OCTOBER 19, 2015
(9:00 a.m.)
CHAIRMAN:
Q. Good morning. Before we move to our witness, I believe there are some preliminary matters.
MS. GLYNN:
Q. Just an undertaking, Mr. Chair.
MS. PENNELL:
Q. Good morning, we have two undertakings this morning; Undertaking 40, which is the Minutes from the Joint Utilities meeting, and Undertaking 51, which is a breakdown of the positions of the additional FTEs included in our 2014 and 2015 test years.
CHAIRMAN:
Q. Okay. So we're now ready to go to Mr. Rolph.
MR. BRAD ROLPH (SWORN) EXAMINATION-IN-CHIEF BY MAUREEN GREENE, Q.C.:
GREENE, Q.C.:
Q. Good morning, Mr. Rolph. For the record, what is your name and your current position?
MR. ROLPH:
A. My name is Brad Rolph. I'm a partner at Grant Thornton Consulting, a subsidiary of Grant Thornton LLP. I'm leader of Grand Thornton's

transfer pricing practice in Canada. I'm also the tax service line leader for Southern Ontario.
GREENE, Q.C.:
Q. Could you please outline your academic background?
MR. ROLPH:
A. I obtained a BA in Economics from Wilfred Laurier University, an MA in Economics from Queens University, and I've completed the course work and the comprehensive theory exams in economics at York University.
GREENE, Q.C.:
Q. And that's at the Ph.D level?
MR. ROLPH:
A. Yes.
GREENE, Q.C.:
Q. Please outline your work experience?
MR. ROLPH:
A. I have over 20 years of transfer pricing experience, the last two of which with Grand Thornton. Prior to joining Grant Thornton, I held senior positions at two transfer pricing boutiques, and I was a partner at Deloitte's between 2000 and 2009. I've advised multi-

national companies from a wide cross section of industries, including a Finnish utility company with regulated and unregulated subsidiaries. I've dealt with a variety of inter-company transactions, including the allocation of centralized management and administrative services and expenses.
GREENE, Q.C.:
Q. You stated that you're Grant Thornton's national leader of transfer pricing practices in Canada and the Americas. Could you please explain what transfer pricing involves?
MR. ROLPH:
A. Transfer pricing deals with the price charged for physical goods, intangible assets and services that are bought, licenced, or sold between related parties, also known as non-arms length parties.
GREENE, Q.C.:
Q. Could you please explain how the principles of transfer pricing are involved with respect to the guidelines to be used in determining the appropriate fees to be charged by Hydro in providing services to affiliated companies in the Nalcor Group, and for services rendered

for Hydro by an affiliated company?
MR. ROLPH:
A. When related parties transact with each other, the potential exists for them to determine and use a price that can disadvantage one party over the other, but on the whole generates a benefit for the corporate group. This situation is a critical issue for tax administrators worldwide. Cross border transfer pricing lies at the core of concerns expressed by tax administrators regarding the ability of multi-national companies to reduce their effective corporate tax rate through the use of inappropriate transfer pricing. Although the affiliate transactions involving Hydro do not transpire across international borders, there exists the potential for the parties to determine and use a transfer price for the affiliate transactions I evaluated that might affect the price or the rate at which users pay for electricity in the province.
GREENE, Q.C.:
Q. Please outline your experience in providing assistance for litigation with respect to

transfer pricing?

MR. ROLPH:

A. I assisted counsel representing a Canadian taxpayer in the discovery process for a matter that was before the Tax Court of Canada earlier this year. I have prepared expert reports in anticipation of litigation for counsel representing Canadian taxpayers that address transfer pricing adjustments reassessed by the Canada Revenue Agency. Two of these matters are currently before the Tax Court of Canada. The remaining matters were settled without me having to provide evidence at trial.

GREENE, Q.C.:

Q. So this is the first time that you have actually given evidence in a hearing in a matter?

MR. ROLPH:

A. Yes.

GREENE, Q.C.:

Q. You've been retained by the Board to provide expert testimony on Hydros inter-company transactions costing guidelines, and you've prepared two reports; the first dated April

25th, 2014, on the original application, and the second dated June 1st, 2015, on Hydro's amended application. Do you adopt both reports as your evidence?

MR. ROLPH:

A. I do.

GREENE, Q.C.:

Q. You also prepared responses to requests for information on your reports. Do you adopt these responses as your evidence?

MR. ROLPH:

A. I do.

GREENE, Q.C.:

Q. You stated in your report that the evaluation framework you used to review Hydro's inter-company costing guidelines was based on your own experience and expertise, and on guidance from managerial and accounting literature, utility industry practice, and tax administration guidance. Would you please explain first what was the utility industry experience you considered?

MR. ROLPH:

A. The utility experience I considered is detailed in Appendix B of my report. I used

information from Industry Canada and the Electricity Forum's database of utilities companies first to identify Canadian utility companies. I then relied on the allocation method used by the largest utility company, that's with the largest revenues in each province, with the exception of Newfoundland and Labrador, to represent the allocation methods used by utility companies in that province.

GREENE, Q.C.:

Q. Did you review Newfoundland Power's inter-affiliate code of conduct and what is its applicability or relevance to Hydro's guidelines for charges for inter-company transactions?

MR. ROLPH:

A. I have reviewed Newfoundland Power's inter-affiliate code of conduct. It establishes standards and conditions for interactions between Newfoundland Power and its utility and non-utility affiliates. These affiliate transactions are by definition "between related parties". To be useful as a reliable benchmark, the price charged in a transaction

must involved two unrelated parties, also known as arms-length parties. I believe that Newfoundland Power's inter-affiliate code of conduct does provide some evidence of its practices that may be of assistance to the board in this matter.

GREENE, Q.C.:

Q. You've explained that you also looked at tax administration guidelines in preparing your report. Why is tax administration guidance useful here?

MR. ROLPH:

A. As I explained earlier, the tax administrators are very concerned about cross border transfer prices. They are concerned that multi-national companies can reduce their effective corporate tax rate through the use of inappropriate transfer prices. As a result, there's been significant work done by the Organization for Economic Cooperation and Development, the OECD, that provides guidance regarding the proper application of the arms-length principle. That's the international norm for establishing arms-length transfer prices. Again although the affiliate transactions involving Hydro do not transpire across international borders, there exists the potential for the parties to determine and use a transfer price for the affiliate transactions that might affect the rate at which users pay for electricity in the province. To mitigate this risk, regulated utilities generally require the use of the lower of the market price for shared service or the cost of that shared service to determine the amounts to be charged to affiliates. This is akin to an application of the arms-length principle.

GREENE, Q.C.:

Q. Please explain how you completed the work necessary to provide your opinion and what documentation did you review?

MR. ROLPH:

A. To prepare my report, I reviewed Hydro's 2013 amended GRA, including Hydro's inter-company costing guidelines. I submitted and reviewed the responses to over 100 questions during the RFI process. I reviewed relevant accounting literature, industry practices, and tax administration guidance.

