro economic forecasts, not growth</p> <p>24 forecast and risk premium forecast, but macro</p> <p>25 economic forecast because policy makers</p>

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<p>1 respond to those economic conditions. So you</p> <p>2 can't say, well, look, if the US continues to</p> <p>3 run fiscal deficits of 13 and a half percent</p> <p>4 for the next twenty years, the US is going to</p> <p>5 be in a disaster situation because that cannot</p> <p>6 possibly happen. Sooner or later policy</p> <p>7 makers in the United States will increase</p> <p>8 taxes and reduce spending. Exactly the same</p> <p>9 as in Canada in the early '90s, we had huge</p> <p>10 problems, everyone recognized the problems,</p> <p>11 inflation was a real problem up until the late</p> <p>12 1970s, early 1980s, and eventually the</p> <p>13 political will was there to solve the problem</p> <p>14 because it got out of line, and the political</p> <p>15 will will be there in the United States to</p> <p>16 solve their problems, whether it's in Obama's</p> <p>17 period, I don't know, but they have really</p> <p>18 significant problems in the US.</p> <p>19 CHAIRMAN:</p> <p>20 Q. And you don't think they're going to spill</p> <p>21 over into Canada?</p> <p>22 DR. BOOTH:</p> <p>23 A. No, in fact, any spill over is going to be</p> <p>24 good in the sense that if the US does just</p> <p>25 carry on, and all of this fiscal stimulus hits</p>	<p>1 has everything going for it. A few years ago,</p> <p>2 I said I can't see what's going to happen</p> <p>3 because every time we looked at all the</p> <p>4 criteria in Canada, it was a check box, tick,</p> <p>5 tick, tick, everything was working out fine.</p> <p>6 Who would have believed the Americans could</p> <p>7 cause so many problems in their sub-prime</p> <p>8 mortgage market. So I'm not saying that</p> <p>9 there's not things out there that could damage</p> <p>10 us, but these are -- and people say, well,</p> <p>11 what are these problems, and my answer is, I</p> <p>12 don't know. All we know is that every time at</p> <p>13 the top of the business cycle lenders made bad</p> <p>14 loans, and it doesn't matter whether it's sub-</p> <p>15 prime this time or whether it's sub or risk</p> <p>16 (phonetic) lending in the 60s and 70s, or it's</p> <p>17 telecom lending in the 90s, bankers end up</p> <p>18 losing money and causing problems in the</p> <p>19 financial system.</p> <p>20 CHAIRMAN:</p> <p>21 Q. And looking for bailouts?</p> <p>22 DR. BOOTH:</p> <p>23 A. Looking for bailouts. The Canadian banks</p> <p>24 haven't looked for bailouts. The Canadian</p> <p>25 banks are really solid. The World Economic</p>
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<p>1 the US economy and they keep their interest</p> <p>2 rates low, so the US economy recovers, but it</p> <p>3 ends up being inflationary with US deficit</p> <p>4 problems, Canadian dollar is going to go to</p> <p>5 \$1.15/\$1.20. The recovery is going to</p> <p>6 stimulate demand for Canadian exports. So</p> <p>7 right now if you put export demand back to</p> <p>8 where it normally is, the Canadian economy</p> <p>9 wouldn't be in any trouble whatsoever. Nearly</p> <p>10 all of our problems are coming from the lack</p> <p>11 of export demand to the United States. If the</p> <p>12 US economy recovers and it doesn't solve their</p> <p>13 problems, our export demand will come back, so</p> <p>14 the Canadian economy will be humming along</p> <p>15 nicely, our dollar will go to a premium, we'll</p> <p>16 have low interest rates, we may even have a</p> <p>17 marginal room for further tax cuts. Already</p> <p>18 the corporate income tax in Canada is</p> <p>19 significantly lower than it is in the United</p> <p>20 States, and they have huge tax increases that</p> <p>21 have to come, either tax increases or program</p> <p>22 spending cuts. The US is essentially back</p> <p>23 where we were in the early 90s, and they've</p> <p>24 got harsh policy decisions to make, but either</p> <p>25 way, I think Canada -- I think Canada still</p>	<p>1 Forum rated the Canadian banking system as the</p> <p>2 strongest in the world, which is why we've</p> <p>3 being relatively immune from all of these</p> <p>4 problems that have hit the rest of the world.</p> <p>5 CHAIRMAN:</p> <p>6 Q. I also read that there's a possibility that in</p> <p>7 the United States there's a commercial sub-</p> <p>8 prime problem as well. Do you know anything</p> <p>9 about that?</p> <p>10 DR. BOOTH:</p> <p>11 A. In the stress test of the US banking, they</p> <p>12 basically applied default rates for different</p> <p>13 loans, and the commercial loan market is in</p> <p>14 bad shape in the United States. The credit</p> <p>15 card market is in bad shape. The stress test</p> <p>16 that the US banks went through with the</p> <p>17 results at least to the beginning of May,</p> <p>18 indicated default rates of 22 percent in the</p> <p>19 US credit cards. These are horrific numbers.</p> <p>20 In Canada, the worse we're looking at is 3/4</p> <p>21 percent. They're looking at default rates on</p> <p>22 housing of about 10/15 percent, whereas the</p> <p>23 major Canadian banks predict about .2 percent.</p> <p>24 I mean, the loan losses in the US are just</p> <p>25 incredible. They've been addicted to debt</p>

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<p>1 because to a great extent it's tax deductible</p> <p>2 in the United States, the interest costs, and</p> <p>3 they're hugely are over indebted, and they're</p> <p>4 in a post -- let's see, they're in a</p> <p>5 depression or a alcoholics recovery from being</p> <p>6 addicted to debt, and how long it's going to</p> <p>7 take for those problems to work through isn't</p> <p>8 quite certain. Some people predict it's going</p> <p>9 to take a long time. Others have said, well,</p> <p>10 they're alcoholics, they'll get back to</p> <p>11 borrowing money in a relatively short period</p> <p>12 of time because Americans are not going to</p> <p>13 abolish the interest deductibility of most of</p> <p>14 the debt that they borrow. So Americans have</p> <p>15 either got to get a grip with some serious</p> <p>16 policy decisions in terms of their tax</p> <p>17 structure and their spending because they</p> <p>18 can't keep spending, having deficits of 13</p> <p>19 percent of GDP, but regardless of those</p> <p>20 American problems, the impact on Canada is</p> <p>21 relatively minimal. I mean, the Canadian</p> <p>22 dollar went up to 95/97 cents, not because of</p> <p>23 the US, but because of China and India, and</p> <p>24 the demand for commodities.</p> <p>25 CHAIRMAN:</p>	<p>1 A. There's two sides to that. First of all, I've</p> <p>2 been sitting in hearings in Canada for a long</p> <p>3 time now, and what I see across Canada is</p> <p>4 Boards that are protective towards the</p> <p>5 utility. I see this in the frequency of rate</p> <p>6 reviews, I see this in the response to</p> <p>7 problems faced by the utility. So the utility</p> <p>8 has a problem, it comes to the Board, the</p> <p>9 Board sets up some deferral mechanism to help</p> <p>10 the utility. That's part of what I regard as</p> <p>11 the regulatory compact, that we lower the risk</p> <p>12 of the utility, we'll then allow the lower</p> <p>13 rates of return, and they finance more debt,</p> <p>14 and debt is tax deductible, so overall it</p> <p>15 lowers the rates. So the regulatory compact</p> <p>16 in Canada is relatively more debt, relatively</p> <p>17 lower ROEs, but almost a complete absence of</p> <p>18 risk. In fact, I've yet to see any risk</p> <p>19 affect a Canadian utility, and I know that</p> <p>20 sounds like an incredibly strong statement,</p> <p>21 but I've sat in regulatory hearings and heard</p> <p>22 witnesses say all of the risks that the</p> <p>23 utility faces. Sooner or later, some of these</p> <p>24 risks has to affect a Canadian utility</p> <p>25 somewhere, and Mr. Johnson put questions</p>
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<p>1 Q. Uh-hm. Mr. Johnson, I think you --</p> <p>2 VICE-CHAIR WHALEN:</p> <p>3 Q. I just --</p> <p>4 CHAIRMAN:</p> <p>5 Q. Oh, I'm sorry.</p> <p>6 VICE-CHAIR WHALEN:</p> <p>7 Q. I hesitated earlier because I wasn't sure if I</p> <p>8 could get my head around just framing the</p> <p>9 question. I'm just going to put it to you. I</p> <p>10 was reading through your evidence last night</p> <p>11 and the last three or four lines of your</p> <p>12 testimony where you highlighted the</p> <p>13 inconsistency or incongruity between</p> <p>14 Newfoundland Power's seemingly approaching a</p> <p>15 lower risk profile with more and more of these</p> <p>16 accounts that they're requesting, coupled with</p> <p>17 a higher ROE request, and, you know, you just</p> <p>18 said it seems inconsistent, but to what extent</p> <p>19 does the risk profile of the company come to</p> <p>20 play for you as an analyst sitting and looking</p> <p>21 at the numbers? Do you actually consider the</p> <p>22 actual risk profile of the utility that's</p> <p>23 before you, or is it done more on a global</p> <p>24 basis?</p> <p>25 DR. BOOTH:</p>	<p>1 towards Ms. McShane and she said, well, just</p> <p>2 because the risk hasn't materialized doesn't</p> <p>3 mean to say it's not there. Well, my</p> <p>4 perception is if the risk does materialize,</p> <p>5 utility comes before the Board, and the rate</p> <p>6 payers pay, and one good example of this is</p> <p>7 this -- the late fees charged in Ontario where</p> <p>8 it went to the Supreme Court, and the Supreme</p> <p>9 Court said this is illegal, it contradicts the</p> <p>10 Interest Rate Act, and as a result there was</p> <p>11 settlement. Did Union Gas and Consumers Gas</p> <p>12 pay the settlement; no, they just came before</p> <p>13 the OEB and they said pass it on to the rate</p> <p>14 payers, and the Consumers Association, the</p> <p>15 rate payers agreed with that. So when I see a</p> <p>16 risk materialize, first of all, I'd be a</p> <p>17 little bit surprised, and secondly, if I see</p> <p>18 that the rate payer -- sorry, if I see the</p> <p>19 utility bearing those costs, I'll be even more</p> <p>20 surprised because it's yet to happen in</p> <p>21 Canada. So this is -- when I look at</p> <p>22 utilities, the utilities wanted to get us to</p> <p>23 look at specific risks, and that's sort of a</p> <p>24 quagmire, because it's always a little bit</p> <p>25 specific to Newfoundland Power, things</p>

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<p>1 specific to Enbridge Gas, things specific to 2 TransCanada. I look at what the capital 3 markets look at, which is do they earn their 4 allowed ROE. That's where the rubber hits the 5 road, that's the sum effect of all of these 6 risks, and the evidence is that the utilities 7 across Canada earn their allowed ROEs, and 8 they exceed them, and typically they exceed 9 them by 50 to 100 basis points because of 10 incentive agreements and traditionally under 11 spending operations and maintenance expenses 12 and things. So there's no short term risk. 13 There may be some long term risk for some of 14 the utilities. TransCanada Pipeline has got 15 some risk because the main line from Alberta 16 is -- unless something happens significantly 17 through the western Canada sedimentary basin, 18 the supply coming out of Western Canada may 19 not be there to have the main line run full. 20 In fact, it's not going to be there. So there 21 are long term risks for some utilities that 22 bear on the fair rate of return, and those 23 long term risks the National Energy Board took 24 into account in the TQM decision, but for a 25 utility like Newfoundland Power, I don't think</p>	<p>1 typing and 26 became 25. If you scroll down a 2 little bit -- 3 MR. JOHNSON: 4 Q. Yeah, there's the table. 5 DR. BOOTH: 6 A. These are the underlying economic assumptions 7 that Mercer uses to estimate the rate of 8 return that the Newfoundland Power pension 9 fund's going to earn, and they've got down 10 equities, US and Canada, 8.5 percent, fixed 11 income 4.4. So this isn't somebody -- an 12 expert coming in on behalf of Newfoundland 13 Power to tell you what the expected return on 14 Canadian equities is. This is independent 15 experts. Mercer goes around and they do 16 exactly the same thing, right away across 17 Canada, in evaluating pension funds, and 18 they're using long run expected rates of 19 return in the Canadian and US equity markets 20 of 8.5 percent, which is 2.5 percent less than 21 the ROE that Newfoundland Power is asking for, 22 and I can't believe that Newfoundland Power is 23 riskier than the US and the Canadian equity 24 market as a whole. 25 MR. JOHNSON:</p>
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<p>1 there's any long term risk, I don't think 2 there's any problems in the utility recovering 3 its rate base through its depreciation 4 charges, and I don't see any evidence of any 5 inability to earn its allowed rate of return. 6 So on a risk basis, I don't see any risk 7 attached to this utility. Almost all of the 8 risk is capital market risk, which is how 9 investors react to the shares of Canadian 10 utilities, not the underlying business of 11 financial risk, which is what you're 12 responsible for. 13 VICE-CHAIR WHALEN: 14 Q. Thank you. 15 CHAIRMAN: 16 Q. Mr. Johnson. 17 MR. JOHNSON: 18 Q. Mr. Chairman, just one question on re-direct. 19 DR. LAURENCE BOOTH - RE-EXAMINATION BY MR. TOM JOHNSON: 20 MR. JOHNSON: 21 Q. I don't think we ever got to see what you were 22 referring to in the Mercer Report. Is that 23 CA-NP-26? 24 DR. BOOTH: 25 A. Yes, that's it. Unfortunately, I do all my</p>	<p>1 Q. That's the only question I had. 2 CHAIRMAN: 3 Q. So they're out there ten years on this, are 4 they? Is that what you -- 5 DR. BOOTH: 6 A. Sorry? 7 CHAIRMAN: 8 Q. This 8 and a half -- when they say "long run", 9 I mean, someone said there's no such thing as 10 a long run, we're all going to be dead, but -- 11 DR. BOOTH: 12 A. John Maynard Keynes, 1936. 13 CHAIRMAN: 14 Q. Yeah, but is this -- the 8.5, are they saying 15 five/ten years? 16 DR. BOOTH: 17 A. Generally, they're talking about a long, long 18 run, indefinite long run, because most defined 19 benefit plans that they look at, particularly 20 the Public Service ones, they're indefinite 21 because you're always going to have the CPP, 22 you're always going to have the RCMP Pension 23 Plan, or Ontario Teachers, because you're 24 constantly replacing these people. So the 25 pension plan is indefinite. Now I would</p>

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<p>1 caution that these equity returns, they're are</p> <p>2 long run equity returns and they tend to be</p> <p>3 what we call compound rates or return, not</p> <p>4 geometric rates of return. At least, that's</p> <p>5 my guess. So the arithmetic rate of return</p> <p>6 consistent with the way that I estimate them</p> <p>7 is probably 1 percent or 1.5 percent higher</p> <p>8 than these, but then the fixed income isn't</p> <p>9 the long Canada fixed income, it's a blend of</p> <p>10 everything. So this isn't directly 100</p> <p>11 percent comparable with the work that I'm</p> <p>12 doing. This I would just take as another</p> <p>13 reasonableness check. Getting up from 8. 5</p> <p>14 percent is difficult, and it's the same with</p> <p>15 the Royal Bank's forecast, and the same with</p> <p>16 the TD forecast, it's -- you just don't see</p> <p>17 many people predicting long run equity returns</p> <p>18 much out of 8.5/9 percent.</p> <p>19 CHAIRMAN:</p> <p>20 Q. And that's been consistent with the history</p> <p>21 going back 40 or 50 --</p> <p>22 DR. BOOTH:</p> <p>23 A. That's consistent with history, and the fact</p> <p>24 is that it's a long run reversion to trend.</p> <p>25 You can't suddenly say, well, 80 years, all of</p>	<p>1 Q. Thank you very much. Do you want to take a</p> <p>2 break now or do you want to carry on?</p> <p>3 KELLY, Q.C.:</p> <p>4 Q. Well, we'll start with Mr. Cicchetti next, so</p> <p>5 it might be just as well since it's past</p> <p>6 quarter to, to take the break down and start</p> <p>7 fresh after the break.</p> <p>8 CHAIRMAN:</p> <p>9 Q. Okay. Is that okay?</p> <p>10 MR. JOHNSON:</p> <p>11 Q. That's fine.</p> <p>12 CHAIRMAN:</p> <p>13 Q. All right.</p> <p>14 (RECESS)</p> <p>15 (11:20 a.m.)</p> <p>16 CHAIRMAN:</p> <p>17 Q. Now before we go to our next witness, I was</p> <p>18 told there are some -</p> <p>19 MS. GLYNN:</p> <p>20 Q. We have a couple of filings.</p> <p>21 CHAIRMAN:</p> <p>22 Q. - procedural matters.</p> <p>23 MS. GLYNN:</p> <p>24 Q. Yes, Mr. Chair. The first is undertaking No.</p> <p>25 3. Ms. McShane, yesterday, agreed to provide</p>
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<p>1 these professionals, whether they're Mercer,</p> <p>2 the Royal Bank, TD, surveys and investors,</p> <p>3 they've all got it wrong, suddenly there's</p> <p>4 going to be a seismic shift, they're wrong and</p> <p>5 we're now going to say 12/13 percent long run</p> <p>6 equity return. It's just -- Mercer did this</p> <p>7 relatively recently, and they're paid to</p> <p>8 determine the unfunded liability and the</p> <p>9 funding status of the pension. So their</p> <p>10 reputation is on the line when they do this.</p> <p>11 CHAIRMAN:</p> <p>12 Q. I think that's it. One question. We were</p> <p>13 trying to figure out what your accent is.</p> <p>14 Some say New Zealand, some say Australia, I</p> <p>15 say you're a Brit.</p> <p>16 DR. BOOTH:</p> <p>17 A. Australians I just treat as being transplanted</p> <p>18 Brits or transplanted London, anyway. I'm a</p> <p>19 Londoner by birth, but I've been in North</p> <p>20 America for longer than I would care to admit.</p> <p>21 CHAIRMAN:</p> <p>22 Q. Not east end London?</p> <p>23 DR. BOOTH:</p> <p>24 A. No, north London.</p> <p>25 CHAIRMAN:</p>	<p>1 a recalculation based on a smaller bond</p> <p>2 spread. So that has been submitted by</p> <p>3 Newfoundland Power. And we also have Exhibit</p> <p>4 MAC-1 which would be Mr. Cicchetti's resume.</p> <p>5 CHAIRMAN:</p> <p>6 Q. All right. So we're ready to proceed now with</p> <p>7 Mr.--I'm sorry, sir.</p> <p>8 MR. CICCHETTI:</p> <p>9 A. Cicchetti.</p> <p>10 CHAIRMAN:</p> <p>11 Q. Cicchetti, okay.</p> <p>12 MR. MARK CICCHETTI, SWORN, EXAMINATION-IN-CHIEF BY MR.</p> <p>13 DANIEL SIMMONS</p> <p>14 CHAIRMAN:</p> <p>15 Q. Thank you. Mr. Simmons, over to you.</p> <p>16 MR. SIMMONS:</p> <p>17 Q. Mr. Cicchetti, you prepared a report dated</p> <p>18 August 2009 which comprises your pre-filed</p> <p>19 evidence. Do you adopt that report as your</p> <p>20 evidence at this hearing?</p> <p>21 MR. CICCHETTI:</p> <p>22 A. Yes.</p> <p>23 MR. SIMMONS:</p> <p>24 Q. And are there any updates or corrections to</p> <p>25 your report?</p>

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<p>1 MR. CICHETTI:</p> <p>2 A. I have one correction to Schedule 8 of my</p> <p>3 testimony.</p> <p>4 MR. SIMMONS:</p> <p>5 Q. I'm sorry, which schedule is that?</p> <p>6 MR. CICHETTI:</p> <p>7 A. MAC-8. In the column on the far right, the</p> <p>8 word "revenues" should be market</p> <p>9 capitalization.</p> <p>10 MR. SIMMONS:</p> <p>11 Q. Thank you. We've entered your CV in evidence,</p> <p>12 but can you give us a brief description of</p> <p>13 your background and qualifications, including</p> <p>14 your involvement in giving testimony in any</p> <p>15 other regulatory proceedings?</p> <p>16 MR. CICHETTI:</p> <p>17 A. Certainly. I am a project manager with C.H.</p> <p>18 Guernsey & Company. I've been involved with</p> <p>19 the regulation of public utilities for</p> <p>20 approximately 27 years and have been involved</p> <p>21 in one form or another in hundreds of cases</p> <p>22 and have testified in at least 50 of those</p> <p>23 cases. This is my first time testifying in</p> <p>24 Canada. I am a former chief of finance for</p> <p>25 the Florida Public Service Commission and a</p>	<p>1 economic activity, particularly exports, to</p> <p>2 occur in Canada, there's going to have to be</p> <p>3 some meaningful recovery in the US.</p> <p>4 There was tremendous amounts of stimulus</p> <p>5 that was applied in the first and second</p> <p>6 quarters and I think everyone expected that we</p> <p>7 would see some economic growth in the third</p> <p>8 and fourth quarter of this year, and it looks</p> <p>9 like we're going to have--the US is going to</p> <p>10 have about three percent growth in the third</p> <p>11 quarter and it's expected to decline somewhat</p> <p>12 to two and a half percent in the fourth</p> <p>13 quarter and the forecasts are for around two</p> <p>14 percent for the first half of next year, and I</p> <p>15 think a lot of economists feel is that about</p> <p>16 it, all we got for the bang for the buck,</p> <p>17 keeping in mind that this second round of</p> <p>18 stimulus occurred after a first round of</p> <p>19 stimulus that gave us the couple of quarters</p> <p>20 of minor economic growth.</p> <p>21 In the US, approximately 70 percent of</p> <p>22 the economy is consumer spending, based on</p> <p>23 consumer spending, and I tend to agree with</p> <p>24 the comments of Ms. Perry and Ms. McShane that</p> <p>25 we're going to have to wait and see if the</p>
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<p>1 former president of the Society of Utility and</p> <p>2 Regulatory Financial Analysts, which is an</p> <p>3 organization whose sole and specific interest</p> <p>4 is in public utility cost of capital issues.</p> <p>5 MR. SIMMONS:</p> <p>6 Q. Thank you. Mr. Cicchetti, can you comment on</p> <p>7 the assumptions that you've made regarding</p> <p>8 current or prospective financial market</p> <p>9 conditions for the purpose of preparing your</p> <p>10 testimony for today?</p> <p>11 MR. CICHETTI:</p> <p>12 A. Yes. I think Dr. Booth did a good job of</p> <p>13 explaining the conditions that led to the</p> <p>14 financial crisis and the history of interest</p> <p>15 rates and inflation and projections for</p> <p>16 interest rates and inflation and one area that</p> <p>17 I do have a disagreement with him is where we</p> <p>18 are currently economically. I believe Dr.</p> <p>19 Booth indicated he felt that we were in a</p> <p>20 normal recovery coming out of a recession and</p> <p>21 I don't think it's that simple, and I preface</p> <p>22 my comments with the understanding that the US</p> <p>23 economy and the Canadian economy are</p> <p>24 intricately intertwined and I think it's</p> <p>25 generally accepted that for significant</p>	<p>1 consumer is going to be able to lead us out of</p> <p>2 this economy, and with that in mind, in the</p> <p>3 US, unemployment is approaching ten percent,</p> <p>4 which is very high, and there doesn't seem to</p> <p>5 be, on the horizon, reasons for that to come</p> <p>6 down. The housing market is still troubled.</p> <p>7 Housing starts unexpectedly declined in</p> <p>8 September. Foreclosures are rising and so</p> <p>9 it's hard to see how the consumer is going to</p> <p>10 have the income to pull us out of the</p> <p>11 significant downturn.</p> <p>12 On top of that, the banking system is</p> <p>13 still fragile. Although we don't hear a lot</p> <p>14 of the headline-grabbing too big to fail banks</p> <p>15 being rescued, a lot of the smaller and mid</p> <p>16 size banks are failing and the FDIC is in the</p> <p>17 process of having to supplement their reserves</p> <p>18 in order to be able to deal with that and that</p> <p>19 has kept lending, in the US, low. So Dr.</p> <p>20 Booth mentioned the concerns about inflation</p> <p>21 and that also has to do with the amount of</p> <p>22 stimulus that's been providing the significant</p> <p>23 amounts of excess reserves in the banks,</p> <p>24 although they're not lending it. But the</p> <p>25 balancing act that they have to have is they</p>

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<p>1 have to be able to drain those reserves as 2 interest rates pick up in order to keep from 3 inflation becoming a problem, because 4 inflation is a monetary phenomena and if you 5 have more dollars chasing a set amount of 6 goods, that's the definition of inflation. So 7 they have a fine balancing act to be able to 8 drain those out as economic activity picks up 9 and so there is some concern about 10 stagflation, which is a stagnant economy with 11 inflation, which was experienced in the '70s, 12 so my point being that I think there's a lot 13 of things that are different from a standard 14 recovery coming out of a recession. There's a 15 lot of things that could potentially go wrong 16 and layered on top of all of that is the fact 17 that long-term government rates are low. If 18 there's not a pick up in activity, maybe they 19 will stay low and I think that relates to the 20 issue that we have with regard to the 21 automatic adjustment formula, and I'll talk 22 about that when we get to the automatic 23 adjustment formula.</p>	<p>1 is the formula, the equation that you would 2 use to calculate the cost of debt, and in that 3 case, you know what your interest payments are 4 going to be semi-annually as you go through 5 time and that's contractual, as well as the 6 repayment of principle. So you know what an 7 underwriter or whoever bought the bonds pays 8 for them and so you simply, through math, 9 solve the equation to find out what discount 10 rate equates those cash flows to the price 11 that you receive for the debt, and so there's 12 no doubt about that. That same model is used 13 to discount the dividends for price of stock. 14 The question then becomes is you don't have 15 those contractual interest rate payments. You 16 have dividends that are going to occur over 17 time and so do you have a valid proxy for 18 those dividend payments.</p>
<p>24 MR. SIMMONS: 25 Q. Mr. Cicchetti, can you describe for us the</p>	<p>19 Now what I use in my model is a service 20 that's called Value Line. They provide 21 information for utilities and all other 22 companies in other industries and it's 23 particularly relevant for the utility industry 24 because utilities are so dividend oriented, 25 considered orphans, widows and orphan stocks,</p>
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<p>1 methodologies that you've used in your cost of 2 equity analysis and maybe tell us something 3 about what you regard as being the strengths 4 and weaknesses of those methodologies and the 5 weights you've given to them and the results 6 of your use of those?</p> <p>7 MR. CICCETTI: 8 A. What I'd like to do, Mr. Chairman and 9 Commissioners, is explain the methodologies I 10 used and why I used them and compare them to 11 some of the other methodologies and then talk 12 about the companies that I've selected and why 13 I selected those companies and the 14 recommendation that I reached.</p> <p>15 The discounted cash flow formula, I 16 think, is the most accurate theoretically 17 correct direct method of measuring the 18 required return on equity and I consider the 19 DCF method to be similar to using the scalpel 20 to perform surgery, whereas the other 21 methodologies are similar to using butter 22 knife, and the reason why I think that is 23 there's not any controversy regarding the 24 equation, the actual DCF formula. In fact, 25 the formula, the discounted cash flow formula</p>	<p>1 and utilities tend not to change their 2 dividends very much. They're very 3 predictable, at least over the next few years, 4 and Value Line is not a sell-side analyst. 5 They do not underwrite securities. They don't 6 have the conflicts of interest that Dr. Booth 7 was talking about. So in my analysis, I'm 8 using those as a valid proxy of investor 9 expectations. Value Line is in pretty much 10 every library in the US. They sell 11 subscriptions to individuals, as well as 12 businesses. It's used extensively in 13 universities and it's in every university 14 library that I've ever seen and could imagine. 15 So it's relatively widespread. They're well 16 respected and they don't have those conflicts 17 of interest. So I believe that it's a very 18 good valid proxy and a good use and it makes 19 the DCF method a very valid method for 20 calculating the required return on equity, 21 particularly for utilities.</p> <p>22 Now we compare that to, let's say, the 23 capital asset pricing model. The capital 24 asset pricing model was derived from a formula 25 that a Professor Markowitz came up with in the</p>

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<p>1 mid '50s on his portfolio theory, and what</p> <p>2 portfolio theory says is that you can minimize</p> <p>3 the risk of your portfolio through</p> <p>4 diversification, and the way you can judge</p> <p>5 that diversification is how does a stock</p> <p>6 affect the relevant risk of the portfolio and</p> <p>7 so that is how does that stock move with</p> <p>8 regard to the market versus how the other</p> <p>9 stocks move with regard to the market and when</p> <p>10 you put them altogether, how can you minimize</p> <p>11 your risk that can be diversified away? And</p> <p>12 that formula is beta or the relevant factor</p> <p>13 there is beta, and so it was then taken from</p> <p>14 that portfolio theory and a couple of</p> <p>15 professors, Sharpe, Lintner and Mark developed</p> <p>16 a capital asset pricing model which says we'll</p> <p>17 take beta and we'll use a number of</p> <p>18 assumptions and we'll then be able to compare</p> <p>19 the market return minus the risk free rate,</p> <p>20 multiply that times the beta, add that to the</p> <p>21 risk free rate and given these assumptions</p> <p>22 that we've made, we can determine the required</p> <p>23 return.</p> <p>24 Now the problem is that model has been</p> <p>25 tested over time. It hasn't performed as</p>	<p>1 made. Dr. Booth hasn't made that adjustment,</p> <p>2 but Ms. McShane has. The betas I use come out</p> <p>3 of Value Line. Value Line makes that</p> <p>4 adjustment and most of the major companies</p> <p>5 that report that information make that</p> <p>6 adjustment. But, the betas are unstable.</p> <p>7 There are four predictors and many empirical</p> <p>8 studies have shown that.</p> <p>9 I was asked to, when I mentioned in my</p> <p>10 testimony that beta is fine in theory, but it</p> <p>11 tends to break down in practice, to cite some</p> <p>12 articles, and I just want to read one</p> <p>13 paragraph. One of the articles I cited was</p> <p>14 "The Capital Asset Pricing Model: Theory and</p> <p>15 Evidence." It's written by Eugene Fama and</p> <p>16 Kenneth French. Professor Fama is the</p> <p>17 McCormick distinguished service professor to</p> <p>18 finance at the Graduate School of Business at</p> <p>19 the University of Chicago, and Professor</p> <p>20 French is the high professor of finance at the</p> <p>21 Tuck School of Business at Dartmouth, and it's</p> <p>22 just a couple of sentences, but this was the</p> <p>23 concluding paragraph. "The CAPM, like</p> <p>24 Markowitz's portfolio model on which it is</p> <p>25 built, is nevertheless a theoretical tour de</p>
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<p>1 expected, still hasn't. One of the reasons</p> <p>2 being, some say, are the assumptions too</p> <p>3 limiting or alternatively, could it be that</p> <p>4 when you're looking at the market, you need to</p> <p>5 look at the returns on all human capital, real</p> <p>6 estate, stocks and generally the betas are</p> <p>7 calculated relative to the stock market, and I</p> <p>8 think in Dr. Booth's case, the Canadian stock</p> <p>9 market.</p> <p>10 So there were a number of problems that</p> <p>11 were identified with beta. For one thing,</p> <p>12 what we're really looking for is the future</p> <p>13 beta that should be applied and it's</p> <p>14 calculated on historical information. So you</p> <p>15 cannot know the true beta. It can't be</p> <p>16 observed. There's been some other tests that</p> <p>17 show you can increase systematic risk and the</p> <p>18 beta will lower. That's counter to rational</p> <p>19 thought and so they say, well, there's a lot</p> <p>20 of question that has to do with beta. They</p> <p>21 tend to regress towards unity. That means</p> <p>22 they tend to regress towards one. So</p> <p>23 adjustments have to be made, and I think most</p> <p>24 of the witnesses and most of the academic</p> <p>25 studies agree that that adjustment has to be</p>	<p>1 force. We continue to teach the CAPM as an</p> <p>2 introduction to the fundamental concepts of</p> <p>3 portfolio theory and asset pricing to be built</p> <p>4 on by more complicated models like Merton's</p> <p>5 ICAPM. But we also warn students that despite</p> <p>6 its seductive simplicity, the CAPM's empirical</p> <p>7 problems probably invalidate its use in</p> <p>8 applications."</p> <p>9 And so when you look at what you actually</p> <p>10 do in a capital asset pricing model, you're</p> <p>11 going to estimate, first of all, the beta and</p> <p>12 we saw in Dr. Booth's testimony, the betas</p> <p>13 recently are as low as zero and there's</p> <p>14 probably evidence in this hearing that they</p> <p>15 range all the way from a negative amount up to</p> <p>16 the .6 or .7 that Ms. McShane and I have used</p> <p>17 in our testimony, and I've addressed some of</p> <p>18 the theoretical problems with the beta. We</p> <p>19 then need a market return, a market risk</p> <p>20 premium, which is the expected market return,</p> <p>21 minus the risk free rate. Now the market</p> <p>22 return that's been used in a lot of Ms.</p> <p>23 McShane and Dr. Booth's testimony is based on</p> <p>24 earned returns in the market over some</p> <p>25 historical period of time. Now those aren't</p>

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<p>1 measuring required returns, which is the cost 2 of equity. Those are averages of the earned 3 returns. A company might earn two percent or 4 25 percent, but that doesn't mean that their 5 required return was either two percent or 25 6 percent. That just happens to be what they've 7 earned. So now we're taking that market 8 return that was earned over some period of 9 time and multiplying it by a beta which has 10 some problems and then adding it to a risk 11 free rate, which at this time has a certain 12 amount of flight to quality implications that 13 is holding down that risk free rate. So my 14 point is, you can see where I would say that 15 the DCF model is looking exactly at companies 16 what investors are paying for their price of 17 stock and expected cash flows versus a model 18 that's taking a more macro look at the entire 19 situation, and that's why I think the 20 discounted cash flow is the most appropriate 21 model to use.</p> <p>22 Dr. Booth mentioned that the comparable 23 earnings isn't even in an academic textbook as 24 a means of calculating the required return, 25 and I agree with him, so I won't address that</p>	<p>1 similar to, indeed generally somewhat lower, 2 than that of electric T & Ds," and I've used a 3 group of low risk LDCs in my analysis, both in 4 a discounted cash flow analysis and a risk 5 premium analysis. So I believe I've got 6 companies that are as comparable as I can get 7 in order to give you insight as to what the 8 required rate of return is for the company.</p> <p>9 And finally, with regard to the automatic 10 adjustment formula, the required return on 11 equity is not solely a function of the long- 12 term government rate. There are other things 13 that are involved in that. So I was surprised 14 to hear this morning when Dr. Booth said he 15 would like to see a one-to-one comparison for 16 every basis point drop in a long term rate or 17 increase, he'd like to see a one-and-one 18 relationship with the return on equity for the 19 company.</p> <p>20 In the risk premium analysis I performed 21 and I think what's generally accepted is risk 22 premiums vary as interest rates vary. For 23 example, when interest rates decrease ROEs 24 tend to decrease less and so interest-risk 25 premiums tend to increase as interest rates</p>
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<p>1 any further.</p> <p>2 Finally, I would like to just address the 3 automatic adjustment formula for a second. I 4 need to talk about the comparable companies. 5 The companies that I used, I tried to get as 6 accurate a representation of Newfoundland 7 Power as I could. If you want a publicly 8 traded stock that's small, T & D related, 9 doesn't have any non-regulated activities, 10 there's none out there. I went through great 11 pains to try and get stocks that I considered 12 similar to the company in order to use in my 13 analysis and in looking at them, there just 14 weren't Canadian companies that were as 15 accurate a sample as I believe the highly 16 rated low-risk utilities that I used, 17 electrics and gas, in my testimony, and I 18 would refer back to the memo or the e-mail 19 that Moody's sent yesterday and of the six 20 companies they cited, although none are 21 publicly traded, five are US companies and in 22 the last paragraph or in the last sentence of 23 the first paragraph, it says "however, I 24 include O & R because Moody's views the 25 business risk profile of gas LDCs to be</p>	<p>1 decrease, and vice versa. As interest rates 2 increase, the risk premium tends to narrow. 3 One of the problems I see with the automatic 4 adjustment formula is as you keep that 5 constant 80 percent, the ROE's going down in 6 the same proportion. It's not reducing less, 7 but going down in the same proportion, so you 8 get to a point, if you have a continued low, 9 long-term Canadian rate, it's going to put 10 pressure on the financial metrics, for 11 example, of the utility because it's allowed 12 return is being tied at least 80 percent to 13 that long-term rate, and so although you may 14 allow the company to be viable and not have 15 its debt ratings reduced, I guess the question 16 becomes do you want to allow them some 17 financial flexibility.</p> <p>18 There is risk, for example, you could 19 have an event that occurs and if the company 20 has had its allowed return kept very tight, 21 such that its metrics are tight, it may have a 22 little more trouble if it needed to raise 23 capital if some catastrophe occurred, God 24 forbid, than if it would have had a little bit 25 more financial flexibility that would have</p>

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<p>1 been associated with, let's say, an ROE that 2 was determined in a proceeding that more 3 accurately reflected the true ROE versus the 4 formula. So I'm saying the formula can work, 5 but we have a financial crisis, for example, 6 as we have, I think it just highlights the 7 shortcomings of it, and you can have the same 8 thing on the upper end, I think, and you can 9 think of things in terms of both ways.</p> <p>10 We talked about--or political pressure 11 was discussed and I would imagine if, for some 12 reason, we had some kind of--the crisis came 13 about again or something occurred, the Federal 14 Reserve in the US didn't get the stimulus out 15 of the system enough such that there was 16 inflation that somehow bled over in order for 17 Canada to compete for funds, the long-term 18 rate had to go up. If for some reason the 19 long-term Canada rate went up and the formula 20 also went up, you might have some political 21 pressure that you didn't foresee at this time 22 that may--you know, your hands have been 23 bound. You don't have the discretion that you 24 might have had had you not had the formula, 25 and political winds can change quickly.</p>	<p>1 current formula. If you held a hearing and 2 reviewed similar relevant testimony, I would 3 imagine you'd find something similar to that. 4 So my point being, if you didn't want to do 5 away with the formula, there may be things 6 that you could do to adjust it that would make 7 it work maybe a little better over the long 8 term.</p> <p>9 The final part of my testimony was some 10 rebuttal of Ms. McShane and I would think the 11 only main part of that was--and it would apply 12 a certain extent to Dr. Booth--is when you're 13 using historical information in your analysis, 14 you're not using what's known as X antforward 15 looking information. So I would be careful 16 when I was evaluating people's testimony to 17 take that into consideration. This is not 18 rocket science. You can look and use common 19 sense to see what's going on. How well do the 20 models reflect reality and how rational are 21 the inputs that the witnesses have used? And 22 with that, that concludes my summary.</p> <p>23 MR. SIMMONS: 24 Q. Thank you, Mr. Cicchetti. I don't have any 25 other questions for you.</p>
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<p>1 It was mentioned that Florida was having 2 some problems in that regard and for, you 3 know, the last 25-27 years that I've been 4 involved, Florida was considered one of the 5 best regulatory agencies in the US. We now 6 have a governor who prior to being governor 7 was an attorney general that represented the 8 citizens actively before the Florida 9 Commission. He has announced he's going to 10 step down as governor and run for the US 11 Senate. So he is, for lack of a better term, 12 effectively campaigning while two of the 13 largest utilities in Florida are in for 14 significant rate increases. So sometimes 15 political change can come in ways that you 16 don't expect, and have implications that you 17 didn't expect. So there's always that kind of 18 risk that's hanging out there, and so those 19 are a couple of the things that I wanted to 20 highlight with regard to the automatic 21 adjustment formula.</p> <p>22 The analysis that I did for the natural 23 gas companies over the last ten years 24 indicated less sensitivity to a change in 25 interest rates than 80 percent that's in this</p>	<p>1 CHAIRMAN: 2 Q. So who goes first now? 3 (11:45 a.m.) 4 KELLY, Q.C. 5 Q. I guess I do, Mr. Chairman. 6 CHAIRMAN: 7 Q. Okay. 8 MR. MARK CICHETTI, CROSS-EXAMINATION BY IAN KELLY, Q.C. 9 KELLY, Q.C. 10 Q. I'm happy to proceed. Mr. Cicchetti, you've 11 given us a good explanation of the DCF model. 12 Can I get you to expand a little bit on the 13 use of the American data? Like you're basing 14 yours off of a group of utilities in the 15 United States. Can you explain why--I take it 16 you obviously view that transferable to 17 Canada. Can I get you to explain why? 18 MR. CICHETTI: 19 A. Well, right now, if you look at inflation 20 forecasts for Canada, they're similar to the 21 US. Forecasts for the long-term bond rates 22 are similar. The single A utility rates have 23 trended together for as long as I think we're 24 looking at in this case. The same with the 25 long-term government rates and the two</p>