GREENE, Q.C.:

Q. Turning now to the principles Hydro does use with respect to inter-company charges, first Hydro does provide certain common services in the areas of human resources, safety and health, and information services to other companies in the Nalcor Group. How does Hydro charge for these human resources, safety and health services, and is Hydro's approach reasonable?

MR. ROLPH:

A. So based on the evidence submitted by Hydro, it determines the amount charged for rendering human resource and safety and health services to Nalcor and its other lines of business based on an indirect cost recovery method without a markup. It calculates the human resource and safety and health related cost to be recovered by adding the relevant operating expenses, such as salary and fringe benefits, office supplies, and professional fees. It then subtracts from that amount any recharges for corporate services rendered to Nalcor or one of its other business lines. In the case of human resource related cost, it also

subtracts payroll taxes and any advertising costs initially borne by Hydro that are charged back to Nalcor as another expense. Hydro then allocates costs to be recovered based on FTEs. In my opinion, it's reasonable for Hydro to determine the amount to charge for rendering human resource and safety and health services to Nalcor and its other lines of business using this approach.

GREENE, Q.C.:

Q. Another common service Hydro provides is information system services, and could you please explain how Hydro does charge for these services and whether its approach is reasonable in your opinion?

MR. ROLPH:

A. So based on the evidence submitted by Hydro, it determines the amount charged for rendering information system services to Nalcor and its other lines of business based on the indirect cost recovery method without a markup. It calculates the information systems cost to be recovered by adding relevant operating expenses, depreciation, and a return on rate base for capitalized relevant common assets,

such as servers and software. It then subtracts any recharges for corporate services rendered to Nalcor or one of its other business lines, and software maintenance costs initially borne by Hydro, they are charged back as another expense to Nalcor, or one of its other business lines. Hydro then allocates these costs to be recovered based on average number of users. In my opinion, it's reasonable for Hydro to determine the amount to charge for rendering information system services to Nalcor and its other lines of business using this approach.

GREENE, Q.C.:

Q. In your report, you said, "These common services related cost might not be full burdened, and as a result Hydro's charges for the common service it provides might be understated". Could you please explain why you think this may be the case?

MR. ROLPH:

A. I thought there was two potential issues that warranted further investigation. The first involves the inclusion of payroll taxes in the HR department's miscellaneous expense line

Page 13

item. Hydro's HR department is responsible for administrating payroll related activities in all of Nalcor's lines of business. There was no indication in the evidence what these payroll tax related expenses were and whether they related to Hydro employees or employees of its affiliates. If these payroll taxes are attributed to Hydro employees providing common services, then these payroll taxes should be included in the cost base to be recovered. The second issue involves the way in which Hydro allocates common expenses. There was no indication in the evidence that Hydro included in its cost to render common services an amount to account for the HR department's share of common expenses, for example. The same is true of safety and health, and the information systems department. If it is the case that Hydro has not allocated share of common expenses internally, then the cost to be recovered for rendering common services are not fully burdened, and as a result the charge for common services to Nalcor and its other lines of business would be understated.

GREENE, Q.C.:

Page 14

Q. You also expressed an opinion in your report that there should be no markup on the common services unless the recipient of the services included private interests and was not a wholly owned Crown entity. Why, in your opinion, is the ownership of the entity relevant and how did it influence your opinion?

(9:15 a.m.)

MR. ROLPH:

A.

GREENE, Q.C.:

Q. Nalcor and Hydro are provincial Crown corporations, and as a result are not subject to tax. Consequently, relying on a tax implications for guidance in this matter, as I would in the transfer pricing matter, would be ineffective. So alternatively, I considered whether the absence of a markup would create an inappropriate subsidy. So first I considered the implications of Nalcor marking up the cost of rendering certain corporate services to Hydro. Such a markup would increase Hydro's revenue requirements and the rates that it would charge its customers. For

Page 15

this reason, I believe that applying a markup to the cost of rendering corporate services to Hydro would be inappropriate. I believe that the same answer applies to situations in which Hydro is providing common or corporate services for the benefit of public energy projects to its affiliates. To do otherwise would create a situation in which Hydro's revenue requirement would decline at the expense of Nalcor, one of the public energy projects of the other lines of business or the province. However, not all of Nalcor's energy projects are entirely publicly owned. Some of its energy projects are partially owned by other provincial governments or private interests. In the context of energy projects involving private interests, in the absence of a markup on the cost of rendering common services or corporate services for the direct benefit of these private energy projects, it would lower the amount charged for such services and increase the profits generated by these projects for the benefit of the private interests. This outcome would create an inappropriate subsidy at the expense of Hydro

Page 16

and its customers. For this reason, I believe that should Hydro render services to Nalcor or one of its other lines of business for the benefit of an energy project involving private interests, the cost of rendering such services should be marked up by an arms-length amount.

GREENE, Q.C.:

Q. Has this principle of determining whether there should be a markup based on the ownership of the entities been applied by any other Canadian regulator?

MR. ROLPH:

A. No, not that I have found.

GREENE, Q.C.:

Q. For the Canadian utilities included in your survey in Appendix B of your report, the nine utilities, I believe, did you determine whether any of these companies apply a markup on common services or corporate services rendered to affiliated companies?

MR. ROLPH:

A. No, not that I have found.

GREENE, Q.C.:

Q. If a markup were to be applied, what would be reasonable for it?

Page 17

MR. ROLPH:
A. In my report, and in response to RFIs regarding my report, I indicated that should Hydro render services to Nalcor or one of its line of businesses for the benefit of energy project involving private interests, the cost of rendering such services should be marked up by an arms-length amount between 2 and 5 percent. This range was based on guidance for determining a markup for low value adding inter-group services provided by the OECD, which appeared in a draft of a document release prior to the submission of my report dated June 1st, 2015. The OECD has since finalized that document and in it amended the guidance to replace the range with a single markup of 5 percent. For this reason, if a markup were to be applied to the common services rendered by Hydro, it would be reasonable for Hydro to apply a 5 percent markup.
GREENE, Q.C.:
Q. In your report, you suggested that clarification should be provided by Hydro about common services charged to Nalcor and

Page 18

its affiliated companies. Did you seek clarification in preparing your report on this issue and what was Hydro's response?
MR. ROLPH:
A. I sought clarification from Hydro to determine which of Nalcor's other lines of businesses were allocated an amount for common services. In its response, Hydro indicated that listing the entities and the amounts that were allocated to each entity was not relevant for the understanding of the issue.
GREENE, Q.C.:
Q. In your opinion, why is it important to know what common services were charged to other entities in the Nalcor Group?
MR. ROLPH:
A. There's two reasons why I think it's important to identify which entities have been allocated cost for common services. The first is transparency. The information would be required to ensure that Hydro has implemented its affiliated pricing policy properly. The second is that not all of Nalcor's energy projects are entirely publicly owned, as I indicated. Some of them are partially owned

Page 19

by private interests. In the absence of that markup on costs rendering the common services or corporate services for the direct benefit of an energy project involving these private interests, it creates an inappropriate subsidy at the expense of Hydro and its customers.
GREENE, Q.C.:
Q. Turning now to common expenses, Hydro initially pays certain common expenses on behalf of itself and other companies in the Nalcor Group and then charges them back. Could you explain first how Hydro charges for rental costs and whether its practice in this regard is reasonable?
MR. ROLPH:
A. From the evidence submitted by Hydro, it determines the amount charged for renting the floor space occupied at Hydro Place by Nalcor and its other lines of business, based on an indirect cost recovery method without a markup, it calculates the building rental costs by recovering or to be recovered by adding relevant operating expenses, depreciation, and a return on rate base for capitalized relevant common assets such as

Page 20

furniture, printers, and fax machines. It then allocates its building rental costs based on the amount of office space occupied and a square footage rental charge. In my opinion, it's reasonable for Hydro to determine the amount to charge for renting office space to Nalcor and its other lines of business using this approach.
GREENE, Q.C.:
Q. How does Hydro charge back for another common expense, telephone infrastructure related cost, and is its approach reasonable?
MR. ROLPH:
A. Based on the evidence submitted by Hydro, it determines the amount charged for telephone infrastructure used by Hydro and its other lines of business based on an indirect cost recovery method without a markup. It calculates the telephone infrastructure cost to be recovered by dividing the LAN costs provided by the network service department by the total number of LAN ports to derive a cost per user, and then divides the telephone cost provided by the network services department and divides it by the number of telephones,

Page 21

fax, and modem lines to derive a cost per telephone per user. It then allocates its telephone infrastructure costs using the average number of users for each of the business lines. In my opinion, it's reasonable for Hydro to determine the amount to charge for providing telephone infrastructure to Nalcor and its other lines of business using this approach.

GREENE, Q.C.:

Q. How does Hydro charge back the other common expenses that it initially incurs and is its approach reasonable?

MR. ROLPH:

A. Based on evidence submitted by Hydro, it determines the amount charged for other expenses paid initially by Hydro, but attributable to Nalcor or one of its other lines of business based on a direct cost recovery without a markup. In my opinion, it is reasonable for Hydro to determine the amount to charge for these other expenses initially paid by Hydro, but attributable to Nalcor or one of its line of businesses using this approach. I have highlighted in my

Page 22

report certain transactions about which the Board may want further clarification to ensure that Hydro has implemented its transactions in accordance with this aspect of its affiliate pricing policy.

GREENE, Q.C.:

Q. Like common services, you also suggested that Hydro should provide information on the common expenses that it charges Nalcor and other entities in the Nalcor Group. Did you also try to get this clarification in preparing your report and what was Hydro's response?

MR. ROLPH:

A. I sought clarification from Hydro to determine the initial amounts it paid, and the amount charged back to Nalcor or one of its other lines of business for these other expenses that were attributable to them. In its response, Hydro did not provide the requested information because it submitted that to do so was unduly onerous and the time effort and expense involved in providing the requested information was not warranted for the understanding and assessment of the issues before the Board.

Page 23

GREENE, Q.C.:

Q. Why, in your opinion, is this clarification necessary?

MR. ROLPH:

A. Transparency. The information will be required to ensure that Hydro has implemented this aspect of its affiliate pricing policy properly.

GREENE, Q.C.:

Q. Turning to the last area of corporate services, Hydro and the other entities in the Nalcor Group provide corporate services to each other. How are the charges for such services determined and is Hydro's approach reasonable?

MR. ROLPH:

A. Nalcor and its affiliates determine the amount charged to each affiliate for which corporate related services are rendered based on a direct charge method, without including a profit margin. The amount charged by Nalcor or any of its lines of business, including Hydro, for corporate related services rendered is based on the amount of time spent by an employee performing the service and the

Page 24

employee's labour rate. An employee's labour rate is determined on a cost recovery basis designed to recover salary, benefits, and indirect costs overhead. It doesn't include a profit margin. The labour rate includes a billing rate and a fixed charge. The billing rate is determined based on an employee's hourly wage amount, plus a variable component that for the 2014 and 2015 test years was equal to 57 percent of the hourly wage amount. The billing rates are reviewed annually and updated accordingly. The fixed charges are intended to recover overhead costs directly associated with employees rendering the corporate related services.

GREENE, Q.C.:

Q. You mentioned that the labour rates used are fully burdened and the proxy used to determine the fringe benefits portion should be reevaluated annually. You also indicated at the time of writing your report the rate for this was 57 percent. Hydro has now indicated that its increased to 68 percent. Have you reviewed this increase in that rate?

MR. ROLPH:

Page 25

A. No, I have not reviewed this increase, nor did I audit or verify the accuracy of the 57 percent. The variable component of the billing rate is intended to cover such costs as Canada Pension Plan, Public Service Pension Plan, insurance, payroll taxes, bonuses, and leave, all of which are costs that should be recovered by the affiliate rendering the corporate service.

GREENE, Q.C.:

Q. In your report, you also recommended that for these corporate services, as for common services, there be no markup unless the ultimate recipient included some privately owned interest. Is your rationale for the position for corporate services the same as you've already expressed for common services?

MR. ROLPH:

A. Yes.

GREENE, Q.C.:

Q. In reviewing the charges for the time charged to Hydro for corporate services, did you audit or look at the amount of time to verify the accuracy of the hours recorded as services for Hydro or whether the corporate and common

Page 26

services provided or forecast for 2015 were appropriate?

MR. ROLPH:

A. No, I did not audit or verify the accuracy of the hours reported for rendering corporate services. To be clear, I also did not audit or verify whether the common or corporate services had been rendered or whether they had been rendered effectively or efficiently. I relied entirely on evidence submitted by Hydro.

(9:30 a.m.)

GREENE, Q.C.:

Q. Are you familiar with Hydro's policies for recording time spent on non-Hydro matters and Nalcor's policy for recording time spent on Hydro matters, and are these policies reasonable in your opinion?

MR. ROLPH:

A. So based on the evidence submitted by Hydro, Nalcor employees that perform corporate related services, including those at Hydro, are required to complete weekly time sheets which allocate their time to specific work orders. Time is coded in 30 minute

Page 27

increments. In my opinion, time should be allocated to specific work orders on a daily basis and submitted weekly. There's no rule of thumb that I know of regarding best practices in terms of minute increments, however, I would recommend that time be coded in 30 minute increments - 15, sorry, minute increments.

GREENE, Q.C.:

Q. And finally, Mr. Rolph, in your opinion should Hydro be required to report to the Board on inter-company transactions, and if so, on what frequency?

MR. ROLPH:

A. Yes, I believe that Hydro should be required to report its inter-company transactions to the Board. I would recommend an annual review of inter-affiliate transactions that describes all the services rendered, the cost charged back to and from the affiliates, the amounts involved and the methods used for determining those amounts.