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<p>1 economies are intricately related. The</p> <p>2 capital markets are intricately related.</p> <p>3 They're similar operating environments and</p> <p>4 when I say similar regulatory environments,</p> <p>5 what I mean is they both operate under cost of</p> <p>6 service regulation, for the most part,</p> <p>7 original cost regulation and so I think the</p> <p>8 main criteria is are the companies comparable</p> <p>9 to the company that you're trying to determine</p> <p>10 the required rate of return for. Just because</p> <p>11 they're US companies, I don't think makes them</p> <p>12 evil or requires any way the--all the things</p> <p>13 that you would consider for a required rate or</p> <p>14 a nominal rate to be applicable in the US, I</p> <p>15 believe are applicable in this case for</p> <p>16 Newfoundland Power.</p> <p>17 KELLY, Q.C.</p> <p>18 Q. And when you talk about a comparable company,</p> <p>19 I take it you're not talking about all of the</p> <p>20 same operating characteristics and precise</p> <p>21 same regulatory mechanisms, but at an</p> <p>22 investment--at an investors expectation level</p> <p>23 are they reasonably comparable? Is that--have</p> <p>24 I got the point correct?</p> <p>25 MR. CICCHETTI:</p>	<p>1 Q. So as long as we've got that comparability in</p> <p>2 investment risk, we can use the US companies</p> <p>3 without having to make further adjustment?</p> <p>4 MR. CICCHETTI:</p> <p>5 A. I believe so, and if there were Canadian</p> <p>6 companies that I could rely on, I would</p> <p>7 certainly do that. One of the problems is it</p> <p>8 doesn't appear that there is an industry here</p> <p>9 in Canada that looks at those type of</p> <p>10 forecasts and then the thought crossed my</p> <p>11 mind, it might not be a bad idea for someone</p> <p>12 to open a business that visited these</p> <p>13 companies, analyzed their prospects and made</p> <p>14 those kind of forecasts available.</p> <p>15 KELLY, Q.C.</p> <p>16 Q. Okay. Now I spent a fair bit of time with Dr.</p> <p>17 Booth talking about some of the difficulties</p> <p>18 with the capital asset pricing model and</p> <p>19 you've touched on those as well. So I don't</p> <p>20 want to go back there. But I think in</p> <p>21 fairness to the Board, I'd like you to give</p> <p>22 the Board some sense of what the difficulties</p> <p>23 are with the DCF model, because would you</p> <p>24 agree that there are difficulties with all the</p> <p>25 models?</p>
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<p>1 A. Yes, and I heard a lot of discussion about</p> <p>2 that yesterday and the point that I would make</p> <p>3 in regard to that is you have total risk</p> <p>4 includes business risk and financial risk, and</p> <p>5 part of business risk is regulatory risk, and</p> <p>6 a significant part of regulatory risk involves</p> <p>7 the allowed rate of return that the company's</p> <p>8 going to earn. So Newfoundland Power, their</p> <p>9 operations wise, the business risk is very</p> <p>10 low. They have very supportive regulation.</p> <p>11 But when you look at their capital structure,</p> <p>12 having a little more leverage than would be on</p> <p>13 average in the US, although its high for</p> <p>14 Canada, and the allowed return, the net result</p> <p>15 is their financial metrics are somewhat lower,</p> <p>16 which in and of itself isn't necessarily bad,</p> <p>17 but it's that combination that makes up total</p> <p>18 risk that causes the company to have a bond</p> <p>19 rating similar, for example, to the ratings of</p> <p>20 the companies that I'm looking at. Had the</p> <p>21 company had similar equity ratios and similar</p> <p>22 allowed returns, I'm sure their bond rating or</p> <p>23 I believe their bond rating would be much</p> <p>24 higher. So it's a trade off.</p> <p>25 KELLY, Q.C.</p>	<p>1 MR. CICCHETTI:</p> <p>2 A. Yes, and with the DCF, as Dr. Booth pointed</p> <p>3 out, you have to have an accurate for--a valid</p> <p>4 proxy for investor expectations. In my case,</p> <p>5 I'm using Value Line, which is the best. Now</p> <p>6 you can argue is Value Line an effective valid</p> <p>7 proxy for investor expectation. I say yes,</p> <p>8 and that's why I use it. I think, again, if</p> <p>9 you go back looking at how stable utility</p> <p>10 deadman's (phonetic) tend to be, they don't</p> <p>11 want to increase them until they know that</p> <p>12 they have earnings that can support an</p> <p>13 increase and they would rather cut off an arm</p> <p>14 than to decrease them. They're fairly stable</p> <p>15 and so in that regard, that is what I see as</p> <p>16 the biggest shortcoming.</p> <p>17 Now those inputs can be manipulated by</p> <p>18 witnesses as well, and I think that goes back--</p> <p>19 I mean, I've used Value Line. You have other</p> <p>20 witnesses, I think you ought to average book</p> <p>21 value and earnings and dividends from this</p> <p>22 time period or this time period and another</p> <p>23 witness says, well, I think we ought to use</p> <p>24 the growth in the economy as the valid</p> <p>25 measure, and so it can become a big issue in</p>

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<p>1 the case and it can be confusing to the</p> <p>2 commissioners that are listening to that, and</p> <p>3 that's why I say you have to cut to the chase</p> <p>4 and say how rational are these inputs? What's</p> <p>5 the best way to do it?</p> <p>6 KELLY, Q.C.</p> <p>7 Q. So there are elements of judgment in the use</p> <p>8 of DCF models as well?</p> <p>9 MR. CICCHETTI:</p> <p>10 A. Absolutely.</p> <p>11 KELLY, Q.C.</p> <p>12 Q. Right, and what Ms. McShane, for example, has</p> <p>13 done is she's used a DCF model and she's used</p> <p>14 capital asset or equity risk premium model and</p> <p>15 looked at both methodologies and exercised</p> <p>16 judgment. Do you, in principle, have</p> <p>17 difficulty with that combined approach?</p> <p>18 MR. CICCHETTI:</p> <p>19 A. Not just as a combined approach. My problem</p> <p>20 has to do with looking at averaging beta</p> <p>21 that's historical and that's based on earned</p> <p>22 returns and not on required returns. What</p> <p>23 we're trying to get to is required returns.</p> <p>24 KELLY, Q.C.</p> <p>25 Q. Absolutely, okay. Now I just want to follow a</p>	<p>1 thirds of that amount.</p> <p>2 KELLY, Q.C.</p> <p>3 Q. So they would be comparable to the betas that</p> <p>4 Ms. McShane's used in her testimony of .65 to</p> <p>5 .70?</p> <p>6 MR. CICCHETTI:</p> <p>7 A. Yes.</p> <p>8 KELLY, Q.C.</p> <p>9 Q. Okay. Can I follow up another point, which is</p> <p>10 I believe at page--the bottom of page 21, a</p> <p>11 little more technical here, in the DCF model,</p> <p>12 you look at dividends. Do you also factor in</p> <p>13 any growth amount in your model?</p> <p>14 MR. CICCHETTI:</p> <p>15 A. Yes.</p> <p>16 KELLY, Q.C.</p> <p>17 Q. Okay, just explain for the Board--you don't</p> <p>18 have to go very far with this--dividends and</p> <p>19 the growth and how that goes together in your</p> <p>20 DCF model.</p> <p>21 MR. CICCHETTI:</p> <p>22 A. As I indicated earlier, the relevant cash</p> <p>23 flows are the dividends that occur over time.</p> <p>24 We know what the dividend is today. With</p> <p>25 Value Line, they make explicit forecasts going</p>
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<p>1 couple of points up, if I could. Can I get</p> <p>2 you to go over to page 20 of your testimony?</p> <p>3 MR. CICCHETTI:</p> <p>4 A. I'm there.</p> <p>5 KELLY, Q.C.</p> <p>6 Q. And at the top of the page there, the first</p> <p>7 two paragraphs. Wait for Mike to get it up</p> <p>8 there. There you go. At line 421, you're</p> <p>9 talking about the comparison group with a</p> <p>10 Value Line beta of .69 and a little bit down</p> <p>11 further, at 426, the comparison group of</p> <p>12 natural gas distribution companies, because</p> <p>13 you got two electric utilities and natural</p> <p>14 gas, of .66. Would you just explain for the</p> <p>15 Board what that is, what that means, where it</p> <p>16 comes from?</p> <p>17 MR. CICCHETTI:</p> <p>18 A. Those are betas taken from Value Line and the</p> <p>19 definition of beta is the risk that it</p> <p>20 contributes to a well-diversified portfolio</p> <p>21 and that has to do with market returns. For</p> <p>22 example, the market overall would be</p> <p>23 considered one. These betas that are</p> <p>24 approximately .67 for a given change in the</p> <p>25 market, you would expect them to change two-</p>	<p>1 out for four years. I've plugged those</p> <p>2 amounts into the model. For the years after</p> <p>3 that, I've used the same methodology that Dr.</p> <p>4 Booth referred to known as the sustainable</p> <p>5 growth method and that is you're going to use</p> <p>6 the retention rate of the company and the</p> <p>7 expected return on equity of the company to</p> <p>8 calculate, and that's basically the earnings</p> <p>9 minus the dividends divided by the earnings</p> <p>10 times the expected return on equity. So</p> <p>11 that's going to be the rate that you would</p> <p>12 expect the dividends to grow forward and it's</p> <p>13 basically an organic concept tied to the</p> <p>14 earnings of the company.</p> <p>15 KELLY, Q.C.</p> <p>16 Q. There's an element of judgment in the growth,</p> <p>17 but you've used it based upon the investor</p> <p>18 expectations from Value Line? Have I got that</p> <p>19 correct?</p> <p>20 MR. CICCHETTI:</p> <p>21 A. Yes.</p> <p>22 KELLY, Q.C.</p> <p>23 Q. Okay. Now beginning at the bottom of 21 and</p> <p>24 through page 22, I don't need to take you</p> <p>25 through the explanation, you explain, and I</p>

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<p>1 think we all agree why there needs to be an 2 adjustment for market issuance costs, and I 3 don't think there's any dispute over that 4 factor. One of the things I'm just trying to 5 understand is you've used five percent kind of 6 going in and we're trying to understand what 7 that means coming out the other end, because I 8 take it to an answer that you've given, we can 9 see this if we put up CA-PUB-16C. Just get 10 this up for one second, CA-PUB-16. No, it 11 should be CA-PUB. No. I'll just read you the 12 question and answer, Mr. Cicchetti. You were 13 asked--this was by the Consumer Advocate, 14 "please confirm that the issue cost adjustment 15 is based on US capital market experience" et 16 cetera, and I won't read the whole question 17 because the question is not that important. 18 You said "confirmed. It is also noted that 19 the issue cost adjustment recommended by Mr. 20 Cicchetti is less than that recommended by Dr. 21 Booth." Now Dr. Booth and Ms. McShane have 22 each used 50 basis points, .50, and one of the 23 things we're trying to understand is you've 24 applied five percent to what and what would 25 that equate at the end of the day to the</p>	<p>1 KELLY, Q.C. 2 Q. Okay, that's good, and does that also flow 3 through to your equity risk premium analysis? 4 If I take you over to page 24. 5 MR. CICCHETTI: 6 A. Yes, I made the same type of adjustment in 7 that analysis. 8 KELLY, Q.C. 9 Q. So that is in your--what you've got built in 10 that five percent flows into at the front end 11 in that too? 12 MR. CICCHETTI: 13 A. Yes. 14 KELLY, Q.C. 15 Q. Because we weren't sure whether you had 16 anything in that or whether you had what we 17 now know to be say .2 or .25. 18 MR. CICCHETTI: 19 A. Yes, that's correct. 20 KELLY, Q.C. 21 Q. So if we wanted to adjust that, we'd need to 22 add roughly quarter of a percentage point to 23 that one as well? 24 MR. CICCHETTI: 25 A. If you wanted to do that.</p>
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<p>1 market risk premium? 2 MR. CICCHETTI: 3 A. It's applied to the price of the stock and 4 it's approximately somewhere between 20 and 25 5 basis points and it seems, my understanding of 6 what I've picked up is it's fairly standard 7 here in Canada to use 50 basis points. 8 KELLY, Q.C. 9 Q. Right, and that's what I was trying to get at. 10 So you've got about .2 to .25 in that, so 11 about quarter of a percentage point less than 12 - 13 MR. CICCHETTI: 14 A. Yeah, I've used five percent and it would be 15 about a ten percent adjustment to make it 16 similar to what Dr. Booth and Ms. McShane 17 used. 18 (12:00 p.m.) 19 KELLY, Q.C. 20 Q. Okay. So we'd be short on your analysis, 21 trying to put it into the more traditional 22 Canadian model of about quarter of a 23 percentage point, give or take? 24 MR. CICCHETTI: 25 A. Yes.</p>	<p>1 KELLY, Q.C. 2 Q. Okay, and can I just ask you one last 3 question? You end up with a utility risk 4 premium of 4.35, if I take you to page 24, at 5 line 518. 6 MR. CICCHETTI: 7 A. Yes. 8 KELLY, Q.C. 9 Q. See that? 10 MR. CICCHETTI: 11 A. Yes. 12 KELLY, Q.C. 13 Q. Okay, and we looked at the beta of .66. So if 14 I take the beta and divide it into 4.35, I'd 15 get an inferred market risk premium of about 16 6.6. So if I tried to equate where you are 17 with kind of where Ms. McShane is, I then have 18 to take off that 25 basis points roughly that 19 you've got in for floatation costs because 20 they add that on after, so I'd get roughly 6.6 21 minus the 2.--sorry, about quarter of a point. 22 So I'd be down in about 6.4 as your inferred 23 market risk premium? 24 MR. CICCHETTI: 25 A. That sounds reasonable, so I'd accept that,</p>

1 subject to check.
2 KELLY, Q.C.
3 Q. Yeah, okay. I'm just trying to get a range of
4 if we took your data and tried to put it into
5 a CAPM model where your market risk premium
6 would be. So it would be about, roughly about
7 6.4, give or take. Okay. Thank you, Mr.
8 Cicchetti, those are my questions.
9 MR. MARK CICCHETTI, CROSS-EXAMINATION BY MR. THOMAS
10 JOHNSON
11 MR. JOHNSON:
12 Q. Mr. Cicchetti, you can affirm for the record
13 in this proceeding that not one of your
14 recommendations flows out of an analysis of
15 Canadian utilities, correct?
16 MR. CICCHETTI:
17 A. Yes.
18 MR. JOHNSON:
19 Q. Now you mentioned in your opening about your
20 concerns about "we" getting out of the
21 recession. You were talking about the United
22 States, correct?
23 MR. CICCHETTI:
24 A. I was talking about United States and Canada.
25 MR. JOHNSON:

1 Q. Now you talked about the housing market still
2 being troubled. That's a "we" for the United
3 States, correct?
4 MR. CICCHETTI:
5 A. With the understanding that the two economies
6 are intricately intertwined.
7 MR. JOHNSON:
8 Q. Do you have any knowledge of the housing
9 market situation here in Canada?
10 MR. CICCHETTI:
11 A. Yes, and I don't mean to say that the housing
12 market is as troubled in Canada as it is in
13 the US. I'm only saying in order for the US
14 economy to pull out of the situation that it's
15 in, that's going to have to change and that
16 has consequences for the Canadian economy.
17 MR. JOHNSON:
18 Q. You're saying you're not saying that the
19 housing market in Canada is as troubled as
20 what's in the United States, but what I'm
21 asking you is do you have any information that
22 the Canadian housing market is troubled?
23 MR. CICCHETTI:
24 A. No.
25 MR. JOHNSON:

1 Q. You referred to ten percent unemployment in
2 the United States.
3 MR. CICCHETTI:
4 A. Yes.
5 MR. JOHNSON:
6 Q. That's not the unemployment figure in Canada,
7 correct?
8 MR. CICCHETTI:
9 A. Correct.
10 MR. JOHNSON:
11 Q. You referred to the fragility of banks.
12 You're talking about American banks, correct?
13 MR. CICCHETTI:
14 A. Yes.
15 MR. JOHNSON:
16 Q. You heard the evidence of Dr. Booth who
17 indicated that Canadian banks are worldwide
18 regarded as being the strongest in the world.
19 Do you have any reason to disagree with that?
20 MR. CICCHETTI:
21 A. Not at all.
22 MR. JOHNSON:
23 Q. Do you have likewise, sir, any reason to take
24 issue with what the Bank of Canada's forecast
25 inflation is, as set out in page 21 of Dr.

1 Booth's report?
2 MR. CICCHETTI:
3 A. No, I don't.
4 MR. JOHNSON:
5 Q. In fact, you would agree with it?
6 MR. CICCHETTI:
7 A. Yes.
8 MR. JOHNSON:
9 Q. You are also aware, from having sat through
10 the testimony, that it has been years since a
11 regulatory board in this country has accepted
12 and given weight to a discounted cash flow
13 analysis, correct?
14 MR. CICCHETTI:
15 A. Yes.
16 MR. JOHNSON:
17 Q. You've also sat through this hearing and
18 you've heard Ms. McShane acknowledge that
19 Canadian boards, to her extensive memory of
20 their decisions in this country, have never
21 accepted adjusted betas, correct?
22 MR. CICCHETTI:
23 A. Yes.
24 MR. JOHNSON:
25 Q. And I take it you will confirm that the Value

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<p>1 Line number, which we've called an adjusted</p> <p>2 beta, is no different, in essence, than what</p> <p>3 these Canadian regulatory boards have refused</p> <p>4 to acknowledge and accept, correct?</p> <p>5 MR. CICCHETTI:</p> <p>6 A. Yes.</p> <p>7 MR. JOHNSON:</p> <p>8 Q. That's right. Now you have indicated that DCF</p> <p>9 is a scalpel, right?</p> <p>10 MR. CICCHETTI:</p> <p>11 A. I made that analogy, yes.</p> <p>12 MR. JOHNSON:</p> <p>13 Q. Okay. How precise can this scalpel be when</p> <p>14 there are companies, Mr. Cicchetti, who are in</p> <p>15 your gas sample, and this is supposed to be a</p> <p>16 low risk comparator group, like South Jersey</p> <p>17 Industries? And we won't go there right away,</p> <p>18 but they say, at page two, "our growth comes</p> <p>19 from the robust growth and profitability of</p> <p>20 non-utility activities, along with reliable</p> <p>21 steady growth of our utility. To illustrate</p> <p>22 this point, our non-utility businesses in 2004</p> <p>23 contributed 27 percent to South Jersey</p> <p>24 Industries' earnings in 2004, compared with 42</p> <p>25 percent contribution to economic earnings in</p>	<p>1 from a non-regulated business which they're</p> <p>2 trying to go from low risk to a medium risk</p> <p>3 platform, how in heaven's name can that be</p> <p>4 compared to Newfoundland Power without</p> <p>5 stretching credulity?</p> <p>6 MR. CICCHETTI:</p> <p>7 A. They have similar overall risk</p> <p>8 characteristics, total risk. I think if we</p> <p>9 went through this same process with the</p> <p>10 Canadian utilities that Dr. Booth used, I</p> <p>11 think you would find similar non-regulated</p> <p>12 operations.</p> <p>13 MR. JOHNSON:</p> <p>14 Q. To that extent?</p> <p>15 MR. CICCHETTI:</p> <p>16 A. Well, we're talking about one company, and</p> <p>17 there's going to be, I think it's been brought</p> <p>18 up many times, differences. You're not going</p> <p>19 to find companies that are exactly like</p> <p>20 Newfoundland Power that you can create a</p> <p>21 group. So you have to use your judgment and</p> <p>22 look at what you believe is a relevant</p> <p>23 comparable group.</p> <p>24 MR. JOHNSON:</p> <p>25 Q. Did you use your judgment and actually analyze</p>
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<p>1 2008," and their corporate documentation,</p> <p>2 again for the record at Tab 3, says at page</p> <p>3 four that one of their corporate goals is to</p> <p>4 execute from a low to moderate risk platform.</p> <p>5 Is that the scalpel you're talking about?</p> <p>6 MR. CICCHETTI:</p> <p>7 A. Yes. I think there's a couple of important</p> <p>8 points that need to be made. One is you're</p> <p>9 looking at the overall investment risk</p> <p>10 characteristics of the business, which</p> <p>11 includes both financial risk and business</p> <p>12 risk, and the ratings that fall from that</p> <p>13 process and the groups of companies that I</p> <p>14 used have an overall profile of total risk</p> <p>15 similar to that of Newfoundland Power.</p> <p>16 Additionally, a lot of the non-regulated</p> <p>17 businesses that the LDCs are and in the US</p> <p>18 formerly were regulated business, for example,</p> <p>19 gas transportation and storage, and so they</p> <p>20 are in the same relevant line of business and</p> <p>21 I think they are very good proxies for the</p> <p>22 company.</p> <p>23 MR. JOHNSON:</p> <p>24 Q. But Mr. Cicchetti, how can a company that</p> <p>25 derives, what was it, 40 percent of earnings</p>	<p>1 the 10K returns of South Jersey Industries and</p> <p>2 say "yes, I think that's a good proxy for</p> <p>3 Newfoundland Power"?</p> <p>4 MR. CICCHETTI:</p> <p>5 A. Yes. I've been through the 10Ks of these</p> <p>6 companies many times over the years and I'm</p> <p>7 aware--I get other investment reports that are</p> <p>8 associated with these companies and I think</p> <p>9 they are valid proxies if you look overall at</p> <p>10 equity ratio, Value Line safety rank, bond</p> <p>11 ratings, and the bond ratings are going to</p> <p>12 take all those things into consideration.</p> <p>13 It's not like the bond rating companies aren't</p> <p>14 aware of all of that, and they have similar</p> <p>15 bond ratings to Newfoundland Power and on top,</p> <p>16 and also you have to recognize that the</p> <p>17 financial metrics of the company are somewhat</p> <p>18 less than these companies, but taken overall</p> <p>19 as a whole, I believe they're very good</p> <p>20 proxies.</p> <p>21 MR. JOHNSON:</p> <p>22 Q. Now, Mr. Cicchetti, you've also acknowledged,</p> <p>23 do you not, that the bond rating is not</p> <p>24 intended to be an indicator of investor--</p> <p>25 equity investor expectations, is it?</p>