GREENE, Q.C.:

Q. Thank you, Mr. Rolph. That completes Mr. Rolph's direct examination, Mr. Chair.

Page 28

CHAIRMAN:

Q. I believe we're over to Newfoundland Hydro now.

MR. CASS:

Q. We have no questions, Mr. Chair. Thank you.

CHAIRMAN:

Q. Okay. Newfoundland Power.

MR. O'BRIEN:

Q. I do have some questions, Mr. Chair.

MR. BRAD ROLPH - CROSS-EXAMINATION BY MR. LIAM O'BRIEN:

MR. O'BRIEN:

Q. Good morning, Mr. Rolph.

MR. ROLPH:

A. Good morning.

MR. O'BRIEN:

Q. In terms of - I'm going to try to stick with your second report, I guess, the June, 2015 report. I wonder if we could have a look at page one of that report, lines 12 to 15, just to get an idea of your assignment and I think you've covered that off in the end here of some of the questions I had with your questioning with Ms. Greene, but your assignment was really to focus on the reasonableness of the methods of Hydro, is

that correct?
MR. ROLPH:
A. That is correct.
MR. O'BRIEN:
Q. And you didn't perform any auditing services, obviously, with respect to whether or not those methods had been performed appropriately or in accordance with policy?
MR. ROLPH:
A. I did not.
MR. O'BRIEN:
Q. Okay, and that goes for all of the common expenses, common services, and corporate services as well?
MR. ROLPH:
A. It does.
MR. O'BRIEN:
Q. And I presume that were you to be asked to do that, that would be quite a task, would it be?
MR. ROLPH:
A. As an economist, yes.
MR. O'BRIEN:
Q. Okay, it would involve a full audit of services and time sheets and that sort of thing?

MR. ROLPH:
A. It would.
MR. O'BRIEN:
Q. And it wouldn't be something that would fall within your purview, would it?
MR. ROLPH:
A. Not necessarily.
MR. O'BRIEN:
Q. Is it something you've ever been asked to do before?
MR. ROLPH:
A. In the context of income tax audits, I've helped taxpayers to prepare such information.
MR. O'BRIEN:
Q. Okay.
MR. ROLPH:
A. So it can be done.
MR. O'BRIEN:
Q. It can be, sure, okay.
GREENE, Q.C.:
Q. Excuse me for a moment. I think some of the parties are having difficulty hearing.
MR. O'BRIEN:
Q. I'm sorry, microphone is not in, okay.
GREENE, Q.C.:

Q. Yes, can you speak more closely to the microphone, Mr. Rolph.
MR. ROLPH:
A. Sorry.
MR. O'BRIEN:
Q. Can I ask that we turn to the CV of Mr. Rolph. I believe it's at page 61. I just had a few questions for you on that, and you've answered some of them. Just in terms of your experience with recent transfer pricing engagements, so page 61, and I just wanted to get a flavour sort of what types of engagements you were involved in. This A.2.1, TESCM, what does that stand for?
MR. ROLPH:
A. Tax Efficient Supply Chain Management.
MR. O'BRIEN:
Q. Okay, and the engagements under that heading, what types of things are we looking at there? Is anything involving utilities there that you would have engaged in?
MR. ROLPH:
A. Not in that particular space, no.
MR. O'BRIEN:
Q. And in what areas would you have been involved

in engagements with utilities?
MR. ROLPH:
A. The engagements that I have done with utilities predominantly involving loans transactions.
MR. O'BRIEN:
Q. And that's under the financial transactions section?
MR. ROLPH:
A. Yes.
MR. O'BRIEN:
Q. I believe you mentioned a Finnish utility company and that's one of the ones under here I see mentioned, but that would be the extent of your involvement in transfer pricing type issues with utilities?
MR. ROLPH:
A. In that particular case, yes.
MR. O'BRIEN:
Q. Okay. In terms of - there's a number of areas if we scroll up, if we look, there's alternative dispute resolution, and advanced pricing arrangements, and expert witnesses. Apart from those financial transactions, you weren't involved in any utility engagements in

those areas, were you?
MR. ROLPH:
A. Not at that time, no.
MR. O'BRIEN:
Q. And this is obviously the first time you're testifying in terms of a utility engagement, is that right?
MR. ROLPH:
A. It is.
MR. O'BRIEN:
Q. I had mentioned to Ms. Greene on Friday that I might run through just a few points with some recent - I shouldn't say "recent", some orders from the Board with respect to these types of issues involving Newfoundland Power. I wonder if I could ask that we pull up Order PU-19, 2003, and if we could look at page 57.
MS. GRAY:
Q. Yes.
MR. O'BRIEN:
Q. Okay, scroll down just a little bit here, okay, and we see, "Newfoundland Power will be required to observe the following principles in all inter-corporate transactions". So there's a number of principles that the Board

had required Newfoundland Power to follow with respect to their inter-corporate transactions. I just want to run through those just a little bit with you just to see if those are the types of principles that you would see applicable to these types of transactions. The first one being, "All inter-corporate transactions between a utility and its affiliates shall be fully transparent and are subject to scrutiny by the Board", and I know that you had mentioned transparency a couple of times in your testimony. Would you agree with that principle as being appropriate?
MR. ROLPH:
A. I would agree with that principle as being appropriate. It's akin to a taxpayer being able to provide evidence that its charges or expenses are reasonable. I can see -
MR. O'BRIEN:
Q. So you would agree that that would be appropriate, okay, and the second one there, "A utility shall have a right to manage its affairs, but must demonstrate to the satisfaction of the Board that all affiliate transactions are prudent", would you agree

with that principle as appropriate?
MR. ROLPH:
A. I would agree with that principle. In a tax context, the service recipient needs to benefit from the service. I think that's what that is trying to get to.
MR. O'BRIEN:
Q. And in terms of prudency, I guess, based on the fact that you haven't performed an audit in this case, you couldn't comment on that with respect to Hydro's application here and its services, is that right?
MR. ROLPH:
A. That's right.
MR. O'BRIEN:
Q. And the third one, "A utility shall ensure that inter-corporate transactions will not disadvantage the interest of rate payers, and furthermore that rate payers and the utility will derive some demonstrable benefit from such transactions". I wonder could you comment on that principle?
MR. ROLPH:
A. So the first part of that principle, I believe, would be akin to adherence to an

arms-length principle, so that the transactions needs to be priced properly and that both the utility and the rate payers are getting a benefit, as I described earlier, from services that are being provided.
MR. O'BRIEN:
Q. So would the two be, not disadvantaging the interest of the rate payers and showing a demonstrable benefit, are they the same thing or are they two different things in your mind?
MR. ROLPH:
A. I suspect that - so they're two different things of a similar item.
MR. O'BRIEN:
Q. Okay.
MR. ROLPH:
A. Let me explain.
MR. O'BRIEN:
Q. Sure.
MR. ROLPH:
A. The service recipient needs to effectively require the service, so has a choice of whether it's going to do the service in-house using its own people or whether it's going to out source effectively that service, and it

Page 37

could be provided by a related party or could be provided by a third party, but in essence it needed the service to be rendered in order to operate its business. So that's the - I think, in number three. The prudent part might come with respect to how much one is paying for that service, and whether you are using a Rolls Royce version of service versus a Camry version of service. I mean, whether or not that's prudent is not up to me.

MR. O'BRIEN:

Q. Is it possible that a rate payer, say, would not be disadvantaged by a transaction, but in the same vein doesn't benefit from the transaction either?

MR. ROLPH:

A. Could you repeat that question?

MR. O'BRIEN:

Q. Is it possible that, say, an entity would not be disadvantaged by a transaction, but also wouldn't necessarily benefit from the transaction either? I guess that was my point with number three, or does it need to be - does there need to be a benefit as long as you're not disadvantaged?

Page 38

MR. ROLPH:

A. If I'm not receiving a benefit, why would I enter into the transaction.

(9:45 a.m.)

MR. O'BRIEN:

Q. I think that's a fair point. I'm wondering whether or not the two are mutually exclusive, not being disadvantaged, and while the Board would say, "And furthermore, the rate payers and the utility will derive some demonstrable benefit", it doesn't seem that particular sentence suggests that the two are mutually exclusive.

MR. ROLPH:

A. I'm not sure that they can be.

MR. O'BRIEN:

Q. Okay, the fourth one there, "The onus is on the utility to show that it is in compliance with the guidelines and principles with respect to the inter-corporate transactions", would you take issue with that?

MR. ROLPH:

A. I would not.

MR. O'BRIEN:

Q. And there's one other that I wanted to point

Page 39

to you, and I wonder if we could bring up an order of the Board, PU-32, 2007, page 30. I'm sorry, page 35. Under Board findings, if we can find the statement here - the second last paragraph of that page, I believe. Okay, the first sentence there, "The Board accepts that inter-corporate transactions may present unique opportunities for Newfoundland Power from time to time, but in accordance with similar findings in Order PU-19, 2003, such transactions should provide a net benefit to rate payers and should only be entered into insofar as they do not compromise the operational or managerial integrity of the utility", and it's the last part of that statement that I wonder if I could ask you to comment on. Is that something you would accept as being an appropriate principle?

MR. ROLPH:

A. I think that speaks to the management of the organization itself, so in a shared service context somebody is going to have to determine where to apply those resources. That's not something that I would have actually looked at.

Page 40

MR. O'BRIEN:

Q. Okay. When you went through - in your report, you go through the background of Hydro in terms of its corporate structure and the various entities, the related entities as well, but you also talk about the corporate structure of Hydro, and we've heard a lot of evidence to date about a matrix organization. Are you familiar with that phrase?

MR. ROLPH:

A. I've heard the phrase, yes.

MR. O'BRIEN:

Q. Can you tell us whether or not you evaluated the reasonableness of Hydro's inter-company transaction costing guidelines with a view to consider whether any of the transactions could compromise the operational or managerial integrity within this type of a matrix organization?

MR. ROLPH:

A. I did not.

MR. O'BRIEN:

Q. Okay. I'd like to ask you just a few points about the arms-length standard. You commented on that and I believe your sources for the arms-length standard was essentially the Organization for Economic Cooperation and Development, is that right, or is this a broader standard?

MR. ROLPH:

A. There's a number of sources of guidance. The OECD's guidance on transfer pricing is the most well known. The Canada Revenue Agency also provides its own interpretation of that guidance, and there's laws in the United States that are codified that also provide some guidance with respect to how one could apply the arms-length principle.

MR. O'BRIEN:

Q. So when you talk about applying the arms-length principle, I guess we're in agreement that Hydro and its related parties here are not specifically arms-length in this scenario, is that right?

MR. ROLPH:

A. That would be correct.

MR. O'BRIEN:

Q. And how would Hydro go about applying the arms-length principle?

MR. ROLPH:

A. Applying the arms-length principle effectively means choosing a transfer pricing method that derives an arms-length price. In the context of the utility industry, you often hear that phrased as the use of the market price or the lower of the cost of providing the service to the service recipient. That's akin in the transfer pricing methodology and guidance applying what is known as the comparable uncontrolled price method that would be akin to the market price, or a cost recovery method and that would be the lower of the cost to provide it.

MR. O'BRIEN:

Q. Of the two, okay.

MR. ROLPH:

A. So it's literally the same concepts are being used, different language are being used in the utility industry as opposed to a specific tax context.

MR. O'BRIEN:

Q. So in a utility situation, have you seen the use of the phrase "arms-length principle" or the use of that principle in evaluating these types of guidelines?

MR. ROLPH:

A. No, I've typically continued to use the market.

MR. O'BRIEN:

Q. Market versus cost type of analysis, okay. I take it from your opinion, would either be acceptable?

MR. ROLPH:

A. I believe either are the same.

MR. O'BRIEN:

Q. Are the same, yeah.

MR. ROLPH:

A. Potatoe potatoe.

MR. O'BRIEN:

Q. Potatoe potatoe. I tell my daughters potato tomato. So the Organization for Economic Cooperation and Development, this is an internationally accepted sort of way of evaluating these types of - transfer pricing, I guess, is it, they set down these guidelines and you've mentioned that it was a draft set of guidelines in your initial report, and those have been finalized now, is that right?

MR. ROLPH:

A. Yes, the OECD has embarked on an initiative

two years ago to address what they refer to as base erosion and profit shifting. I describe that in my testimony as multi-national companies using transfer pricing and other tax loopholes to lower their corporate effective tax rates. So the OECD prepared 15 action items or launched a plan to initiate 15 action items. One of the things they were addressing was centralized managerial and administrative costs.

MR. O'BRIEN:

Q. Okay, and you mentioned that while Hydro and its transactions between its affiliates don't go across international borders, why would again - just explain to me why these principles set out by the Organization for Economic Cooperation and Development would apply to Hydro?

MR. ROLPH:

A. Transfer pricing at its core is really an accounting concept, so whether it's across international borders or whether it's across provincial borders, or whether it's actually within a company corporate structure itself, or within between divisions within a company,

Page 45

there are situations where goods and services are being bought and sold which have implications for not only taxpayers, but also for minority shareholders and employees in the determination of their bonuses. So because it has such a high profile, the cross border transfer pricing has created an environment where a lot of work has been done to create guidance on how to actually apply an arms-length price, and I think that we can just use that guidance and apply it as we believe it should in this particular context.

MR. O'BRIEN:
Q. And is there any difference between applying that price in a taxation scenario versus a utility scenario applying those principles?

MR. ROLPH:
A. I don't believe so.

MR. O'BRIEN:
Q. Okay. The common services which you spoke of earlier, I understand that - and this, I guess, flows from the arms-length principle, it was your opinion that whether or not an activity should be charged out in the first place would come down to whether or not the

Page 46

recipient would have been willing to pay for that service, or alternatively perform it in-house, is that right?

MR. ROLPH:
A. That's right.

MR. O'BRIEN:
Q. So here when we're talking about common services, as you indicated, we've got human resources, safety and health, and information services, those were the three areas that you dealt with in your report, is that right?

MR. ROLPH:
A. Those are the only known common services that Hydro identified, yes.

MR. O'BRIEN:
Q. And I believe - did you identify those as intra-group services, are they what those are considered?

MR. ROLPH:
A. Yeah, so inter-group or inter-company tend to get - are words that tend to get used back and forth.

MR. O'BRIEN:
Q. So what types of services could be, I guess, provided back and forth that wouldn't be

Page 47

considered inter-group services, in your mind, wouldn't appropriately be considered inter-group services?