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<p>1 MR. CICHETTI:</p> <p>2 A. No, but it's a relevant measure of risk.</p> <p>3 MR. JOHNSON:</p> <p>4 Q. Okay, but it's not, in your--in your analysis,</p> <p>5 how do you--how does one make its way into</p> <p>6 your comparable proxy group?</p> <p>7 MR. CICHETTI:</p> <p>8 A. I'm going to analyze various aspects of</p> <p>9 business and financial risk for companies that</p> <p>10 are in the same or similar industries that</p> <p>11 have similar business and financial risks.</p> <p>12 For example, regulated natural gas companies,</p> <p>13 regulated electric companies of similar size</p> <p>14 to the company being studied and general</p> <p>15 overall knowledge of the industry in general.</p> <p>16 MR. JOHNSON:</p> <p>17 Q. Well how did you consider then what regulatory</p> <p>18 support these different companies had?</p> <p>19 MR. CICHETTI:</p> <p>20 A. Well, regulatory support is one factor in the</p> <p>21 analysis and I think Moody's pointed out, and</p> <p>22 did it well, that the regulatory support here</p> <p>23 is phenomenal and I agree with that. It's</p> <p>24 just that you have to look at everything as a</p> <p>25 whole.</p>	<p>1 Q. How about Emera? Did you look at Emera?</p> <p>2 MR. CICHETTI:</p> <p>3 A. Yes.</p> <p>4 MR. JOHNSON:</p> <p>5 Q. Okay. They're publicly traded?</p> <p>6 MR. CICHETTI:</p> <p>7 A. Yes.</p> <p>8 MR. JOHNSON:</p> <p>9 Q. They own Nova Scotia Power?</p> <p>10 MR. CICHETTI:</p> <p>11 A. Yes.</p> <p>12 MR. JOHNSON:</p> <p>13 Q. Okay, and did you look at their 10K filing?</p> <p>14 MR. CICHETTI:</p> <p>15 A. Yes.</p> <p>16 MR. JOHNSON:</p> <p>17 Q. Okay, but they -</p> <p>18 MR. CICHETTI:</p> <p>19 A. No, I looked at their annual report.</p> <p>20 MR. JOHNSON:</p> <p>21 Q. Okay, but how come they didn't make it into</p> <p>22 the group?</p> <p>23 MR. CICHETTI:</p> <p>24 A. They're very large. They were larger than--I</p> <p>25 was looking at small cap and mid cap</p>
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<p>1 MR. JOHNSON:</p> <p>2 Q. In terms of the Canadian companies that you</p> <p>3 looked at, but at the end of the day really</p> <p>4 didn't do anything with, what--did you look at</p> <p>5 their filings to see if they could be</p> <p>6 comparable?</p> <p>7 MR. CICHETTI:</p> <p>8 A. I looked at various investment research</p> <p>9 reports.</p> <p>10 MR. JOHNSON:</p> <p>11 Q. Did you look at Gas Metro?</p> <p>12 MR. CICHETTI:</p> <p>13 A. If it wasn't publicly traded, I didn't look at</p> <p>14 it. I can't remember the names of all the</p> <p>15 companies that I looked at, but I did look at</p> <p>16 everyone that I could find, looked at their</p> <p>17 annual reports and looked at investment rating</p> <p>18 reports.</p> <p>19 MR. JOHNSON:</p> <p>20 Q. So you can't--do you know if--you don't know</p> <p>21 if Gas Metro is publicly traded, do you?</p> <p>22 MR. CICHETTI:</p> <p>23 A. I can't remember the names of all the</p> <p>24 companies off the top of my head.</p> <p>25 MR. JOHNSON:</p>	<p>1 companies.</p> <p>2 MR. JOHNSON:</p> <p>3 Q. Mr. Cicchetti, if we could, just to go back</p> <p>4 and we'll join up with this again. You</p> <p>5 referred to the idea that betas go to one as</p> <p>6 being conventional wisdom, accepted theory.</p> <p>7 Is that right?</p> <p>8 MR. CICHETTI:</p> <p>9 A. Generally speaking, yes.</p> <p>10 MR. JOHNSON:</p> <p>11 Q. Okay. Are you familiar with the report or the</p> <p>12 study that Dr. Booth cites at Footnote 10,</p> <p>13 page 38 of his evidence?</p> <p>14 MR. SIMMONS:</p> <p>15 Q. I'm sorry, did you say footnote 10 on page 38?</p> <p>16 MR. JOHNSON:</p> <p>17 Q. Yes.</p> <p>18 MR. SIMMONS:</p> <p>19 Q. We see footnotes 11, 12 and 13 on page 38.</p> <p>20 MR. JOHNSON:</p> <p>21 Q. Oh, page 11.</p> <p>22 MR. SIMMONS:</p> <p>23 Q. Footnote 11?</p> <p>24 MR. JOHNSON:</p> <p>25 Q. Footnote 11. He cites Gombola and Kahl, "Time</p>

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<p>1 Series Properties of Utility Betas" who comes</p> <p>2 to the exact same conclusions as he does. Are</p> <p>3 you familiar with that study?</p> <p>4 MR. CICCHETTI:</p> <p>5 A. I'm familiar with the conclusions.</p> <p>6 MR. JOHNSON:</p> <p>7 Q. Yeah, and this Fama French model that you</p> <p>8 spoke of, has that been applied in Canada, to</p> <p>9 your knowledge?</p> <p>10 MR. CICCHETTI:</p> <p>11 A. I don't know if it has or if it hasn't.</p> <p>12 MR. JOHNSON:</p> <p>13 Q. I guess we agree on one thing for sure and</p> <p>14 that's comparable earnings has no place before</p> <p>15 this Board. Is that your advice to the Board?</p> <p>16 MR. CICCHETTI:</p> <p>17 A. Yes.</p> <p>18 MR. JOHNSON:</p> <p>19 Q. Yeah. Do you have any experience with an</p> <p>20 automatic adjustment formula?</p> <p>21 MR. CICCHETTI:</p> <p>22 A. I don't know exactly how to answer that. In</p> <p>23 Florida, we developed what's known as a</p> <p>24 leverage formula. We have many small water</p> <p>25 and waste water utilities that can't afford</p>	<p>1 A. Yes.</p> <p>2 MR. JOHNSON:</p> <p>3 Q. Okay, and you refer, at page three of your</p> <p>4 evidence, on line 66, that you reviewed the</p> <p>5 status of the power markets in Canada and the</p> <p>6 United States, the characteristics of</p> <p>7 Newfoundland Power and examined the related</p> <p>8 business and financial risks that are</p> <p>9 important to investors. What are the business</p> <p>10 and financial risks that are important to</p> <p>11 investors?</p> <p>12 MR. CICCHETTI:</p> <p>13 A. Those are on my schedules that lay out the</p> <p>14 investment risk characteristics.</p> <p>15 MR. JOHNSON:</p> <p>16 Q. Would things like fuel protection be important</p> <p>17 to investors?</p> <p>18 MR. CICCHETTI:</p> <p>19 A. Yes, as I discussed in my description of</p> <p>20 business risk, those would be the kinds of</p> <p>21 things that would affect the company.</p> <p>22 MR. JOHNSON:</p> <p>23 Q. Yeah. There might be investors out there who</p> <p>24 really are not all that familiar with a</p> <p>25 company's bond rating, for instance, correct?</p>
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<p>1 utility cost of capital expert witnesses to</p> <p>2 come in for rate proceedings. Many of them</p> <p>3 are just subdivisions, water and waste water</p> <p>4 utilities for subdivisions. So in order to</p> <p>5 deal with that situation, we developed a</p> <p>6 formula that based on the theories of</p> <p>7 Madiglioni and Miller that the overall cost of</p> <p>8 capital would remain the same as you varied</p> <p>9 the leverage in the capital structure and</p> <p>10 correspondingly varied the allowed return</p> <p>11 associated with that leverage. How it works</p> <p>12 is each year the staff of the Florida</p> <p>13 Commission will update the cost of equity</p> <p>14 analysis that would get plugged into that</p> <p>15 formula and then companies can choose whether</p> <p>16 or not they want to rely on the results of</p> <p>17 that formula based on their capital structure</p> <p>18 or they can hire a witness and I can't</p> <p>19 remember the last time that a small water or</p> <p>20 waste water utility decided that they didn't</p> <p>21 want to rely on the formula.</p> <p>22 MR. JOHNSON:</p> <p>23 Q. So that's your experience with formulas of</p> <p>24 this type?</p> <p>25 MR. CICCHETTI:</p>	<p>1 MR. CICCHETTI:</p> <p>2 A. Correct.</p> <p>3 MR. JOHNSON:</p> <p>4 Q. And they would look to see does this company</p> <p>5 earn its allowed return? Would that be fair</p> <p>6 for an investor to take that on board?</p> <p>7 MR. CICCHETTI:</p> <p>8 A. I understand your point generally. I just</p> <p>9 wonder if someone couldn't understand the bond</p> <p>10 rating, could they understand the difference</p> <p>11 between allowed returns and earned returns for</p> <p>12 a public utility, but generally speaking, I</p> <p>13 could see maybe one would understand one and</p> <p>14 not the other. That's possible.</p> <p>15 MR. JOHNSON:</p> <p>16 Q. But would an equity investor feel safer in a</p> <p>17 supportive regulatory environment than in one</p> <p>18 that is not as supportive?</p> <p>19 MR. CICCHETTI:</p> <p>20 A. I would assume so, yes.</p> <p>21 MR. JOHNSON:</p> <p>22 Q. Yeah. Would they feel more comfortable in an</p> <p>23 environment where a utility has the ability to</p> <p>24 make applications to establish accounts</p> <p>25 outside of a general rate application?</p>

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1 MR. CICCETTI:
 2 A. Yes.
 3 MR. JOHNSON:
 4 Q. Yeah, and would they feel more comfort, less
 5 risk if they had their energy supply cost
 6 variances covered off in an account?
 7 MR. CICCETTI:
 8 A. I would assume so.
 9 MR. JOHNSON:
 10 Q. Yeah, and similarly, if they had pension
 11 expense variances covered off in an account,
 12 they would relatively that this is less risky
 13 than a utility that did not have those
 14 protections, correct?
 15 MR. CICCETTI:
 16 A. I think that's a fair assumption.
 17 MR. JOHNSON:
 18 Q. Yeah, that would be the equity investor. His
 19 or her mind would work like that, wouldn't it?
 20 MR. CICCETTI:
 21 A. Those would be some of the things that they
 22 would take into consideration, yes.
 23 MR. JOHNSON:
 24 Q. Yeah. You've indicated that it's a stand-
 25 alone approach that a regulatory board must

1 risk. The answer to your question is would
 2 the non-regulated operations tend to increase
 3 the required return? Yes, they would.
 4 MR. JOHNSON:
 5 Q. Yeah.
 6 MR. CICCETTI:
 7 A. Would it be a meaningful amount? That's
 8 disputable.
 9 MR. JOHNSON:
 10 Q. Well, what judgment should be--what's the
 11 cutoff percentage of non-regulated income in
 12 order to make you comfortable that the proxy
 13 group is not overstating what the fair return
 14 would be?
 15 MR. CICCETTI:
 16 A. It would depend. It would depend on the
 17 utility, but if you were to exclude all
 18 publicly traded utility companies that had
 19 non-regulated operations, I don't know that
 20 you would be left with any to compare to.
 21 MR. JOHNSON:
 22 Q. I could grant you that, but what I'm
 23 interested in knowing is--because you've got
 24 to look at it from where I'm sitting. I'm
 25 representing customers, because we've talked

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1 keep its eye on when looking at what the
 2 return should be for a regulated utility?
 3 MR. CICCETTI:
 4 A. Yes.
 5 MR. JOHNSON:
 6 Q. Okay, and you mentioned at page nine of your
 7 report that many operating utilities--this is
 8 at line 201. "Many operating utilities are
 9 subsidiaries of larger conglomerate
 10 corporations that have both regulated and
 11 higher non-risk regulations. The stand-alone
 12 approach to utility regulation recognizes that
 13 the reasonable and prudent cost associated
 14 with the provision of utility service should
 15 be based on the cost that would be incurred if
 16 the utility was an independent stand-alone
 17 entity." What implication is there if the
 18 holding company has higher non-risk -- higher
 19 risk of non-regulated operations and that
 20 utility becomes part of a proxy sample when
 21 we're trying to establish the fair rate of
 22 return for a wholly regulated company?
 23 MR. CICCETTI:
 24 A. Again, you would have to look at the entire
 25 business risk and financial risk and total

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

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<p>1 structure, a company that's out competing and</p> <p>2 hustling and getting -- generating great</p> <p>3 returns, doesn't that represent a problem from</p> <p>4 the point of view of the customer whose rates</p> <p>5 are going to be including a return on equity</p> <p>6 for the utility company when the utility</p> <p>7 company is totally regulated and doesn't have</p> <p>8 that competitive influence?</p> <p>9 MR. CICCETTI:</p> <p>10 A. Well, I guess, I'd get back to the point is it</p> <p>11 a meaningful amount? In the cases of the</p> <p>12 companies I chose, I don't think it has that</p> <p>13 much of an impact. If the Board was concerned</p> <p>14 about that to a significant extent, I say the</p> <p>15 required return is calculated within a range.</p> <p>16 They could take that into consideration when</p> <p>17 they're making their determination.</p> <p>18 MR. JOHNSON:</p> <p>19 Q. So what would be the--what would be a rule of</p> <p>20 thumb that you would use to say, look, if that</p> <p>21 has more than X percent of non-regulated</p> <p>22 income, I think you're going to have to think</p> <p>23 about an adjustment of some sort?</p> <p>24 MR. CICCETTI:</p> <p>25 A. I don't think there is a rule of thumb.</p>	<p>1 A. It can be.</p> <p>2 MR. JOHNSON:</p> <p>3 Q. And how does that risk arise?</p> <p>4 MR. CICCETTI:</p> <p>5 A. Through investment and non-regulated</p> <p>6 operations affecting the overall cost of</p> <p>7 capital to a meaningful amount.</p> <p>8 MR. JOHNSON:</p> <p>9 Q. Now you recommend that the Board not apply any</p> <p>10 adjustments to the numbers that flow out of</p> <p>11 your DCF tests, right?</p> <p>12 MR. CICCETTI:</p> <p>13 A. Correct.</p> <p>14 MR. JOHNSON:</p> <p>15 Q. Take them at face value and say, Board, that's</p> <p>16 fair for Newfoundland Power. Have I got you</p> <p>17 correct?</p> <p>18 MR. CICCETTI:</p> <p>19 A. Yes.</p> <p>20 MR. JOHNSON:</p> <p>21 Q. We've had some discussion, as you know, about</p> <p>22 the introduction of the pension expense</p> <p>23 variant deferral account, and you were here</p> <p>24 for that testimony?</p> <p>25 MR. CICCETTI:</p>
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<p>1 MR. JOHNSON:</p> <p>2 Q. No? How much unregulated income would you--</p> <p>3 would one of these subsidiaries or one of</p> <p>4 these holding companies have to have for Mark</p> <p>5 Cicchetti to say "oops, I think that that</p> <p>6 company no longer should be in that sample"?</p> <p>7 MR. CICCETTI:</p> <p>8 A. Well, it would depend on what the non-</p> <p>9 regulated income was coming from. If it's an</p> <p>10 industry that's not much risk and it's not</p> <p>11 substantial and I don't know exactly--I would</p> <p>12 have to look at it to say is this substantial</p> <p>13 for this round of business, I would have to</p> <p>14 make that determination, but generally</p> <p>15 speaking, these are considered regulated</p> <p>16 utilities. If they become somewhat more non-</p> <p>17 regulated, they'd become a company that's in a</p> <p>18 different industry. These are generally</p> <p>19 regulated electric and gas utilities.</p> <p>20 MR. JOHNSON:</p> <p>21 Q. Well, if--I guess the upshot is that there is</p> <p>22 a risk, depending upon the choice of the proxy</p> <p>23 group, of overestimating the fair return on</p> <p>24 equity, isn't there?</p> <p>25 MR. CICCETTI:</p>	<p>1 A. I believe I was here for a good portion of it.</p> <p>2 MR. JOHNSON:</p> <p>3 Q. And you can recall the testimony about how</p> <p>4 much money would have gone into that variance</p> <p>5 account in past years had it been in</p> <p>6 operation?</p> <p>7 MR. CICCETTI:</p> <p>8 A. I don't remember the details. I wasn't</p> <p>9 involved particularly with that issue, so I</p> <p>10 wasn't paying close attention to it.</p> <p>11 MR. JOHNSON:</p> <p>12 Q. In your judgment, Mr. Cicchetti, would an</p> <p>13 introduction of a new deferral account, like a</p> <p>14 PEVDA, lessen the risk of a utility?</p> <p>15 MR. CICCETTI:</p> <p>16 A. It's hard to say. I mean, I guess there is a</p> <p>17 point of diminishing returns. Once you say,</p> <p>18 you know, this--we're going to give certain</p> <p>19 amount of credit for supportive regulation,</p> <p>20 you know, does it incrementally keep</p> <p>21 increasing every time something happens or is</p> <p>22 it just in general considered supportive?</p> <p>23 MR. JOHNSON:</p> <p>24 Q. Well, let's put it this way. Let's turn it</p> <p>25 around. Let's say the Board says, "look,</p>

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1 guys, you got the energy supply cost variance.
 2 You got rate stabilization. You got the
 3 municipal tax adjustment. We're going to take
 4 off one of these now." Would that influence
 5 the risk of the utility?
 6 MR. CICCHETTI:
 7 A. Well, I think you'd have to see how much it
 8 increases the variability of their earnings
 9 and try to measure the risk impact and I don't
 10 know that without having taken a closer at it
 11 exactly how that would impact investors
 12 overall perception of the quality of
 13 regulation.
 14 (12:30 p.m.)
 15 MR. JOHNSON:
 16 Q. A deferred account usually helps cut down on
 17 volatility in earnings, doesn't it?
 18 MR. CICCHETTI:
 19 A. Yes.
 20 MR. JOHNSON:
 21 Q. And cutting down on volatility in earnings is
 22 a risk reducer, isn't it?
 23 MR. CICCHETTI:
 24 A. Yes. I'm just getting back to the point of
 25 what is the extent of it and how does that

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1 relative to the total amount.
 2 MR. JOHNSON:
 3 Q. So if the Board feels that the amount is
 4 material enough not to be diminimus, they
 5 could be safe in concluding that the company
 6 has been made less risky?
 7 MR. CICCHETTI:
 8 A. If they had reason to believe that it has in
 9 fact reduced the risk in the eyes of the
 10 investor, then I wouldn't disagree with that.
 11 MR. JOHNSON:
 12 Q. Right. Now you've indicated that Newfoundland
 13 Power, at page 14, faces very little
 14 competition, as it is an isolated geographic
 15 location. You've also pointed to the fact
 16 that it serves 85 percent of the customers on
 17 the island of Newfoundland and that the
 18 customers mix is primarily residential and
 19 commercial, so there is virtually no risk
 20 associated with customer concentration as it
 21 doesn't have any industrial customers, and in
 22 your sample, Mr. Cicchetti, have you seen any
 23 utility that protected from competition?
 24 MR. CICCHETTI:
 25 A. No.

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1 MR. JOHNSON:
 2 Q. And you also go on to say "because the
 3 customer base is stable, capital expenditures
 4 and a need to raise capital are expected to be
 5 relatively modest into the future." I've gone
 6 through the 10Ks on these companies and I've
 7 seen examples of fairly robust capital
 8 expenditure plans. Have you seen any where
 9 the rate base was so stable and the need to
 10 raise capital was expected to be so relatively
 11 modest going into the foreseeable future?
 12 MR. CICCHETTI:
 13 A. No. I just would again emphasize you need to
 14 look at the entire picture.
 15 MR. JOHNSON:
 16 Q. Yeah. Now you have said, and we've already
 17 talked around this a bit, on page 17 of your
 18 report, at line 364, you've indicated that--
 19 well, it starts up at line 362.
 20 "Consequently, determining a valid proxy for
 21 investor expectations regarding the expected
 22 cash flows of a stock, the expected dividends,
 23 is the most important and often most
 24 contentious issue in determining the cost of
 25 equity using the DCF formula." And I think

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1 that's really what these binders are all
 2 about. I mean, that's--why is it the most
 3 contentious?
 4 MR. CICCHETTI:
 5 A. Because there is no--you cannot know what all
 6 investors think at any point in time. So you
 7 have to find the proxy for investor
 8 expectations, and so with regard to the growth
 9 in the dividends of a stock, you need to come
 10 up with a valid proxy.
 11 MR. JOHNSON:
 12 Q. And so you've seen battlegrounds, battles
 13 fought in hearings, have you, about the
 14 appropriate proxy groups?
 15 MR. CICCHETTI:
 16 A. About the appropriate growth rate for
 17 dividends of a stock, yes.
 18 MR. JOHNSON:
 19 Q. No, but I thought your line said
 20 "consequently, determining a valid proxy for
 21 investor expectations." So you're not saying
 22 the battleground is the selection of the
 23 companies, are you?
 24 MR. CICCHETTI:
 25 A. No.