MR. ROLPH:
A. One of them is the stewardship costs. So any cost that the corporate parent incurs in order for it to be a corporation for its shareholders. It would - that cost shouldn't be allocated out to subsidiaries.

MR. O'BRIEN:
Q. Let me ask if we can turn to page 28 of Mr. Rolph's report. There's a list here of some services, I think, starting at line 16. Okay, there's a comment here at line 16 - actually, if we go up to line 11, activities that ordinarily would be considered inter-group services can include administrative services, financial services, marketing services, services in staff matters. Now from line 16 down to 21, you've got a number there that an activity would not be considered an inter-group service. Can you just take us briefly through those bullets and what services you're talking about there?

MR. ROLPH:

Page 48

A. The first bullet is what I just got through describing.

MR. O'BRIEN:
Q. Okay.

MR. ROLPH:
A. The second bullet is the activity is actually a duplication sort of services.

MR. O'BRIEN:
Q. Sure.

MR. ROLPH:
A. So in this example, if Nalcor also performed its own HR services, it would be odd for it to be also allocated HR services from Hydro.

MR. O'BRIEN:
Q. All right, and if the benefit results from a recipient status as a member of a control group, what does that mean?

MR. ROLPH:
A. What that means is that in certain circumstances the price of, say, a commodity, you may get - a subsidiary might get the benefit of volume, and the guidance is that because you're an affiliate, you should be able to benefit from that larger volume discount just as much as the parent company

Page 49

should.

MR. O'BRIEN:

Q. So in that case, that wouldn't be considered an inter-group service?

MR. ROLPH:

A. Right. So the difference between what you would pay normally and what you get as a benefit of being the multinational group, the guidance is that that would not be something that you would charge for.

MR. O'BRIEN:

Q. Okay. I guess lines 22 to 30 here, you talk about shareholder activity. Is that -- related costs, that's applicable to line 17 there, the shareholder benefits? Is that right?

MR. ROLPH:

A. Yes.

MR. O'BRIEN:

Q. Okay. And with respect to those shareholder benefits then that you talk about here, shareholder activity costs, I was wondering in particular, costs related to the legal structure of a parent company, what types of costs are you talking about there?

Page 50

MR. ROLPH:

A. Actually, in particular, shareholder meeting costs, I identified that as one of the items that may require further investigation.

MR. O'BRIEN:

Q. Okay.

MR. ROLPH:

A. There was a -- it wasn't clear to me that -- Hydro it seemed was paying initially for some of the costs with respect to the parent shareholder meetings.

MR. O'BRIEN:

Q. Okay.

MR. ROLPH:

A. And then that was getting allocated out to a variety of the subsidiaries in a manner that was -- there was no evidence of how that was being done. So I questioned whether that -- all those expenses just should be set back up to Nalcor.

MR. O'BRIEN:

Q. The parent company. And in terms of say work done on the legal structure of the parent company that may in fact, I guess, time spent in reorganizing the parent company or in

Page 51

reorganizing Hydro within the parent company, would those types of costs be something you would expect to be borne by Hydro?

MR. ROLPH:

A. I would expect those to be borne by Nalcor.

MR. O'BRIEN:

Q. So they wouldn't be considered intracompany costs?

MR. ROLPH:

A. No.

(10:00 a.m.)

MR. O'BRIEN:

Q. Okay. Let's talk about just the HR costs again, just for a little bit. So Hydro provides those services to the affiliates? Is that right?

MR. ROLPH:

A. It does.

MR. O'BRIEN:

Q. Okay. And you had indicated that you felt it was reasonable to allocate those costs by way of an indirect allocation? Is that right?

MR. ROLPH:

A. That's correct.

MR. O'BRIEN:

Page 52

Q. And I believe it's done by way of an FTE allocator. Is that right?

MR. ROLPH:

A. That is correct.

MR. O'BRIEN:

Q. And that's something you've seen in other jurisdictions?

MR. ROLPH:

A. Many times.

MR. O'BRIEN:

Q. Okay. And you're satisfied that that meets the arms-length standard? Can you just explain that to me?

MR. ROLPH:

A. Yes, I think the approach that they're using, which is effectively identifying fully burdened costs of providing the service and then allocating it based on head count, would be an application of a transfer price and method known as the cost plus method.

MR. O'BRIEN:

Q. In the end, what does that result in? Does it result in sort of a wash in terms of costs in that Hydro recovers its cost, just on a cost recovery basis and any overhead costs

associated with that work as well?
MR. ROLPH:
A. Yes. So fully burdened means all direct and indirect expenses required to render the service.
MR. O'BRIEN:
Q. Okay. I want to ask if we can turn to page 37 of Mr. Rolph's report, lines eight -- okay, lines eight to -- yeah, okay, this is the conclusion you've got for the HR. These are the bullets, I guess, that represent your conclusion for the allocation of the HR costs. Is that right?
MR. ROLPH:
A. That's correct.
MR. O'BRIEN:
Q. That first bullet there, you conclude that "allocating the costs of HR-related services rendered by Hydro to its affiliates using an indirect cost recovery method is reasonable. It would not be practical for Hydro to conduct the research required to determine a direct charge for such services based on market data." Can you explain that last sentence to me?

MR. ROLPH:
A. So in the context of providing intergroup services, there's typically two methodologies that are used to derive the arms-length price. One of them is the comparable uncontrolled price method or the CUP method, and the other is this cost plus method. Many times people want to go and find a market price.
MR. O'BRIEN:
Q. Something to compare it to.
MR. ROLPH:
A. Something to compare it to. Oftentimes, that's just impractical to do. You would spend a lot of time and effort and money for not a whole lot of benefit. So I believe in this particular case that allocating the expenses that are incurred based on FTEs is a reasonable approach.
MR. O'BRIEN:
Q. Okay. So in terms of human resources type services, would you believe that it would be difficult to find a market price for those types of services?
MR. ROLPH:
A. It's difficult to find a comparable price for

that service. That service, you could find a price for that service but comparing apples to apples would be very difficult and it's very rarely done.
MR. O'BRIEN:
Q. Okay. The second bullet, "further disclosure is warranted" -- you mentioned this in your direct. "Further disclosure is warranted regarding Hydro's treatment of the payroll taxes reported in the HR department's operating costs." Can you just elaborate a bit on that for me?
MR. ROLPH:
A. It was just a line item that was in the list of operating expenses that they used in order to determine the cost recovery amount and they subtracted it out at the bottom and there wasn't a clear indication of where it went.
MR. O'BRIEN:
Q. And is that something you -- I guess from your direct, it's something you figured should have been included in the cost base, is it?
MR. ROLPH:
A. Yes. Well, it might -- depending on what it is, it could or could not be something that

would be included in the cost base.
MR. O'BRIEN:
Q. Did you seek any further clarification from Hydro on that point?
MR. ROLPH:
A. Yes.
MR. O'BRIEN:
Q. And do you recall what the response was?
MR. ROLPH:
A. I believe it was an onerous task.
MR. O'BRIEN:
Q. Okay. And just tell me sort of why that might be a concern for you if you don't get that clarification?
MR. ROLPH:
A. Just from a transparency issue predominantly. It's a very -- there's a transfer pricing policy and there's implementing the policy. So you can have a really great policy but if you're not implementing it in accordance with the policy, you're not going to derive the result that you want to get at the end of the day, which is a fair share of services relative to usage.
MR. O'BRIEN:

Page 57

Q. And would that be -- would that have any ramifications to the rate payer if the policy wasn't being applied appropriately?
MR. ROLPH:
A. It would increase the costs. I believe it would increase the costs that are being held in Hydro and then as a result the cost base would be higher and the rate would be higher.
MR. O'BRIEN:
Q. Your third bullet here, "note the HR-related costs to be recovered from the administrative fee might not be fully burdened. As a result the amount charged by Hydro to its affiliates for this common service might be understated." Is that relating to the second bullet or is there another issue with respect to -
MR. ROLPH:
A. That's related to the second issue that I brought up earlier today.
MR. O'BRIEN:
Q. And what was that?
MR. ROLPH:
A. With respect to the way in which Hydro does or doesn't allocate internally the common expenses.

Page 58

MR. O'BRIEN:
Q. Oh right, okay. You're concerned there might be a possibility of a cross subsidy there? You're just going to have to say yes or no for the record, sorry.
MR. ROLPH:
A. Yes.
MR. O'BRIEN:
Q. And you asked for clarification on that point? Is that correct?
MR. ROLPH:
A. I'm not sure that I actually asked for clarification on that particular point.
MR. O'BRIEN:
Q. What sort of information would you look for in order to clarify that?
MR. ROLPH:
A. It would be presumably in their books and records. It should have been a journal entry, one would have thought, that indicated how much of that common expense was allocated to the HR department.
MR. O'BRIEN:
Q. With respect to safety and health, from what I heard in your direct, you had similar

Page 59

conclusions with respect to the allocation, it was reasonable on an indirect charge. Is that right?
MR. ROLPH:
A. That's correct.
MR. O'BRIEN:
Q. And in terms of your comments about any particular information that you -- or further clarification you might require, was it similar comments for those services?
MR. ROLPH:
A. Yes. I had similar comments with respect to the allocation of common expenses and whether or not that was built into the cost base or not.
MR. O'BRIEN:
Q. Okay. And with respect to that, if you don't have that additional information, does that cause any transparency issues in your mind?
MR. ROLPH:
A. Yes.
MR. O'BRIEN:
Q. I wonder if we could turn to page 30, lines 33 to 35, and we're still under the safety and health services. Line 33, I believe. Okay.

Page 60

Or maybe we'll start at 32. "Whether the common services rendered by Hydro or the corporate services rendered by affiliates for Hydro and by Hydro for its affiliates might be marked up depends on the specific service rendered. For example, the safety and health and IS services rendered by Hydro are services that, in my experience, would normally be marked up because they require engineering and IT skills to perform these functions." I wonder why -- whether you can elaborate why it was reasonable or you feel it's reasonable to use an indirect charge in this particular situation?
MR. ROLPH:
A. It would still be an indirect charge. It would just be with a markup.
MR. O'BRIEN:
Q. And the markup, have you recommended a markup in your report?
MR. ROLPH:
A. I have not.
MR. O'BRIEN:
Q. Why is that?
MR. ROLPH:

A. Because the two entities are non-tax paying entities.
MR. O'BRIEN:
Q. Okay. And that goes to, I guess, the point in your report where you talk about the ownership, I guess?
MR. ROLPH:
A. It does.
MR. O'BRIEN:
Q. Okay. I'll take you to that now in a bit. The corporate services, let's just talk about corporate services for a minute, and you've indicated a direct charge was an appropriate method and that met with the arms-length standard. Is that right?
MR. ROLPH:
A. That is correct.
MR. O'BRIEN:
Q. Okay. So rather than allocate by indirect charge, this method would require allocation, I believe you said, based on time spent by an employee as well as the employee's labour rate and a fixed charge on top of that? Is that right?
MR. ROLPH:

A. That's correct.
MR. O'BRIEN:
Q. Okay. What are the practicalities that in this particular case would weigh in favour of a direct charge versus an indirect charge, what we saw in common services situation?
MR. ROLPH:
A. It's really around time spent by the individuals. I've seen it actually done both ways.
MR. O'BRIEN:
Q. Have you?
MR. ROLPH:
A. So you can base it on time spent or you could base it on -- I have seen it based on FTEs, but because it's so -- tends to be so specific to a particular task or a group of tasks, the predominant one is time.
MR. O'BRIEN:
Q. Okay. So in terms of, I guess, from a practical standpoint, would it be easier to allocate a direct charge for corporate services than it would be for common services? It would be, would it?
MR. ROLPH:

A. It would.
MR. O'BRIEN:
Q. Okay. And that would -- would that depend on the amount of time generally spent or allocated in a corporate situation versus a common services situation?
MR. ROLPH:
A. Yeah. So you can imagine if you're doing an HR function, trying to figure out which person that you've actually dealt with and what entity they're from on a day -- on a 15-minute interval basis. It would be very onerous, I think.
MR. O'BRIEN:
Q. Okay.
MR. ROLPH:
A. In your corporate service perspective, you're typically dealing on a project, so you're, I think, able to identify your time a little bit more precisely.
MR. O'BRIEN:
Q. You talked with Ms. Greene just about recording time, that sort of thing, and you've made some recommendations I think yourself in terms of how increments of time and that sort

of thing. Have you reviewed Hydro's -- any of Hydro's policies for recording time, apart from what's in the exhibit that we have?
MR. ROLPH:
A. All I've reviewed was their policy with respect to recording time.
MR. O'BRIEN:
Q. And would that be -- if we could turn to Exhibit 8, is that the exhibit that was filed or there was a subsequent policy or a subsequent information filed, but would that be Exhibit 8 that you're talking about what you looked at, intercompany transaction costing guidelines? Maybe I can refer you to -
(10:15 a.m.)
MR. ROLPH:
A. Yes, please refer me.
MR. O'BRIEN:
Q. There's another document that we have. Undertaking 25, pull that up. Just wondering if you've reviewed this particular document and go to page two of that document.
MR. ROLPH:
A. Yeah.

Page 65

MR. O'BRIEN:
Q. Yes, have you seen this document? You have? Is that a yes, for the record?
MR. ROLPH:
A. That would be a yes. Sorry.
MR. O'BRIEN:
Q. Okay. I just wanted to ask you a couple of things about that document. If we go to page two of -- and I believe it's -- yes, on the bottom left-hand corner there, the page is. Yeah, there we go. I wanted to ask you about a comment there at the bottom, the last bullet, "note: in some locations electronic timesheets are completed on behalf of employees by designated administrative staff. Please ask your supervisor or administrative staff what the process is in your area." Would you have any comment on the reasonableness of that approach to recording time?
MR. ROLPH:
A. I believe that it's a personal preference. At times, I've had my administrative assistant do my time and at other times, I haven't.
MR. O'BRIEN:

Page 66

Q. Would you have any concern in terms of accuracy of time if someone else is recording your time?
MR. ROLPH:
A. I think it would depend on the information that that person was provided. So if that person was provided accurate information to input the hours, it wouldn't be a problem. If they're trying to figure out the time on their self without any guidance or direction, that would be a bit of a concern.
MR. O'BRIEN:
Q. In his evidence, Mr. Martin indicated that his executive assistant records his time from reviewing his schedule. Is that something that you would consider of a concern in terms of timekeeping?
MR. ROLPH:
A. I haven't reviewed his schedule, so I don't know how detailed it is.
MR. O'BRIEN:
Q. It would depend on how detailed the information is in that schedule?
MR. ROLPH:
A. Depending on how accurate the schedule is.