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1 MR. JOHNSON:

2 Q. Okay. In terms of your proxy groups that you
3 use, have you used these proxy groups a lot?

4 MR. CICCHETTI:

5 A. I've used local gas distribution companies and
6 tried to put together a group that's similar
7 to whatever group I'm looking at, the same
8 with electrics, and I don't think I've used
9 the exact same groups prior.

10 MR. JOHNSON:

11 Q. I think you gave a response to an RFI that in
12 the last two years you've used it.

13 MR. CICCHETTI:

14 A. I used the same methodology.

15 MR. JOHNSON:

16 Q. No, you indicated that you used the same
17 groups. So the question that was posed was
18 CA-PUB-14. I think this is where the
19 miscommunication is. The question was "can
20 Mr. Cicchetti provide copies of all testimony
21 presented by him over the last"--this is PUB-
22 14 -- CA-PUB-14F. "Can Mr. Cicchetti provide
23 copies of all testimony presented by him over
24 the last two years and indicate the tests that
25 he performed and the sample of firms that he

1 MR. CICCHETTI:

2 A. Now looking at just the gas companies, it's
3 possible that I've used those, depending on
4 the company that we're looking at, it may
5 include some or some may drop in and out.
6 Just the gas companies, it's possible that
7 I've used just that group in past testimony.

8 MR. JOHNSON:

9 Q. And so would--this has--you would have used a
10 list much like this in, let's say the last two
11 years, three years?

12 MR. CICCHETTI:

13 A. Yes.

14 MR. JOHNSON:

15 Q. Okay, testifying, giving evidence?

16 MR. CICCHETTI:

17 A. Yes.

18 MR. JOHNSON:

19 Q. Okay, and what companies would you have relied
20 on that sample to give evidence in respect of?

21 MR. CICCHETTI:

22 A. I think at one time or another, maybe all of
23 them, maybe one or two that would have dropped
24 out. I'd have to double check.

25 MR. JOHNSON:

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1 used? It would be sufficient to indicate that
2 all his evidence over the last two years is
3 based on the same techniques and samples
4 presented in this hearing if that's the case."
5 And what you've indicated is that, and you're
6 right, you've used similar analysis in your
7 testimony over the last two years, but this is
8 the first time using this proxy group.

9 MR. CICCHETTI:

10 A. Of all the companies, yes.

11 MR. JOHNSON:

12 Q. Okay, and when did you construct this proxy
13 group?

14 MR. CICCHETTI:

15 A. I believe it was some time in July or August.

16 MR. JOHNSON:

17 Q. Okay. So in fairness, Mr. Cicchetti, you
18 don't have a long working knowledge of these
19 companies?

20 MR. CICCHETTI:

21 A. Oh, I do.

22 MR. JOHNSON:

23 Q. Have you used, in the last two years, your
24 sample, let's say at Schedule MAC-7, which is
25 your comparable gas companies?

1 Q. No, but what company's rate hearing were you
2 involved in where you used this sample?

3 MR. CICCHETTI:

4 A. I'd have to double check.

5 MR. JOHNSON:

6 Q. Could you provide an undertaking to provide
7 that information?

8 MR. CICCHETTI:

9 A. Certainly.

10 MR. JOHNSON:

11 Q. Say the last three years.

12 MR. CICCHETTI:

13 A. Okay.

14 MR. JOHNSON:

15 Q. And similarly -

16 MR. CICCHETTI:

17 A. And you want those same--it would be have
18 testified in another case using those same
19 companies in an LDC index?

20 MR. JOHNSON:

21 Q. Same or substantially the same. And would you
22 be able to do the same in respect of your
23 comparative--comparable electric companies in
24 Schedule MAC-8?

25 MR. CICCHETTI:

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<p>1 A. Certainly.</p> <p>2 MR. JOHNSON:</p> <p>3 Q. Thank you. So the assumption then, to the</p> <p>4 extent that these have been used in same or</p> <p>5 substantially the same content, is that these</p> <p>6 companies are of similar risk to Newfoundland</p> <p>7 Power?</p> <p>8 MR. CICCHETTI:</p> <p>9 A. Yes, I believe so. These are very low risk</p> <p>10 and I would refer again to the e-mail from</p> <p>11 Moody's, the line I cited, "however I include</p> <p>12 O & R because Moody's views the business risk</p> <p>13 profile of gas LDCs to be similar to, indeed,</p> <p>14 generally somewhat lower than that of electric</p> <p>15 T & Ds."</p> <p>16 MR. JOHNSON:</p> <p>17 Q. No, but just to be clear, so there's no</p> <p>18 misunderstanding, you're saying that the</p> <p>19 evidence that you've been involved in for</p> <p>20 other utilities, those other utilities where</p> <p>21 you used these samples would be similar in</p> <p>22 risk to Newfoundland Power?</p> <p>23 MR. CICCHETTI:</p> <p>24 A. Oh, those other utilities?</p> <p>25 MR. JOHNSON:</p>	<p>1 earnings, return on equity and dividends, and</p> <p>2 were you able to get value--on how many of</p> <p>3 these were you able to Value Line ratings?</p> <p>4 MR. CICCHETTI:</p> <p>5 A. I think about three.</p> <p>6 MR. JOHNSON:</p> <p>7 Q. About three. Which ones?</p> <p>8 MR. CICCHETTI:</p> <p>9 A. I believe it was TransCanada, TransAlta and</p> <p>10 Enbridge.</p> <p>11 MR. JOHNSON:</p> <p>12 Q. And what were their Value Line ratings?</p> <p>13 MR. CICCHETTI:</p> <p>14 A. I believe the safety ratings were three, the</p> <p>15 betas four. I believe -</p> <p>16 MR. JOHNSON:</p> <p>17 Q. The safety rating being Newfoundland Power</p> <p>18 would be what safety rating?</p> <p>19 MR. CICCHETTI:</p> <p>20 A. One.</p> <p>21 MR. JOHNSON:</p> <p>22 Q. One, being the safest?</p> <p>23 MR. CICCHETTI:</p> <p>24 A. Yes.</p> <p>25 MR. JOHNSON:</p>
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<p>1 Q. Yeah, the cases you were involved in involving</p> <p>2 these other utilities where you relied on</p> <p>3 these samples.</p> <p>4 MR. CICCHETTI:</p> <p>5 A. I'm not sure. I would have to double check.</p> <p>6 MR. JOHNSON:</p> <p>7 Q. Because that's the critical piece, right, that</p> <p>8 you know, to confirm the actual company that</p> <p>9 you used these samples for.</p> <p>10 MR. CICCHETTI:</p> <p>11 A. Well, I might have used them in terms of</p> <p>12 determining a risk premium for a sample of low</p> <p>13 risk natural gas companies.</p> <p>14 MR. JOHNSON:</p> <p>15 Q. Well, let's--we'll get a confirmation of what</p> <p>16 they were used for. Now you indicated in your</p> <p>17 comparable companies analysis, starting at</p> <p>18 page 18, that you examined the companies</p> <p>19 listed by Value Line as the Canadian energy</p> <p>20 industry--I'm looking at line 389-390 of your</p> <p>21 testimony, and I take it, then you go on to</p> <p>22 say that you also examined Enbridge, however</p> <p>23 none of the Canadian companies that you</p> <p>24 examined were similar to Newfoundland Power</p> <p>25 and had long-term analyst forecast for growth</p>	<p>1 Q. And TransCanada would be?</p> <p>2 MR. CICCHETTI:</p> <p>3 A. I'd have to check, but I think one of the</p> <p>4 three would have qualified just on the basis</p> <p>5 of the safety rank and the others were riskier</p> <p>6 on the basis of the safety rank.</p> <p>7 MR. JOHNSON:</p> <p>8 Q. And riskier, not less than three?</p> <p>9 MR. CICCHETTI:</p> <p>10 A. Yes.</p> <p>11 MR. JOHNSON:</p> <p>12 Q. Okay. Would you undertake to provide the</p> <p>13 definition of three under the Value Line</p> <p>14 methodology?</p> <p>15 MR. CICCHETTI:</p> <p>16 A. It's a relative ranking from one to five,</p> <p>17 based on their financial strength rating and</p> <p>18 their price stability rating, and in their</p> <p>19 materials, they recommend that conservative</p> <p>20 investors stay with an investment or safety</p> <p>21 rank of one or two.</p> <p>22 MR. JOHNSON:</p> <p>23 Q. But isn't there a descriptor for what rank</p> <p>24 three means?</p> <p>25 MR. CICCHETTI:</p>

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<p>1 A. If there is, I can't recall it.</p> <p>2 MR. JOHNSON:</p> <p>3 Q. Just would rank one be highest safety?</p> <p>4 MR. CICCHETTI:</p> <p>5 A. Yes.</p> <p>6 MR. JOHNSON:</p> <p>7 Q. And would you agree with me that the</p> <p>8 definition for that, "these stocks as a group,</p> <p>9 the safest, most stable and least risky</p> <p>10 investments relative to the Value Line</p> <p>11 universe"?</p> <p>12 MR. CICCHETTI:</p> <p>13 A. Yes, that sounds familiar.</p> <p>14 MR. JOHNSON:</p> <p>15 Q. Sound familiar?</p> <p>16 MR. CICCHETTI:</p> <p>17 A. Yes.</p> <p>18 MR. JOHNSON:</p> <p>19 Q. And rank two would be above average and would</p> <p>20 you agree that the descriptor is "these</p> <p>21 stocks, as a group, are safer and less risky</p> <p>22 than most"?</p> <p>23 MR. CICCHETTI:</p> <p>24 A. Yes.</p> <p>25 MR. JOHNSON:</p>	<p>1 MR. CICCHETTI:</p> <p>2 A. Yes, they're listed.</p> <p>3 MR. JOHNSON:</p> <p>4 Q. Okay, and that's listed in your report, okay,</p> <p>5 and then of course, that will be there as well</p> <p>6 for your natural gas distribution comparables?</p> <p>7 MR. CICCHETTI:</p> <p>8 A. Yes.</p> <p>9 (12:45 p.m.)</p> <p>10 MR. JOHNSON:</p> <p>11 Q. Now you indicate in your report that, at page</p> <p>12 19, that "regarding the use of natural gas</p> <p>13 distribution companies," and I'm looking at</p> <p>14 line 407, "regarding the use of natural gas</p> <p>15 distribution companies as proxies for</p> <p>16 Newfoundland Power, it should be noted it is</p> <p>17 helpful to have results from a different by</p> <p>18 similar industry to verify the reasonableness</p> <p>19 of cost of equity results."</p> <p>20 MR. CICCHETTI:</p> <p>21 A. Yes, that's what it says.</p> <p>22 MR. JOHNSON:</p> <p>23 Q. But Mr. Cicchetti, you'll confirm that you</p> <p>24 didn't use these companies to verify the</p> <p>25 reasonable cost of equity results. You used</p>
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<p>1 Q. And for three, the descriptor is "average.</p> <p>2 These stocks, as a group, are of average risk</p> <p>3 and safety."</p> <p>4 MR. CICCHETTI:</p> <p>5 A. That sounds right.</p> <p>6 MR. JOHNSON:</p> <p>7 Q. And TransAlta, are you aware of the fact they</p> <p>8 don't have non-regulated businesses?</p> <p>9 MR. CICCHETTI:</p> <p>10 A. Yes, they're a pipeline company.</p> <p>11 MR. JOHNSON:</p> <p>12 Q. Yeah. Now in respect of the Value Line</p> <p>13 rankings, you had to be one or two to make it</p> <p>14 into your proxy group?</p> <p>15 MR. CICCHETTI:</p> <p>16 A. Yes.</p> <p>17 MR. JOHNSON:</p> <p>18 Q. And I understand that, going over to page 20,</p> <p>19 that the Value Line safety ranking average was</p> <p>20 1.67 for your electric utility companies.</p> <p>21 MR. CICCHETTI:</p> <p>22 A. Correct.</p> <p>23 MR. JOHNSON:</p> <p>24 Q. Okay, and do you know who were the ones and</p> <p>25 who were the twos?</p>	<p>1 it to ground your entire risk premium</p> <p>2 analysis, didn't you?</p> <p>3 MR. CICCHETTI:</p> <p>4 A. Yes, that's, I guess, a matter of semantics.</p> <p>5 MR. JOHNSON:</p> <p>6 Q. Okay.</p> <p>7 MR. CICCHETTI:</p> <p>8 A. I was speaking in general, not specifically,</p> <p>9 to the analysis in this report.</p> <p>10 MR. JOHNSON:</p> <p>11 Q. Now you indicated as well, at the bottom of</p> <p>12 page 19, that in your screening process, you</p> <p>13 used small or mid cap companies, and what was</p> <p>14 the thinking there?</p> <p>15 MR. CICCHETTI:</p> <p>16 A. That that approximates the size of the company</p> <p>17 and I wanted to exclude large cap companies.</p> <p>18 I try to get as accurate a proxy group as I</p> <p>19 can and so I tried to stay close, in terms of</p> <p>20 size.</p> <p>21 MR. JOHNSON:</p> <p>22 Q. And what would be the problem with having</p> <p>23 medium to large cap companies?</p> <p>24 MR. CICCHETTI:</p> <p>25 A. Well, as I said, Newfoundland Power is not a</p>

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1 large cap company. They're approximately 890
 2 million dollars of regulated assets. I would
 3 assume if they were market traded, they'd be
 4 somewhere in the mid cap range, small. I
 5 mean, they're kind of on the border line
 6 there.
 7 MR. JOHNSON:
 8 Q. But I mean, we know--you know, we know that
 9 they're not large cap, but for that matter, we
 10 know as well that they're not a US natural gas
 11 utility. So what I'm getting at is why would
 12 you exclude medium-large cap from the point of
 13 view of the accuracy of your analysis?
 14 MR. CICCHETTI:
 15 A. I did not exclude mid cap. I relied on small
 16 and mid cap. I excluded large cap to try and
 17 get away from the types of things that affect
 18 large companies that wouldn't affect a company
 19 the size of Newfoundland Power.
 20 MR. JOHNSON:
 21 Q. What type of things would they be?
 22 MR. CICCHETTI:
 23 A. Well, smaller companies have unique
 24 characteristics. I mean, they don't have the
 25 same service territory size, the same access

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1 to the capital markets that the large capital
 2 companies have. There's just some inherent
 3 differences, so -
 4 MR. JOHNSON:
 5 Q. But you're telling me about the differences,
 6 but I want to know--who cares if there's
 7 differences in those? You know what I'm
 8 saying? What's the point of the differences?
 9 MR. CICCHETTI:
 10 A. The point is to get a comparison group that is
 11 similar to Newfoundland Power and Newfoundland
 12 Power, in my opinion, in terms of size, is
 13 small to mid cap size. They're a regulated
 14 utility, electric utility. We look at their
 15 equity ratio, their safety rank, and just the
 16 importance of it is to try and get a group of
 17 comparable companies similar to the company
 18 that you're looking at.
 19 MR. JOHNSON:
 20 Q. I'd also note that you screened or looked for
 21 companies at least, at page--line 416 on the
 22 same page, that were not currently involved in
 23 a merger, and now a company being involved in
 24 a merger, they'd still have their S & P
 25 ranking, wouldn't they, and their Value Line

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1 ranking, right?
 2 MR. CICCHETTI:
 3 A. Correct.
 4 MR. JOHNSON:
 5 Q. And so that tells me that there is a different
 6 equity investor expectation for a company that
 7 might be in a merger situation.
 8 MR. CICCHETTI:
 9 A. What I have found in calculating required
 10 rates of return for companies, when you see
 11 one that's in a merger, my experience has been
 12 because of the changes in stock prices, you
 13 get anomalous results and so I prefer to
 14 remove companies that are involved in a merger
 15 when I'm doing a comparison analysis.
 16 MR. JOHNSON:
 17 Q. Now your risk premium analysis is really--I
 18 mean, we just had DCF DCF in your report,
 19 right? I mean, we're seeing DCF applied
 20 basically twice?
 21 MR. CICCHETTI:
 22 A. No, I consider it a risk premium analysis.
 23 MR. JOHNSON:
 24 Q. But totally driven by--the only thing that's
 25 different is now we're going to talk about the

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1 risk free rate?
 2 MR. CICCHETTI:
 3 A. Well, not only that, you're looking over an
 4 extended period of time and you're using
 5 required rates of return to do that.
 6 MR. JOHNSON:
 7 Q. And you indicated to Mr. Kelly's questions
 8 what your risk premium would end up being if
 9 you--your 435 is what the utility equity risk
 10 premium is, right?
 11 MR. CICCHETTI:
 12 A. Yes.
 13 MR. JOHNSON:
 14 Q. But the equity risk premium for the market
 15 that you would take out of that is
 16 significantly higher?
 17 MR. CICCHETTI:
 18 A. If you work through the math under those
 19 assumptions, I believe, subject to check,
 20 that's the answer that you would get.
 21 MR. JOHNSON:
 22 Q. Up around Ms. McShane?
 23 MR. CICCHETTI:
 24 A. That appears to be the case, yes.
 25 MR. JOHNSON:

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<p>1 Q. Mr. Cicchetti, regarding your gas and electric 2 samples, which have a safety ranking of one 3 and two, according to Value Line, these then 4 result in your DCF estimates in MAC-11 and 5 MAC-10, right?</p> <p>6 MR. CICCHETTI:</p> <p>7 A. Those are the companies I used to make the 8 calculations, yes.</p> <p>9 MR. JOHNSON:</p> <p>10 Q. Yeah, and could you provide, as an 11 undertaking, an equivalent table for only 12 those utilities with a safety ranking of one?</p> <p>13 MR. CICCHETTI:</p> <p>14 A. Certainly.</p> <p>15 MR. JOHNSON:</p> <p>16 Q. Thank you. Mr. Cicchetti, if I could, in 17 fact, turn you now to South Jersey Industries?</p> <p>18 MS. GLYNN:</p> <p>19 Q. South Jersey will be Consent No. 20.</p> <p>20 MR. JOHNSON:</p> <p>21 Q. At Tab 1 again, we see a description of what 22 South Jersey Industries is.</p> <p>23 MR. CICCHETTI:</p> <p>24 A. Yes.</p> <p>25 MR. JOHNSON:</p>	<p>1 Newfoundland Power moving from a low to 2 moderate risk platform.</p> <p>3 MR. JOHNSON:</p> <p>4 Q. They'd be very low risk, Newfoundland Power, 5 wouldn't they?</p> <p>6 MR. CICCHETTI:</p> <p>7 A. Well, they're equivalent to, for example, the 8 group of companies that I've used in my 9 analysis when you look at total risk 10 perspective.</p> <p>11 MR. JOHNSON:</p> <p>12 Q. If you could just go back to the bottom of 13 page two in this letter to shareholders? On 14 the left-hand column where they say "growth 15 and income. Yesterday, today and tomorrow" 16 and under "yesterday" in the second paragraph, 17 you see that?</p> <p>18 MR. CICCHETTI:</p> <p>19 A. Yes.</p> <p>20 MR. JOHNSON:</p> <p>21 Q. "Our success comes from the robust growth and 22 profitability of our non-utility activities, 23 along with the reliable steady growth of our 24 utility. To illustrate this point, our non- 25 utility businesses contributed 27 percent to</p>
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<p>1 Q. "An energy services holding company, provides 2 a variety of energy-related products and 3 services through its five wholly owned 4 subsidiaries," et cetera. I would like just 5 to confirm for the record what I put to you 6 earlier, that at Tab 3, which is the 2008 7 annual report to shareholders, at page four, 8 in the left-hand column.</p> <p>9 MR. CICCHETTI:</p> <p>10 A. Okay.</p> <p>11 MR. JOHNSON:</p> <p>12 Q. That this particular company has indicated, as 13 part of its financial overview, that one of 14 its goals is to--the third bullet down, is to 15 execute from a low to moderate risk platform?</p> <p>16 MR. CICCHETTI:</p> <p>17 A. That's what it says.</p> <p>18 MR. JOHNSON:</p> <p>19 Q. No indication that Newfoundland Power is 20 seeking to execute from a low to moderate risk 21 platform, is there?</p> <p>22 MR. CICCHETTI:</p> <p>23 A. I'm not exactly sure what that means, what 24 context they're saying that, but I'm not aware 25 of the company in any shape or form,</p>	<p>1 SJ's earnings in 2004, compared with a 42 2 percent contribution to economic earnings in 3 2008. This change occurred despite utility 4 net income increasing from 31.5 million to 5 39.4 million during that time." See that?</p> <p>6 MR. CICCHETTI:</p> <p>7 A. Yes.</p> <p>8 MR. JOHNSON:</p> <p>9 Q. But, and you look up under performance 10 highlights, again on the left-hand side, you 11 see what they say about their performance 12 highlights? "Dividend growth over the past 13 three years was 28.4 percent. Equity of 14 capitalization improved 7.9 percentage points 15 to 47.4." Do you think their dividend growth 16 had anything to do with the significant 17 earnings from the non-utility side of the 18 business?</p> <p>19 MR. CICCHETTI:</p> <p>20 A. It's possible.</p> <p>21 MR. JOHNSON:</p> <p>22 Q. I put to you, sir, that it's more than 23 possible. It's obvious.</p> <p>24 MR. CICCHETTI:</p> <p>25 A. Well, I don't know that they specifically</p>

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<p>1 raised their dividend because they had two</p> <p>2 good years with regard to non-utility, non-</p> <p>3 regulated investment. I don't know that for</p> <p>4 certain.</p> <p>5 MR. JOHNSON:</p> <p>6 Q. Could we turn to CH Energy Group Inc.?</p> <p>7 MS. GLYNN:</p> <p>8 Q. CH Energy will be Consent No. 20--21, sorry.</p> <p>9 MR. JOHNSON:</p> <p>10 Q. Tab 1, under the business description, Mr.</p> <p>11 Cicchetti, CH Energy Group is the holding</p> <p>12 company of Central Hudson Gas and Electric,</p> <p>13 Central Hudson, it's known as, and Central</p> <p>14 Hudson Enterprises Corporation. Central</p> <p>15 Hudson, the regulated electric and natural gas</p> <p>16 subsidiary has one wholly owned subsidiary,</p> <p>17 Phoenix Development Inc. CHEC, the parent</p> <p>18 company of CH Energy Group's unregulated</p> <p>19 business segments has two wholly owned</p> <p>20 subsidiaries, Griffith Energy. Would non-</p> <p>21 regulated be a significant part of CH Energy</p> <p>22 Group?</p> <p>23 MR. CICCHETTI:</p> <p>24 A. Well, I think if you look at the following</p> <p>25 page, 1 of 3, it has in the middle on the</p>	<p>1 MR. JOHNSON:</p> <p>2 Q. Right. So electric, 608 million, was it; yeah.</p> <p>3 Natural gas, 189 million. Competitive business</p> <p>4 subsidiaries, \$535,144,000.00.</p> <p>5 MR. CICCHETTI:</p> <p>6 A. Yes, and that would relate to the amount of</p> <p>7 gas that they have to purchase.</p> <p>8 MR. JOHNSON:</p> <p>9 Q. Yeah. So the person who is looking to invest</p> <p>10 in CH Energy Group, they have an eye not just</p> <p>11 on the utility operations, they have a big eye</p> <p>12 on the competitive business subsidiaries,</p> <p>13 don't they?</p> <p>14 MR. CICCHETTI:</p> <p>15 A. Right, except I would point out that when</p> <p>16 you're looking at sales, and you're purchasing</p> <p>17 gas to flow through your pipeline or your</p> <p>18 transportation or storage, that's going to be</p> <p>19 a rather significant number, but it's pretty</p> <p>20 much just a pass through.</p> <p>21 MR. JOHNSON:</p> <p>22 Q. Aren't we agreed, though, that in terms of the</p> <p>23 overall earnings of this company, that non-</p> <p>24 regulated is very significant?</p> <p>25 MR. CICCHETTI:</p>
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<p>1 right hand side a little chart called</p> <p>2 "Business Segment", and I think right there</p> <p>3 will tell you exactly how it relates.</p> <p>4 MR. JOHNSON:</p> <p>5 Q. And what does that chart say to you?</p> <p>6 MR. CICCHETTI:</p> <p>7 A. It looks like a fairly significant portion.</p> <p>8 MR. JOHNSON:</p> <p>9 Q. Just turn, Mr. Cicchetti, to Tab 4, and in</p> <p>10 particular now, for the record, we're at the</p> <p>11 SEC filing, the 10K, page 41 of 367.</p> <p>12 MR. CICCHETTI:</p> <p>13 A. Can you repeat that, please?</p> <p>14 MR. JOHNSON:</p> <p>15 Q. Tab 4, page 41 of 367. Do you see the five</p> <p>16 year summary of consolidated operations and</p> <p>17 selected financial data?</p> <p>18 MR. CICCHETTI:</p> <p>19 A. Yes.</p> <p>20 MR. JOHNSON:</p> <p>21 Q. And you see in 2008 -- I take it that both</p> <p>22 electric and natural gas, they're regulated</p> <p>23 here?</p> <p>24 MR. CICCHETTI:</p> <p>25 A. I believe so, yes.</p>	<p>1 A. Again going back, if you look at just sales</p> <p>2 and you're talking about gas pass through, if</p> <p>3 you'll look on the left hand side -- well,</p> <p>4 it's a good portion.</p> <p>5 (1:00 PM)</p> <p>6 MR. JOHNSON:</p> <p>7 Q. Turn to page 65 of Tab 4. You see a</p> <p>8 description of a proceeding in front of the</p> <p>9 regulator for the petition of Central Hudson</p> <p>10 Gas and Electric, they petitioned apparently</p> <p>11 for authority to defer certain gas expenses</p> <p>12 for the year, and the background apparently is</p> <p>13 that in 2007, Central Hudson filed a petition</p> <p>14 with the regulator seeking approval to defer</p> <p>15 certain incremental and material non-labour</p> <p>16 gas expenses that were incurred during rate</p> <p>17 year one, but were not included in rates under</p> <p>18 the 2006 rate plan, and this indicates under</p> <p>19 notable activity that the PSC denied Central</p> <p>20 Hudson's request, noting that while Central</p> <p>21 Hudson satisfied the standards for</p> <p>22 demonstrating the expense items were</p> <p>23 incremental, and Central Hudson hadn't earned</p> <p>24 its allowed rate of return, the PSC did not</p> <p>25 view the expense items as material and</p>

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<p>1 extraordinary in nature. So the shareholders</p> <p>2 in Central Hudson were told by the regulator</p> <p>3 to pick that up, right?</p> <p>4 MR. CICCHETTI:</p> <p>5 A. That's what it says.</p> <p>6 MR. JOHNSON:</p> <p>7 Q. Have you got any experience or any knowledge</p> <p>8 that something like that has happened with</p> <p>9 Newfoundland Power in this jurisdiction?</p> <p>10 MR. CICCHETTI:</p> <p>11 A. Not to my knowledge.</p> <p>12 MR. JOHNSON:</p> <p>13 Q. Could it happen in this jurisdiction, to your</p> <p>14 knowledge?</p> <p>15 MR. CICCHETTI:</p> <p>16 A. I don't think it's impossible that it could</p> <p>17 happen. I don't think it's likely. I have no</p> <p>18 reason to believe it would be likely, but it's</p> <p>19 not out of the realm of possibility.</p> <p>20 MR. JOHNSON:</p> <p>21 Q. Would an equity investor have a consideration</p> <p>22 like that in mind?</p> <p>23 MR. CICCHETTI:</p> <p>24 A. Certainly.</p> <p>25 MR. JOHNSON:</p>	<p>1 A. I'm sorry, Mr. Johnson, I don't appear to have</p> <p>2 that same --</p> <p>3 MR. JOHNSON:</p> <p>4 Q. Oh, I'm sorry. I'm looking at page 21.</p> <p>5 KELLY, Q.C.:</p> <p>6 Q. There's another page 21 before the one you're</p> <p>7 looking at. You're looking for the one that's</p> <p>8 got the map on it probably.</p> <p>9 MR. HAYES:</p> <p>10 Q. It's in the 10K. It's another document.</p> <p>11 MR. JOHNSON:</p> <p>12 Q. It's in the 10K? Yeah, for some reason I</p> <p>13 don't have a tab in mine. Page 21 on the</p> <p>14 bottom right.</p> <p>15 MR. CICCHETTI:</p> <p>16 A. I believe I have it.</p> <p>17 MR. JOHNSON:</p> <p>18 Q. So we've covered MGE and its divisions, and</p> <p>19 they also own assets. MG Power owns assets in</p> <p>20 the West Campus Cogen facility in Madison,</p> <p>21 Wisconsin, and the Elm Road Coal Plant under</p> <p>22 construction at Oak Creek. MGE Transco</p> <p>23 Investment owns interest in the American</p> <p>24 Transmission Company through its members, MGE</p> <p>25 and MGE Energy. MGE Construct provides</p>
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<p>1 Q. Let's look to MGE Inc.</p> <p>2 MS. GLYNN:</p> <p>3 Q. MGE is Consent #22.</p> <p>4 MR. JOHNSON:</p> <p>5 Q. There's a fairly convenient description at</p> <p>6 page 21 of these materials at the corporate</p> <p>7 profile.</p> <p>8 MR. CICCHETTI:</p> <p>9 A. Tab 3?</p> <p>10 MR. JOHNSON:</p> <p>11 Q. I don't have a tab, for whatever reason. I've</p> <p>12 just got -- the first cover of mine just deals</p> <p>13 with celebrating 100 years of delivering</p> <p>14 dividends to you.</p> <p>15 MR. SIMMONS:</p> <p>16 Q. That's Tab 3.</p> <p>17 KELLY, Q.C.:</p> <p>18 Q. Which page?</p> <p>19 MR. JOHNSON:</p> <p>20 Q. Page 21. On the left hand column, corporate</p> <p>21 profile, MG Energy Inc. is the parent company</p> <p>22 of Madison Gas and Electric, and its divisions</p> <p>23 which serve natural gas and electric customers</p> <p>24 in south central and western Wisconsin.</p> <p>25 MR. CICCHETTI:</p>	<p>1 construction services for building new</p> <p>2 generation facilities. Central Wisconsin</p> <p>3 Development Corp. promotes business growth in</p> <p>4 MGE's service area, and MAGAEL holds title to</p> <p>5 properties acquired. Now you see up at the</p> <p>6 top right there's a description of MGE</p> <p>7 Electric Services have generation and</p> <p>8 distribution, 137,000 customers, population of</p> <p>9 292,000. Now if you look at page 8 -- so</p> <p>10 you'd have to go back a little bit. No,</p> <p>11 that's wrong, you've got to go further into</p> <p>12 the 10K, I'm sorry. At the bottom of page 7,</p> <p>13 they talk about electric utility operations.</p> <p>14 They say at the very last line, "Electric</p> <p>15 revenues for 2008, 2007, and 2006, were</p> <p>16 comprised of the following", and then you go</p> <p>17 over to the next page, and you see, Mr.</p> <p>18 Cicchetti, residential, 33.9 percent,</p> <p>19 commercial, 54 percent, industrial 6 percent,</p> <p>20 public authorities, including the UW, 9.2</p> <p>21 percent, with 100 percent. Now if you were an</p> <p>22 equity investor, Mr. Cicchetti, would you</p> <p>23 prefer this profile or Newfoundland Power's?</p> <p>24 MR. CICCHETTI:</p> <p>25 A. I would have to look at the entire picture,</p>

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<p>1 and I don't know that just because they have</p> <p>2 54 commercial, it would make one better or</p> <p>3 worse than the other.</p> <p>4 MR. JOHNSON:</p> <p>5 Q. Okay, well, let's be specific about this. If</p> <p>6 we were talking about comparing Newfoundland</p> <p>7 Power's situation as to where it derives its</p> <p>8 electric revenues versus MG - this particular</p> <p>9 utility, where it gets its revenues, which one</p> <p>10 would be safer?</p> <p>11 MR. CICCHETTI:</p> <p>12 A. If you looked at that sole one item, then the</p> <p>13 commercial concentration would make this</p> <p>14 company more risky relative to Newfoundland</p> <p>15 Power, on that one particular item.</p> <p>16 MR. JOHNSON:</p> <p>17 Q. Yeah, I grant you, and why would that be?</p> <p>18 MR. CICCHETTI:</p> <p>19 A. Commercial would be more volatile, more</p> <p>20 susceptible to downturns in the economy,</p> <p>21 depending on how concentrated they were.</p> <p>22 Residential is considered the least risky to</p> <p>23 serve.</p> <p>24 MR. JOHNSON:</p> <p>25 Q. And that's -- residential being less risky,</p>	<p>1 2007, and 2006, MGE's electric energy delivery</p> <p>2 requirements were satisfied by the following</p> <p>3 sources". You see that their purchase power</p> <p>4 is 39.2 percent. They generate coal, with coal</p> <p>5 nearly 52 percent. Natural gas, 6 percent.</p> <p>6 The rest is fairly negligible. Now if you</p> <p>7 were an equity investor, I take it, it follows</p> <p>8 from our discussion a moment ago that</p> <p>9 Newfoundland Power's profile is considerably</p> <p>10 less risky than this one?</p> <p>11 MR. CICCHETTI:</p> <p>12 A. To the extent that they're a wires company,</p> <p>13 transmission and distribution, versus a</p> <p>14 company that is generation, generally</p> <p>15 speaking, yes, but again, you know, each</p> <p>16 company is going to have its differences and</p> <p>17 you need to look at the entire picture.</p> <p>18 MR. JOHNSON:</p> <p>19 Q. Yes, but the devil is in the details, isn't</p> <p>20 it, because after a while these differences</p> <p>21 start mounting up and they start affecting the</p> <p>22 overall picture?</p> <p>23 MR. CICCHETTI:</p> <p>24 A. Well, that's why you have to look at the</p> <p>25 overall picture.</p>
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<p>1 that's accepted conventional wisdom, isn't it?</p> <p>2 MR. CICCHETTI:</p> <p>3 A. I would think so, yes.</p> <p>4 MR. JOHNSON:</p> <p>5 Q. Just like it's accepted conventional wisdom</p> <p>6 that T & D is less risky than companies that</p> <p>7 have generation?</p> <p>8 MR. CICCHETTI:</p> <p>9 A. Generally speaking, yes.</p> <p>10 MR. JOHNSON:</p> <p>11 Q. Why would that be?</p> <p>12 MR. CICCHETTI:</p> <p>13 A. It just has to do -- if you run generation,</p> <p>14 you are subject to a much greater capital</p> <p>15 investment, more susceptible to something</p> <p>16 going wrong, higher operating costs than if</p> <p>17 you were just a wires company and it's just</p> <p>18 passing through cost of transmission and</p> <p>19 distribution.</p> <p>20 MR. JOHNSON:</p> <p>21 Q. Just look to the top of page nine regarding</p> <p>22 fuel supply and generation, and you will see</p> <p>23 "MGE satisfies its customers electric demand</p> <p>24 with internal generation and purchase power.</p> <p>25 During the years ending December 31st, 2008,</p>	<p>1 MR. JOHNSON:</p> <p>2 Q. That's right. Let's look at page 18. Now at</p> <p>3 the very top, they put out in their 10K in</p> <p>4 bold letters, "We face risk for the recovery</p> <p>5 of fuel and purchase power cost when they</p> <p>6 exceed the base rate established in MGE's</p> <p>7 current rate structure". Now, Mr. Cicchetti,</p> <p>8 I won't leave it at that because that would</p> <p>9 leave a false impression, but I do want to</p> <p>10 take you to page 56 where this is explained a</p> <p>11 bit more. You see regulatory recovery risk,</p> <p>12 and I'll just read it, "MGE's electric</p> <p>13 operations burn natural gas in several of its</p> <p>14 peak power plants or as supplemental fuel as</p> <p>15 several coal-fired plants, and in many cases</p> <p>16 the cost to purchase power is tied to the cost</p> <p>17 of natural gas. MGE bears significant</p> <p>18 regulatory risk for the recovery of such fuel</p> <p>19 and purchase power cost when costs are higher</p> <p>20 than the base rate established in its current</p> <p>21 rate structure". The next paragraph says, "As</p> <p>22 noted above in commodity price risk, the</p> <p>23 electric operations of MGE operate under a</p> <p>24 "Fuel Rules" adjustment clause for fuel and</p> <p>25 purchase power costs associated with the</p>

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

17 MR. CICCHETTI:

18 A. But I'm sure -- I've assumed they would hedge
 19 that risk.

20 MR. JOHNSON:

21 Q. Yeah. Does Newfoundland Power have a similar
 22 risk?

23 MR. CICCHETTI:

24 A. No, but again there's going to be individual
 25 differences between these companies, and you

1 MR. CICCHETTI:

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

22 MR. JOHNSON:

23 Q. That's why a lot of these companies, I take
 24 it, would be getting a higher ROE? Could be,
 25 right?

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

7 MR. JOHNSON:

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

13 MR. CICCHETTI:

14 A. Sounds right.

15 MR. JOHNSON:

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

21 MR. CICCHETTI:

22 A. Well, if you want to look at one particular
 23 item --

24 MR. JOHNSON:

25 Q. Yeah, I want to look at one particular item?

1 MR. CICCHETTI:

2 A. An allowed return is one thing, but what we're
 3 calculating using the DCF formula and the
 4 comparable companies, is the required return.
 5 They may have an higher allowed return, but
 6 that stop price and the expected return is
 7 being factored in to the equation and
 8 producing a required return, such that if you
 9 then apply that required return to that
 10 company, you would expect that company to earn
 11 that return and their marketable ratio to come
 12 down accordingly. So just because these
 13 companies might have higher allowed returns
 14 doesn't change the nature of how you calculate
 15 the required return.

16 MR. JOHNSON:

17 Q. Sounds rather mechanical to me, Mr. Cicchetti.

18 MR. CICCHETTI:

19 A. It's a matter of math.

20 MR. JOHNSON:

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

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<p>1 MR. CICCHETTI:</p> <p>2 A. Well, depending --</p> <p>3 MR. JOHNSON:</p> <p>4 Q. What do you think that they would do? Would</p> <p>5 you expect that they'd put in strategies to</p> <p>6 minimize that risk?</p> <p>7 MR. CICCHETTI:</p> <p>8 A. Certainly.</p> <p>9 MR. JOHNSON:</p> <p>10 Q. Yeah, and so they'd try to manage the risk,</p> <p>11 and would you agree with me that they ought to</p> <p>12 be compensated for having to manage that risk?</p> <p>13 MR. CICCHETTI:</p> <p>14 A. It's part of their job.</p> <p>15 MR. JOHNSON:</p> <p>16 Q. No, no, but, in fairness, if a leadership team</p> <p>17 in a company is at risk for a couple of</p> <p>18 million bucks and they're managing that risk</p> <p>19 for the benefit of the shareholder, they</p> <p>20 should get compensated for that in the ROE,</p> <p>21 shouldn't they?</p> <p>22 MR. CICCHETTI:</p> <p>23 A. I'm not sure I follow you. I don't think</p> <p>24 that's the case. I mean, they're there to run</p> <p>25 the company and they get a salary for running</p>	<p>1 includes business risk, and financial risk in</p> <p>2 determining whether or not they're comparable</p> <p>3 to Newfoundland Power.</p> <p>4 MR. JOHNSON:</p> <p>5 Q. Just go down the page of page 18, operating</p> <p>6 risk, "We are affected by weather, which</p> <p>7 affects customer demand, and can affect the</p> <p>8 operation of our facilities. The demand for</p> <p>9 electric and gas is affected by weather. Very</p> <p>10 warm and very cold temperatures, especially</p> <p>11 for prolonged periods, can dramatically</p> <p>12 increase the demand for electricity for</p> <p>13 cooling and heating respectively. Our</p> <p>14 electric revenues are sensitive to the summer</p> <p>15 cooling season, and to a lesser extent, the</p> <p>16 winter heating season". If, as it appears,</p> <p>17 this company is affected by weather and it</p> <p>18 doesn't have it normalized, so it's earnings</p> <p>19 are not protected from it, and we add that,</p> <p>20 should -- other things being equal, should</p> <p>21 they expect that they should be rewarded for</p> <p>22 that in their ROE as opposed to a company that</p> <p>23 doesn't have such protection, or are we back</p> <p>24 to you've got to look at the credit rating?</p> <p>25 MR. CICCHETTI:</p>
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<p>1 the company, and if hedging fuel cost is part</p> <p>2 of their job, I don't understand how --</p> <p>3 MR. JOHNSON:</p> <p>4 Q. Let's put it this way, would it be fair -- you</p> <p>5 take company "A" and company "B", and they are</p> <p>6 identical, okay, except company "A" is at risk</p> <p>7 for fuel costs, okay. Should company "B", who</p> <p>8 is not at risk for fuel cost, expect the same</p> <p>9 return on equity, other things being equal?</p> <p>10 MR. CICCHETTI:</p> <p>11 A. Again now you're looking at one particular</p> <p>12 item and trying to draw a conclusion from it.</p> <p>13 We've already accepted the fact that</p> <p>14 Newfoundland Power has certain clauses that on</p> <p>15 that basis allow them to be less risky in</p> <p>16 those particular areas, and experience</p> <p>17 supportive regulation. That is being taken</p> <p>18 into account in coming up with their bond</p> <p>19 rating, coming up with their financial</p> <p>20 profile, but to try and specifically look at</p> <p>21 one particular thing with this company versus</p> <p>22 another thing with another company, they're</p> <p>23 going to have a job, which is why you look at</p> <p>24 a group, and you have to look at the overall</p> <p>25 picture, which includes total risk, which</p>	<p>1 A. You have to look at the overall picture.</p> <p>2 MR. JOHNSON:</p> <p>3 Q. And the overall picture is encapsulated in the</p> <p>4 credit rating, is it?</p> <p>5 MR. CICCHETTI:</p> <p>6 A. That's one aspect of it, and certainly in</p> <p>7 evaluating their credit rating, Moody's and</p> <p>8 Standard and Poor's, and DBRS, or whoever, is</p> <p>9 going to consider those type of items.</p> <p>10 MR. JOHNSON:</p> <p>11 Q. Well, why do we waste all this time of talking</p> <p>12 about company's business risks, and regulatory</p> <p>13 risks? Why don't we just say, look, you've</p> <p>14 got this credit rating, this is what you get?</p> <p>15 MR. CICCHETTI:</p> <p>16 A. Mr. Johnson, I have people wondering why we're</p> <p>17 going through this particular exercise. I</p> <p>18 could just say that there are differences</p> <p>19 between the companies, and if you go through</p> <p>20 these 10Ks, you will find these types of</p> <p>21 disclosures and disclaimers for various issues</p> <p>22 for all the different companies. It's a part</p> <p>23 of the nature of the regulated electric and</p> <p>24 natural gas business.</p> <p>25 MR. JOHNSON:</p>

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<p>1 Q. You see, the problem I have, and you've</p> <p>2 already agreed earlier, is that you were not</p> <p>3 able to identify one as less risky than</p> <p>4 Newfoundland Power, and I'm wondering if that</p> <p>5 be the case, how it would be fair to customers</p> <p>6 to let's just forget about that, it is what it</p> <p>7 is, all of them don't have the same</p> <p>8 protections as Newfoundland Power, but let's</p> <p>9 get on with it and apply this model.</p> <p>10 MR. CICCHETTI:</p> <p>11 A. Well, again you have to look at Newfoundland</p> <p>12 Power's allowed return, their equity ratio,</p> <p>13 how that translates into their financial</p> <p>14 metrics, and I think that's about the clearest</p> <p>15 way that I can say. Sure there are things on</p> <p>16 the regulatory side and the business risk side</p> <p>17 that are very favourable for them, but you</p> <p>18 have to look at the entire picture and see how</p> <p>19 do these compare, and when we look at the</p> <p>20 investment risk characteristics that I've</p> <p>21 presented, I think -- it's my opinion they are</p> <p>22 comparable overall.</p> <p>23 MR. JOHNSON:</p> <p>24 Q. I take it we'd have no disagreement at all</p> <p>25 that the median -- the median utility in the</p>	<p>1 A. They're compensated for the risk that they</p> <p>2 incur.</p> <p>3 MR. JOHNSON:</p> <p>4 Q. With a return on equity, correct?</p> <p>5 MR. CICCHETTI:</p> <p>6 A. Correct.</p> <p>7 MR. JOHNSON:</p> <p>8 Q. Wisconsin Energy.</p> <p>9 MS. GLYNN:</p> <p>10 Q. Wisconsin Energy is Consent 23.</p> <p>11 (1:30 p.m.)</p> <p>12 MR. JOHNSON:</p> <p>13 Q. Again there's a business description at Tab 1,</p> <p>14 "Wisconsin Energy Corporation is a diversified</p> <p>15 holding company. The company conducts its</p> <p>16 operations primarily in two operating</p> <p>17 segments; a utility energy segment and a non-</p> <p>18 utility energy segment. The company's primary</p> <p>19 subsidiaries include Wisconsin Electric Power</p> <p>20 Company, known as Wisconsin Electric,</p> <p>21 Wisconsin Gas LLC, known as Wisconsin Gas,</p> <p>22 Edison Sault Electric Company, and WE Power</p> <p>23 LLC, WE Power. The company's utility energy</p> <p>24 segment consists of Wisconsin Electric,</p> <p>25 Wisconsin Gas, and Edison Sault. Its non-</p>
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<p>1 United States versus the median utility in</p> <p>2 Canada, Canada would have a higher credit</p> <p>3 rating on the whole than the United States,</p> <p>4 right?</p> <p>5 MR. CICCHETTI:</p> <p>6 A. I think that's fact, yes.</p> <p>7 MR. JOHNSON:</p> <p>8 Q. And just the bottom of page 32, the very last</p> <p>9 paragraph refers to MGE's GCIM. I think this</p> <p>10 gets explained in the context of the</p> <p>11 paragraph. "Under MGE's GCIM, if actual gas</p> <p>12 commodities saving and capacity release</p> <p>13 revenues are above or below a benchmark as set</p> <p>14 by the PSCW, then MGE's gas sales service</p> <p>15 customers and shareholders share in any</p> <p>16 increased cost or savings per percentages set</p> <p>17 by the PSCW". So it's not all put over on the</p> <p>18 customer, it's a shared issue, isn't it?</p> <p>19 MR. CICCHETTI:</p> <p>20 A. I think that's an incentive mechanism.</p> <p>21 MR. JOHNSON:</p> <p>22 Q. That's right, and what's the saying in</p> <p>23 capitalism, "No risk, no reward", right, and</p> <p>24 how do equity investors get rewarded?</p> <p>25 MR. CICCHETTI:</p>	<p>1 utility segment consists primarily of WE</p> <p>2 Power". Now if I could turn you to Tab 2,</p> <p>3 page 5 of 15, you see under utility, this</p> <p>4 company's utility operations are clearly</p> <p>5 electricity generation, distribution, and</p> <p>6 sales. So they are obviously a generator. If</p> <p>7 you turn to Tab 3, and now we're into the 10K,</p> <p>8 there's a description of a utility energy</p> <p>9 segment and their non-utility energy segment.</p> <p>10 That's just for the record, it just confirms</p> <p>11 the previous descriptions from the initial</p> <p>12 business profile, and if you could just look</p> <p>13 to page 12, Mr. Cicchetti, the installed</p> <p>14 capacity by fuel types, this would be a fairly</p> <p>15 sizeable generator of electricity, I take it,</p> <p>16 a total of 5,593 megawatts?</p> <p>17 MR. CICCHETTI:</p> <p>18 A. Yes, that's what it says.</p> <p>19 MR. JOHNSON:</p> <p>20 Q. And page 13 at the bottom, they refer to their</p> <p>21 coal-fired generation. They say under coal</p> <p>22 supply, "We diversify the coal supply for our</p> <p>23 power plants by purchasing coal from mines in</p> <p>24 Wyoming and Colorado, as well as from various</p> <p>25 other western mines. During 2009, 100 percent</p>

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<p>1 of our projected coal requirements of 11.6</p> <p>2 million tons are under contracts, which are</p> <p>3 not tied to 2009 market pricing fluctuations".</p> <p>4 So then does that look to you like they're at</p> <p>5 risk for the price of coal?</p> <p>6 MR. CICCHETTI:</p> <p>7 A. I'm not sure. It could be that they're under</p> <p>8 contracts that are at a set price and not</p> <p>9 based on the market price.</p> <p>10 MR. JOHNSON:</p> <p>11 Q. Let's look over to the next page on coal</p> <p>12 deliveries because this is certainly more</p> <p>13 clear. They've got to get the coal to their</p> <p>14 generating units, and the second paragraph</p> <p>15 states, "Certain of our coal transportation</p> <p>16 contracts contain fuel cost adjustments that</p> <p>17 are tied to the cost of fuel utilized by the</p> <p>18 locomotives. The PSCW has approved a program</p> <p>19 that allows us to hedge up to 75 percent of</p> <p>20 our potential fuel for electric generation in</p> <p>21 order to help manage our risk of higher</p> <p>22 delivered cost of coal. The costs of this</p> <p>23 program are included in our fuel and purchase</p> <p>24 power costs". Now as I read that, they're</p> <p>25 allowed to hedge up to 75 percent, they don't</p>	<p>1 MR. JOHNSON:</p> <p>2 Q. Do you know that for a fact, or is that just</p> <p>3 what you think?</p> <p>4 MR. CICCHETTI:</p> <p>5 A. I'm just making a statement in general.</p> <p>6 MR. JOHNSON:</p> <p>7 Q. Yes, so that's just what you think, that's not</p> <p>8 tied to a fact, that's your impression?</p> <p>9 MR. CICCHETTI:</p> <p>10 A. Correct.</p> <p>11 MR. JOHNSON:</p> <p>12 Q. And under natural gas-fired generation, third</p> <p>13 paragraph down, "The PSCW has approved a</p> <p>14 program that allows us to hedge up to 75</p> <p>15 percent of our estimated gas usage for</p> <p>16 electric generation in order to help manage</p> <p>17 our natural gas price risk. The costs of this</p> <p>18 program are included in our fuel and purchase</p> <p>19 power costs". Similar again, right?</p> <p>20 MR. CICCHETTI:</p> <p>21 A. Yes.</p> <p>22 MR. JOHNSON:</p> <p>23 Q. Just go to page 17. Just for the record, it's</p> <p>24 a further description at the bottom of their</p> <p>25 electric hedging programs.</p>
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<p>1 have a guaranteed recovery of the coal</p> <p>2 transportation costs, do they?</p> <p>3 MR. CICCHETTI:</p> <p>4 A. That appears to be what it says.</p> <p>5 MR. JOHNSON:</p> <p>6 Q. Yeah. So they're at risk and management is</p> <p>7 paid and the investor in that company is paid</p> <p>8 to manage it, right?</p> <p>9 MR. CICCHETTI:</p> <p>10 A. Well, I'm not sure what the details of that</p> <p>11 particular contract are, but I don't know that</p> <p>12 that, in and of itself, is something that has</p> <p>13 increased the risk that an investor might</p> <p>14 consider on average, in general. That's one -</p> <p>15 these are pretty standard, for the most part,</p> <p>16 parts of being in the electric generation</p> <p>17 business.</p> <p>18 MR. JOHNSON:</p> <p>19 Q. In the United States. That's where you're</p> <p>20 going with that, right?</p> <p>21 MR. CICCHETTI:</p> <p>22 A. No, I mean, I -- there are electricities</p> <p>23 generated in Canada also, and these are the</p> <p>24 kind of things that have to be dealt with if</p> <p>25 you're going to generate electricity.</p>	<p>1 CHAIRMAN:</p> <p>2 Q. Mr. Johnson, could you tell us how much longer</p> <p>3 are you going to be? Do you have any -- I</p> <p>4 mean, I'm not trying to --</p> <p>5 MR. JOHNSON:</p> <p>6 Q. No, I know. I would think probably half hour.</p> <p>7 CHAIRMAN:</p> <p>8 Q. Okay. So will we keep going and hopefully</p> <p>9 finish up today?</p> <p>10 MR. JOHNSON:</p> <p>11 Q. That would be perfect with me.</p> <p>12 CHAIRMAN:</p> <p>13 Q. Everybody agree to that?</p> <p>14 KELLY, Q.C.:</p> <p>15 Q. Mr. Chair, I don't know if there's anyone who</p> <p>16 would benefit from a five minute break I'm</p> <p>17 fine to carry on.</p> <p>18 CHAIRMAN:</p> <p>19 Q. Does anybody want to take a short break?</p> <p>20 MR. CICCHETTI:</p> <p>21 A. Mr. Chairman, I would. I don't think it'll</p> <p>22 take me five minutes.</p> <p>23 CHAIRMAN:</p> <p>24 Q. We'll resume when Mr. Cicchetti returns.</p> <p>25 (RECESS)</p>

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<p>1 CHAIRMAN:</p> <p>2 Q. All right, as they said in World War I, once</p> <p>3 more into breach.</p> <p>4 MR. JOHNSON:</p> <p>5 Q. Thank you. Mr. Cicchetti, when we left off,</p> <p>6 we were at the bottom of page 16 discussing</p> <p>7 Wisconsin Energy at Tab 3 and I was just</p> <p>8 identifying for the purposes of the record</p> <p>9 some details about electric hedging programs</p> <p>10 which I think we've already covered. I would</p> <p>11 then turn to page 17 which gives this</p> <p>12 particular utility's breakdown of operating</p> <p>13 revenues by class. And at the top, you'll see</p> <p>14 "Residential - 977,000,000; small commercial</p> <p>15 industrial - 890,000,000; and large commercial</p> <p>16 industrial - 659,000,000. So again, in</p> <p>17 keeping with our previous discussions, this</p> <p>18 would not be on a stand-alone basis as ideal</p> <p>19 as Newfoundland Power's situation?</p> <p>20 MR. CICCHETTI:</p> <p>21 A. With all the previous disclaimers, yes.</p> <p>22 (1:45 a.m.)</p> <p>23 MR. JOHNSON:</p> <p>24 Q. And the previous disclaimers meaning you can't</p> <p>25 take one thing and, yeah, okay. And then at</p>	<p>1 around halfway down, they start by saying "Our</p> <p>2 non-utility energy segment primarily consists</p> <p>3 of WE Power. WE Power is principally engaged</p> <p>4 in the engineering, construction and</p> <p>5 development of electric power generating</p> <p>6 facilities for long-term lease." And then,</p> <p>7 Mr. Cicchetti, they go over on page 43 to say,</p> <p>8 to state what the results of operations are</p> <p>9 regards consolidated earnings. And you will</p> <p>10 see that this outfit has utility energy</p> <p>11 earnings of 581.9 million, but significant</p> <p>12 non-utility energy earnings of 89.3 million</p> <p>13 dollars and there's a corporate and other,</p> <p>14 which I take from that took a loss. So that</p> <p>15 would be a fairly material amount of non-</p> <p>16 regulated earnings for this company?</p> <p>17 MR. CICCHETTI:</p> <p>18 A. Yes.</p> <p>19 MR. JOHNSON:</p> <p>20 Q. And again, that would be a riskier profile to</p> <p>21 Newfoundland Power, I guess it goes without</p> <p>22 saying.</p> <p>23 MR. CICCHETTI:</p> <p>24 A. The question would be how much riskier.</p> <p>25 MR. JOHNSON:</p>
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<p>1 page 18, under "Competition", they indicate, I</p> <p>2 don't know to what extent competition is an</p> <p>3 issue there, Mr. Cicchetti, but there's a</p> <p>4 paragraph that says "Competition in varying</p> <p>5 degrees exists between natural gas and other</p> <p>6 forms of energy available to customers. A</p> <p>7 number of large commercial industrial</p> <p>8 customers are dual fuel customers that are</p> <p>9 equipped to switch between natural gas and</p> <p>10 alternative fuels, but they are allowed to</p> <p>11 offer lower priced gas sales and</p> <p>12 transportation services to these customers.</p> <p>13 So would that be something that would be</p> <p>14 typical in the U.S. environment?</p> <p>15 MR. CICCHETTI:</p> <p>16 A. Fairly typical, yes.</p> <p>17 MR. JOHNSON:</p> <p>18 Q. And would that be a risk to earnings for such</p> <p>19 a utility?</p> <p>20 MR. CICCHETTI:</p> <p>21 A. Certainly.</p> <p>22 MR. JOHNSON:</p> <p>23 Q. Yes. Page 41 deals with corporate</p> <p>24 developments and this is where you get into</p> <p>25 the non-utility. At the second paragraph,</p>	<p>1 Q. But riskier, nevertheless.</p> <p>2 MR. CICCHETTI:</p> <p>3 A. Yes.</p> <p>4 MR. JOHNSON:</p> <p>5 Q. And then at the bottom of page 43, utility</p> <p>6 energy segment contribution to operating</p> <p>7 income, they note 2008 versus 2007 that the</p> <p>8 utility energy segment contributed 581 million</p> <p>9 as we've seen, but then they go on to say</p> <p>10 "during '08, we experienced less favourable</p> <p>11 weather in the summer months which decreased</p> <p>12 electric sales. In addition, our fuel and</p> <p>13 purchase power cost increased primarily as a</p> <p>14 result of the Power Purchase Agreement entered</p> <p>15 into." So again at risk for purchase power</p> <p>16 and weather.</p> <p>17 MR. CICCHETTI:</p> <p>18 A. Again, the standard disclaimers apply.</p> <p>19 MR. JOHNSON:</p> <p>20 Q. Response. Again, an area where Newfoundland</p> <p>21 Power is considerably less risky.</p> <p>22 MR. CICCHETTI:</p> <p>23 A. With the standard disclaimer, yes.</p> <p>24 MR. JOHNSON:</p> <p>25 Q. If we could turn to Allette.</p>

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<p>1 MS. GLYNN:</p> <p>2 Q. And that would be Consent No. 24.</p> <p>3 MR. JOHNSON:</p> <p>4 Q. Tab 2--no actually--yeah, Tab 2 is fine, page</p> <p>5 3 of 14. This again is the Dow Jones Company</p> <p>6 report description. Allette provides energy</p> <p>7 services in the upper mid west and has real</p> <p>8 estate holdings in Florida that operates in</p> <p>9 two segments, regulated operations and</p> <p>10 investments and other. Under regulated,</p> <p>11 that's Minnesota Power and Superior Water,</p> <p>12 light and power company, as well as an</p> <p>13 investment in American Transmission Company, a</p> <p>14 Wisconsin based regulated utility, and it goes</p> <p>15 on and talks about Florida real estate, et</p> <p>16 cetera. If you turn to Tab 1 at page 1 of 2,</p> <p>17 it gives--it talks about large industrial</p> <p>18 customers. "Minnesota Power sells a high</p> <p>19 percentage of its electric power to large</p> <p>20 industrial facilities. Eleven of our</p> <p>21 customers require ten megawatts or more of</p> <p>22 generating capacity. Among these are four</p> <p>23 Taconite products, four papermills and two</p> <p>24 petroleum pipeline companies. Taconite is an</p> <p>25 iron bearing rock important as a raw material</p>	<p>1 investments. But then we go on to see earlier</p> <p>2 in 2007 in '06 that non-regulated operations</p> <p>3 were 14 percent and 17 percent, so even a bit</p> <p>4 more.</p> <p>5 MR. CICCHETTI:</p> <p>6 A. I'm not sure I follow that.</p> <p>7 MR. JOHNSON:</p> <p>8 Q. Oh, I'm sorry, if you just go across the</p> <p>9 table, I was referring to 2007 and 2006.</p> <p>10 MR. CICCHETTI:</p> <p>11 A. Oh, okay.</p> <p>12 MR. JOHNSON:</p> <p>13 Q. Do you see that?</p> <p>14 MR. CICCHETTI:</p> <p>15 A. Yes.</p> <p>16 MR. JOHNSON:</p> <p>17 Q. Now at page 8, this comes back to the Taconite</p> <p>18 and industrial facilities, you'll see they</p> <p>19 have a table there showing industrial customer</p> <p>20 electric sales in 2008 and out of the</p> <p>21 industrial, 64 percent is Taconite; 22 percent</p> <p>22 paper, pulp and wood products and pipelines.</p> <p>23 Now, in the paragraph just below that, Mr.</p> <p>24 Cicchetti, it talks about how beginning in the</p> <p>25 fall of 2008 world-wide steel producers began</p>
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<p>1 source for steel." Now some of these</p> <p>2 industries have been hit in your country, Mr.</p> <p>3 Cicchetti, I take it?</p> <p>4 MR. CICCHETTI:</p> <p>5 A. Yes.</p> <p>6 MR. JOHNSON:</p> <p>7 Q. And hit hard.</p> <p>8 MR. CICCHETTI:</p> <p>9 A. Yes.</p> <p>10 MR. JOHNSON:</p> <p>11 Q. And if you go to page 7 of Tab 3, again it</p> <p>12 gives a breakdown of electric sales and</p> <p>13 customers, and you can see residential, 9</p> <p>14 percent; commercial, 12 percent; industrial,</p> <p>15 57 percent. If you're a shareholder, would</p> <p>16 you be more nervous there than Newfoundland?</p> <p>17 MR. CICCHETTI:</p> <p>18 A. That's one aspect of the business risk that's</p> <p>19 different than Newfoundland, yes.</p> <p>20 MR. JOHNSON:</p> <p>21 Q. And just above that table we have a split</p> <p>22 between regulated operations and non. And I</p> <p>23 see in terms of operating revenue, at least,</p> <p>24 89--what's that, 89 million, is it, for</p> <p>25 regulated operations; 11 million for</p>	<p>1 to dramatically cut steel production in</p> <p>2 response to reduced demand driven by the world</p> <p>3 credit situation. And so, that's not good, is</p> <p>4 it?</p> <p>5 MR. CICCHETTI:</p> <p>6 A. No, but again you have to look at that in</p> <p>7 relation to all the other aspects of the</p> <p>8 company and if it's still considered overall a</p> <p>9 low risk company.</p> <p>10 MR. JOHNSON:</p> <p>11 Q. Now at page 32 of this tab under "outlook",</p> <p>12 they say "Allete has committed to earning a</p> <p>13 financial return that rewards our</p> <p>14 shareholders, allows for re-investment in our</p> <p>15 businesses and sustains growth. Minnesota</p> <p>16 Power's industrial customers are facing weak</p> <p>17 conditions in the market for their products</p> <p>18 and have and may continue to reduce the amount</p> <p>19 of energy they use. We will work to see this</p> <p>20 released energy in the wholesale market and</p> <p>21 believe that our ability to produce energy at</p> <p>22 low cost will be a competitive advantage." So</p> <p>23 they've got no guarantees here if the Taconite</p> <p>24 people can't use the power, right?</p> <p>25 MR. CICCHETTI:</p>

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<p>1 A. Yeah, but there are no guarantees for anyone, 2 including Newfoundland Power. 3 MR. JOHNSON: 4 Q. Newfoundland Power doesn't have a single 5 industrial customer, though, does it? 6 MR. CICCHETTI: 7 A. But it's not a guaranteed return. 8 MR. JOHNSON: 9 Q. Page 34--oh, I'm sorry, page 32 under 10 "Regulated Operations". "Minnesota Power 11 expects significant rate base growth over the 12 next several years as it continues its program 13 to comply with renewable energy requirements 14 and environmental mandates." Again, a 15 distinction from Newfoundland Power that's 16 much more moderate in rate base growth, 17 correct? 18 MR. CICCHETTI: 19 A. Yes, again one of many distinctions. 20 MR. JOHNSON: 21 Q. Could we turn to OGE. 22 MS. GLYNN: 23 Q. OGE Energy will be Consent No. 25. 24 MR. JOHNSON: 25 Q. Tab 2 gives a description of OGE, an energy</p>	<p>1 utility. Are you there? 2 MR. CICCHETTI: 3 A. Yes. 4 MR. JOHNSON: 5 Q. Okay. "Regulated electric utility, 773, 000 6 customers, generating capacity, 6800 7 megawatts, nine power plants, two wind farms, 8 fuel 68 percent coal, 30 percent natural gas, 9 two percent wind." And you see a description 10 of Enogex, LLC, the non-regulated. And then 11 in terms of this contribution of non- 12 regulated, just refer you to page 10 under 13 "Financial Performance". 14 MS. GLYNN: 15 Q. Under Tab 4? 16 (2:00 p.m.) 17 MR. JOHNSON: 18 Q. Under Tab 4, I'm sorry, yes. Mr. Cicchetti, 19 what do these figures tell us about the 20 importance of Enogex to this OGE Energy Corp? 21 MR. CICCHETTI: 22 A. It's a relatively large portion, but it's 23 natural gas transportation and distribution, 24 which is the business that OGE is in, other 25 than that this happens to be an unregulated</p>
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<p>1 services provider offering physical delivery 2 and related services for both electricity and 3 natural gas, primarily in the south, central 4 United States. Company conducts its 5 activities through four business segments, 6 electric utility, natural gas transportation 7 and storage, natural gas gathering and 8 processing, et cetera. And they also 9 reference Enogex which is engaged in the 10 business of gathering process and transporting 11 and storing of natural gas. Are you familiar 12 with Enogex? 13 MR. CICCHETTI: 14 A. Yes. 15 MR. JOHNSON: 16 Q. Are they a big outfit? 17 MR. CICCHETTI: 18 A. Relative to OGE, if you look at sales, all the 19 gas that they transport through their system 20 and that's going to make it look like a larger 21 portion, but that's just a pass through. 22 MR. JOHNSON: 23 Q. Okay, well just--we'll come to it in a second, 24 if we go to Tab 3, we'll get a closer look at 25 Oklahoma Gas and Electric Company, the</p>	<p>1 portion. I wouldn't consider the risk to be 2 substantially greater than the regulated 3 operations, other than from regulation, 4 regulation in and of itself makes the company 5 less risky overall. 6 MR. JOHNSON: 7 Q. What was the Enogex's return on equity in 8 2008? 9 MR. CICCHETTI: 10 A. 24.9 percent. 11 MR. JOHNSON: 12 Q. 2007? 13 MR. CICCHETTI: 14 A. 21.9 percent. 15 MR. JOHNSON: 16 Q. 2006? 17 MR. CICCHETTI: 18 A. 26.2 percent. 19 MR. JOHNSON: 20 Q. Okay, how about Oklahoma Gas & Electric, what 21 was its return on equity average in '08, '07 22 and '06? 23 MR. CICCHETTI: 24 A. 9.3 percent. We are representing them in 25 their rate case.</p>

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<p>1 MR. JOHNSON:</p> <p>2 Q. You are representing -</p> <p>3 MR. CICCHETTI:</p> <p>4 A. Our company is, yes.</p> <p>5 MR. JOHNSON:</p> <p>6 Q. And how about '07?</p> <p>7 MR. CICCHETTI:</p> <p>8 A. 12.0 percent.</p> <p>9 MR. JOHNSON:</p> <p>10 Q. So the shareholders in OGE, I think it's fair</p> <p>11 to say, with Enogex 393 million in gross</p> <p>12 margin on revenues in 2008, compared to</p> <p>13 Oklahoma Gas & Electric Company's gross margin</p> <p>14 on revenue--or I should say the operating</p> <p>15 income of Enogex of 185 million in '08,</p> <p>16 compared to 143 million--I'm sorry, I should</p> <p>17 be looking at the net income line. Net income</p> <p>18 91 million for Enogex in '08 and net income of</p> <p>19 143 million for Oklahoma Gas & Electric</p> <p>20 Company. So, I mean, let's face it, the</p> <p>21 investors in OGE Energy Corp are getting quite</p> <p>22 a lift from the non-regulated side?</p> <p>23 MR. CICCHETTI:</p> <p>24 A. Yes, and those operations are transportation</p> <p>25 and storage of natural gas. It's not that</p>	<p>1 MR. JOHNSON:</p> <p>2 Q. It would get your attention, wouldn't it?</p> <p>3 MR. CICCHETTI:</p> <p>4 A. Certainly.</p> <p>5 MR. JOHNSON:</p> <p>6 Q. Yeah. Page 16, just for the record is another</p> <p>7 breakdown on the bottom left-hand column of</p> <p>8 operating income or loss by business segment</p> <p>9 and it's set out again there for '08, '07 and</p> <p>10 '06. And if I look at--your company is doing</p> <p>11 a rate case for this regulated utility?</p> <p>12 MR. CICCHETTI:</p> <p>13 A. Yes.</p> <p>14 MR. JOHNSON:</p> <p>15 Q. Page 16 on the bottom, it looks to me like</p> <p>16 OGE, OG&E is at risk for weather, would that</p> <p>17 be right?</p> <p>18 MR. CICCHETTI:</p> <p>19 A. Yes.</p> <p>20 MR. JOHNSON:</p> <p>21 Q. Just compare OGE's--what you know about their</p> <p>22 regulatory mechanisms compared to what you</p> <p>23 found out about Newfoundland Power?</p> <p>24 MR. CICCHETTI:</p> <p>25 A. I would say it's, OG&E has good regulation,</p>
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<p>1 much difference, in the past, recent past, how</p> <p>2 it was regulated.</p> <p>3 MR. JOHNSON:</p> <p>4 Q. But what does that--how should that make me</p> <p>5 feel better?</p> <p>6 MR. CICCHETTI:</p> <p>7 A. You'd have to look at the entire operations of</p> <p>8 the company, how much riskier is this non-</p> <p>9 regulated line of business? It's not</p> <p>10 materially that much riskier, it's part of the</p> <p>11 natural gas energy business.</p> <p>12 MR. JOHNSON:</p> <p>13 Q. But wouldn't it affect the equity investors'</p> <p>14 expectation as to what the return is going to</p> <p>15 be from OGE Energy Corp verses what the return</p> <p>16 should be to a shareholder of Newfoundland</p> <p>17 Power?</p> <p>18 MR. CICCHETTI:</p> <p>19 A. I'm sure it comes into consideration, yes.</p> <p>20 MR. JOHNSON:</p> <p>21 Q. How?</p> <p>22 MR. CICCHETTI:</p> <p>23 A. Well they're re-evaluating the entire company.</p> <p>24 I'm sure that 24.9 percent has gotten</p> <p>25 someone's attention.</p>	<p>1 but this is exceptional regulation.</p> <p>2 MR. JOHNSON:</p> <p>3 Q. Yeah, exceptional regulation. And how about</p> <p>4 the deferral accounts that OGE has and the</p> <p>5 protections it has compared to Newfoundland</p> <p>6 Power?</p> <p>7 MR. CICCHETTI:</p> <p>8 A. They have some, but not to, as a percentage</p> <p>9 extent, so I don't have to go on, I'll just</p> <p>10 say all my previously stated disclaimers</p> <p>11 apply.</p> <p>12 MR. JOHNSON:</p> <p>13 Q. Finally I'll just go over the Alliant Energy</p> <p>14 and then I'll call it a day.</p> <p>15 MS. GLYNN:</p> <p>16 Q. Alliant will be Consent No. 26.</p> <p>17 MR. JOHNSON:</p> <p>18 Q. Tab 1, again gives a description of Alliant</p> <p>19 Energy operating as a regulated investor owned</p> <p>20 public utility holding company. "The</p> <p>21 company's primary focus is to provide</p> <p>22 regulated electricity and natural gas service</p> <p>23 to approximately one million electric, and</p> <p>24 approximately 400,000 natural gas customers in</p> <p>25 the mid west through its two public utilities</p>

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<p>1 subsidiaries." It goes on to give further</p> <p>2 descriptions there, but I just would like to</p> <p>3 turn to Tab 4 and page 2, which again gives</p> <p>4 the sales mix of the regulated entity. Are</p> <p>5 you there, Mr. Cicchetti?</p> <p>6 MR. CICCHETTI:</p> <p>7 A. Did you say page 4?</p> <p>8 MR. JOHNSON:</p> <p>9 Q. I'm sorry, Tab 4, page 2.</p> <p>10 MR. CICCHETTI:</p> <p>11 A. I'm there.</p> <p>12 MR. JOHNSON:</p> <p>13 Q. And they're giving the company at a glance,</p> <p>14 who we are, and you'll see their electric</p> <p>15 sales mix, 40 percent industrial; 24 percent</p> <p>16 residential; 20 percent commercial and 15</p> <p>17 percent for resale. They only have 25 percent</p> <p>18 purchase power, the rest they generate, well</p> <p>19 actually no, they purchase nuclear at 17</p> <p>20 percent. I see at page, the same tab, F5,</p> <p>21 there's a reference to a special arrangement</p> <p>22 that companies have in the United States under</p> <p>23 a tax--under the Economic Stimulus Act, page</p> <p>24 F5 under Regulatory Developments. February,</p> <p>25 2008, the Economic Stimulus Act of 2008 was</p>	<p>1 MR. JOHNSON:</p> <p>2 Q. You accept Dr. Booth's evidence as regards the</p> <p>3 inflation forecast for Canada, don't you?</p> <p>4 MR. CICCHETTI:</p> <p>5 A. Yes.</p> <p>6 MR. JOHNSON:</p> <p>7 Q. Yes. But the long-Canada bond yields are</p> <p>8 lower than the risk free rate in the United</p> <p>9 States?</p> <p>10 MR. CICCHETTI:</p> <p>11 A. They're fairly close. Right now, I think as</p> <p>12 of yesterday, the U.S. long rate was about 4. 2</p> <p>13 and the long-term Canada rate was between 3. 95</p> <p>14 and 4 or might have been--yes, at about 3.95.</p> <p>15 MR. JOHNSON:</p> <p>16 Q. Did I see in your evidence or was it in your</p> <p>17 evidence or was it in reply to an RFI that you</p> <p>18 took issue with the fact that there has been a</p> <p>19 recognized difference between the risk premium</p> <p>20 in Canada verses the United States?</p> <p>21 MR. CICCHETTI:</p> <p>22 A. I'm not sure what you're referring to.</p> <p>23 MR. JOHNSON:</p> <p>24 Q. If you could refresh my thinking, I think you</p> <p>25 said that there was no empirical evidence that</p>
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<p>1 enacted which allows a 50 percent bonus tax</p> <p>2 depreciation deduction for certain property</p> <p>3 that is acquired or constructed in '08, that</p> <p>4 would be a part of the stimulus.</p> <p>5 MR. CICCHETTI:</p> <p>6 A. It appears to be so, yes.</p> <p>7 MR. JOHNSON:</p> <p>8 Q. Mr. Cicchetti, you will confirm for the record</p> <p>9 that notwithstanding that market--that</p> <p>10 there's market integration, as we've heard</p> <p>11 between Canada and the United States, that</p> <p>12 that, that you have confirmed in response to</p> <p>13 CA-PUB-15, that that does not mean--and I'm</p> <p>14 referring to 15(c), where we asked you the</p> <p>15 question, can Mr. Cicchetti confirm that</p> <p>16 market integration simply means that capital</p> <p>17 can flow freely between two markets, but that</p> <p>18 dose not mean that the rate of inflation or</p> <p>19 risk is the same. If not, please provide, et</p> <p>20 cetera. And your answer to that was</p> <p>21 confirmed, right?</p> <p>22 MR. CICCHETTI:</p> <p>23 A. Yes, and as I pointed out, reviewing the</p> <p>24 inflation projections for the two countries,</p> <p>25 they are very similar.</p>	<p>1 that was the case, is that ringing a bell now?</p> <p>2 MR. CICCHETTI:</p> <p>3 A. That doesn't ring a bell.</p> <p>4 MR. JOHNSON:</p> <p>5 Q. No?</p> <p>6 MR. CICCHETTI:</p> <p>7 A. There may have been some technical issue why I</p> <p>8 might not have agreed with the question, if</p> <p>9 that's what it was, it just doesn't ring a</p> <p>10 bell.</p> <p>11 MR. JOHNSON:</p> <p>12 Q. Those are my questions, Mr. Cicchetti, thank</p> <p>13 you.</p> <p>14 MR. CICCHETTI:</p> <p>15 A. Thank you.</p> <p>16 CHAIRMAN:</p> <p>17 Q. Okay, I guess--do you have to ask?</p> <p>18 VICE-CHAIR WHALEN:</p> <p>19 Q. No, I don't have any questions.</p> <p>20 CHAIRMAN:</p> <p>21 Q. Back to you then.</p> <p>22 MR. SIMMONS:</p> <p>23 Q. Thank you, Mr. Chairman. Mr. Cicchetti,</p> <p>24 you've been asked to give an undertaking to do</p> <p>25 a recalculation of schedules MAC 10 and 11</p>

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<p>1 using only the companies you have identified</p> <p>2 that have a safety rank of 1. And can I just</p> <p>3 ask you to look first at schedule MAC 8, which</p> <p>4 shows a group of those companies and I'm going</p> <p>5 to 8 because 8 is the one where the safety</p> <p>6 ranking is shown.</p> <p>7 MR. CICCHETTI:</p> <p>8 A. I'm there.</p> <p>9 MR. SIMMONS:</p> <p>10 Q. And on this particular one, if you just use</p> <p>11 the companies that have a safety ranking of</p> <p>12 one, you're going to reduce your selection</p> <p>13 from, I think it's nine companies down to</p> <p>14 three. And I'm must curious as to whether</p> <p>15 reducing your sample of companies that much</p> <p>16 would have any impact, positive, negative,</p> <p>17 neutral, on the usefulness of the information</p> <p>18 that's obtained in the table?</p> <p>19 MR. CICCHETTI:</p> <p>20 A. It's possible, I don't--I'm not anticipating</p> <p>21 any problem, but I can just make that</p> <p>22 calculation for those three and provide it.</p> <p>23 MR. SIMMONS:</p> <p>24 Q. Okay, and if you look at MAC No. 9, it would</p> <p>25 be the same question, the number of companies</p>	<p>1 did the calculations, they hadn't had their</p> <p>2 upgrade yet, and so at the time that was a BBB</p> <p>3 1 for the company and an A from DBRS.</p> <p>4 MR. SIMMONS:</p> <p>5 Q. Is it possible to approximate what the general</p> <p>6 range of S&P bond rating that would be</p> <p>7 equivalent to?</p> <p>8 MR. CICCHETTI:</p> <p>9 A. For the companies that I'm going to pull out</p> <p>10 that are just 1?</p> <p>11 MR. SIMMONS:</p> <p>12 Q. Yes, for the Newfoundland Power bond rating,</p> <p>13 which is the closer to among these ratings on</p> <p>14 the S&P bond rating here?</p> <p>15 MR. CICCHETTI:</p> <p>16 A. It's going to be above, it's going to be</p> <p>17 approximately A+.</p> <p>18 MR. SIMMONS:</p> <p>19 Q. And one of the companies that you've just</p> <p>20 answered question on was MGE Energy Inc., and</p> <p>21 it was pointed out to you a number specific</p> <p>22 features of that company which, when compared</p> <p>23 to the corresponding feature of Newfoundland</p> <p>24 Power, you agreed suggested that for that</p> <p>25 feature, Newfoundland Power appeared to be a</p>
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<p>1 and the sample of comparable gas companies</p> <p>2 would go from six to three.</p> <p>3 MR. CICCHETTI:</p> <p>4 A. Yeah, I certainly feel more comfortable having</p> <p>5 more because if there's any particular anomaly</p> <p>6 between that happens to get washed out when</p> <p>7 you use a group of companies, that's a benefit</p> <p>8 of using a group, but I'm not anticipating any</p> <p>9 particular problem.</p> <p>10 MR. SIMMONS:</p> <p>11 Q. Okay, if I could bring you back to MAC 8 then</p> <p>12 please, there are S&P bond ratings here that</p> <p>13 you've used in this table. Do you know or can</p> <p>14 you tell me how these bond ratings compare to</p> <p>15 the Moody's bond rating for Newfoundland</p> <p>16 Power?</p> <p>17 MR. CICCHETTI:</p> <p>18 A. They're similar.</p> <p>19 MR. SIMMONS:</p> <p>20 Q. Okay, there's a range of readings used here</p> <p>21 ranging from BBB+ up to AA- and at the time</p> <p>22 you prepared your report, the Moody's bond</p> <p>23 rating for Newfoundland Power was what?</p> <p>24 MR. CICCHETTI:</p> <p>25 A. It had actually changed, by the time--when I</p>	<p>1 riskier company than MGE Energy Inc.</p> <p>2 MR. JOHNSON:</p> <p>3 Q. No, the other way.</p> <p>4 MR. SIMMONS:</p> <p>5 Q. Correct, Newfoundland Power is a less riskier</p> <p>6 company than MGE Energy Inc., thank you. The</p> <p>7 safety rank for MG Energy Inc. is 1. Is there</p> <p>8 a safety rank available from the same rating</p> <p>9 agency for Newfoundland Power?</p> <p>10 MR. CICCHETTI:</p> <p>11 A. No.</p> <p>12 MR. SIMMONS:</p> <p>13 Q. The bond rating for MGE Energy is AA-, how</p> <p>14 does that compare to the equivalent, Moody's</p> <p>15 bond rating for Newfoundland Power?</p> <p>16 MR. CICCHETTI:</p> <p>17 A. That's higher and I would just point out I</p> <p>18 hoped that what I said to Mr. Johnson was on</p> <p>19 those specific items that he pointed out, they</p> <p>20 might have been relatively risky, but overall,</p> <p>21 I mean when you look at MGE this way, they</p> <p>22 have a higher bond rating.</p> <p>23 MR. SIMMONS:</p> <p>24 Q. And do you know whether Standard and Poors in</p> <p>25 their methodology would have looked at the</p>

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1 type of factors that were pointed out to you
 2 for MGE Energy when determining that bond
 3 rating?
 4 MR. CICCHETTI:
 5 A. Yes, I'm fairly certain that they have.
 6 MR. SIMMONS:
 7 Q. Thank you, I have no other questions, Mr.
 8 Chairman.
 9 CHAIRMAN:
 10 Q. Well, I guess that concludes today and it's
 11 not necessary, therefore, to sit tomorrow, I
 12 believe we've agreed. So we're back next
 13 Tuesday, is it?
 14 MS. GLYNN:
 15 Q. No, Monday, Mr. Chairman.
 16 CHAIRMAN:
 17 Q. Monday, is it?
 18 MS. GLYNN:
 19 Q. Company witnesses are Monday.
 20 CHAIRMAN:
 21 Q. Okay, I want to thank our two cost of capital
 22 witnesses and the third one -
 23 MR. JOHNSON:
 24 Q. He had to leave, Mr. Chairman.
 25 CHAIRMAN:

1 CERTIFICATE
 2 I, Judy Moss, hereby certify that the foregoing is
 3 a true and correct transcript in the matter of
 4 Newfoundland Power's 2010 General Rate Application
 5 heard on the 22nd day of October, A.D., 2009 before
 6 Commissioners of the Public Utilities Board, Prince
 7 Charles Building, St. John's, Newfoundland and
 8 Labrador and was transcribed by me to the best of
 9 my ability by means of a sound apparatus.
 10 Dated at St. John's, Newfoundland and Labrador
 11 this 22nd day of October, A.D., 2009.
 12 Judy Moss

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1 Q. He's gone, but I think the quality of your
 2 presentation is exceptional and has given the
 3 Board much food for thought.
 4 MR. CICCHETTI:
 5 A. Thank you, Mr. Chairman.
 6 CHAIRMAN:
 7 Q. So with that, we will adjourn until Monday
 8 morning at 9:00.
 9 Upon concluding at 2:15 p.m.

NP's 2010 General Rate Application

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