Page 67

MR. O'BRIEN:
Q. There's been some mention as well that -- by Mr. Martin and a couple of other individuals that from an executive standpoint, I guess, there's a policy or rule at Hydro to only charge hours into Hydro for activities which were solely related to Hydro. Are you aware of that?
MR. ROLPH:
A. I've heard that, yes.
MR. O'BRIEN:
Q. Is that something that you saw in any of the documents that you reviewed?
MR. ROLPH:
A. That's not something that I saw in any of the documents, no.
MR. O'BRIEN:
Q. Is it something that you've come across in any other situation of your own review?
MR. ROLPH:
A. Based on my experience, no.
MR. O'BRIEN:
Q. Would it cause you any concern from a transparency perspective?
MR. ROLPH:

Page 68

A. It would.
MR. O'BRIEN:
Q. And why is that?
MR. ROLPH:
A. Because it means that the allocation of an individual's time is not being accurately allocated.
MR. O'BRIEN:
Q. In terms of common expenses now, Mr. Rolph, you mentioned the office space was one, telephone infrastructure was another and there was another group just entitled other expenses, I guess, not covered by administrative fee. Is that right?
MR. ROLPH:
A. That's correct.
MR. O'BRIEN:
Q. Those are the three. I wonder if we can have a quick look at page 48, lines two to four, of Mr. Rolph's June report? And this is the conclusion section with respect to network services, I believe. Yes, the first bullet there at line two, "further inquiry is warranted to confirm the telephone infrastructure costs to be recovered by Hydro

Page 69

from Nalcor and its other lines of business are fully burdened and do not include any non-operating expenses." What do you mean by that when you say that?

MR. ROLPH:

A. So, in applying this particular methodology, you only want to include operating expenses and not what I would refer to as financial expenses, like interest. It wasn't clear to me that items such as interest weren't being included in that base.

MR. O'BRIEN:

Q. And did you seek -

MR. ROLPH:

A. So it's really a clarification of what was in the base.

MR. O'BRIEN:

Q. Did you seek clarification on that?

MR. ROLPH:

A. I did not.

MR. O'BRIEN:

Q. Okay. If we can turn to the other expenses, page 53, lines two to four? Okay, and this is the conclusion for under the other expenses grouping. I wanted to ask you just about the

Page 70

first bullet there, "further clarification is warranted regarding which of the other expenses are initially paid for by Hydro and subsequently charged back to Nalcor -- to one of Nalcor's other lines of business." Now you -- I believe you indicated in your direct, you did ask for this information?

MR. ROLPH:

A. I did.

MR. O'BRIEN:

Q. You did, and it wasn't forthcoming?

MR. ROLPH:

A. It wasn't forthcoming.

MR. O'BRIEN:

Q. No? And why is it important for you to have that information?

MR. ROLPH:

A. From a transparency perspective. In order to be able to demonstrate that they're applying the affiliate pricing policy, there should be a paper trail effectively that indicates this is the charge that they paid initially on behalf of one of their affiliates and this is how much they charged back to the affiliate.

MR. O'BRIEN:

Page 71

Q. And is there a concern from rate payers' perspective of any implication there?

MR. ROLPH:

A. I think that it's more of a implementation issue than anything else. The magnitude of these transactions were not very high.

MR. O'BRIEN:

Q. Okay. So in terms of materiality, it wouldn't be something that you'd have a concern about?

MR. ROLPH:

A. Correct.

MR. O'BRIEN:

Q. Let's just briefly talk about your testimony concerning the difference, I guess, between an investor-owned, say, utility and a Crown-owned utility. I guess that seemed to be one of the focuses you had as to how you looked at whether or not corporate services should be -- have a markup, that kind of thing. Can you give me a little bit more information on that and how you see that, how there's a difference here between say Hydro and an investor-owned utility?

MR. ROLPH:

A. In a investor-owned utility scenario, the

Page 72

corporate group is effectively trying to generate profit and in a situation where Newfoundland Power were providing a service to Fortis, for example, the -- and didn't charge a markup, then Newfoundland Power wouldn't effectively be sharing in the profits of the fruit of their efforts for providing that service. The same would be in the reverse order. And that's really where -- in that scenario, why a markup would be applied.

MR. O'BRIEN:

Q. And in terms of this scenario we have here, you've mentioned there'd be a concern of a cross subsidy, say if Nalcor provided a service with a markup to Hydro? Is that correct?

MR. ROLPH:

A. That's correct.

MR. O'BRIEN:

Q. And also going back, if Hydro provided a service to Nalcor, in your report you indicate there'd be a concern of an inappropriate markup. Is that right?

MR. ROLPH:

A. That's correct.

Page 73

MR. O'BRIEN:
Q. And just explain to me why it would be a concern to you there, from Hydro providing a service to say Nalcor or one of the other entities, why it would be inappropriate for Hydro to provide that service with a markup?
MR. ROLPH:
A. Because each of the entities are not profit entities and both of them are, in particular Hydro, its business is generated on a cost basis. So, in terms of applying a markup on services provided by Nalcor, all that's going to do is increase the costs that Hydro is bearing and that would get put on as an additional burden to the rate payers.
MR. O'BRIEN:
Q. And why is it an additional burden to the rate payers? Are you equating a rate payer with a taxpayer in that scenario?
MR. ROLPH:
A. No. I'm saying that because the rate at which the electricity is paid is based on a cost based approach and if you increase the costs, then the rate is going to have to increase in order to pay for the additional costs.

Page 74

MR. O'BRIEN:
Q. Okay. I wonder if we could have a look at NP-PUB-26? So this was an RFI and there was a question asked of you to "explain in full Mr. Rolph's view as to the degree, if any, that the Board should make distinctions between rate payers and taxpayers in its regulatory decision making concerning Hydro. In the response, please explicitly address the distinction that Mr. Rolph perceives between rate payers and taxpayers."
And if we go down to line 13 here, your response indicates "a taxpayer" -- maybe I'll start at line 10 there. "From my perspective concerning Newfoundland and Labrador Hydro, a rate payer could be a residential or a commercial customer in Rural Newfoundland and Labrador, a major industrial customer or Newfoundland Power Inc. A taxpayer, on the other hand, could be a person or any form of business enterprise not limited to those that reside in the province that pays any form of tax including, but not limited to, personal income tax, corporate income tax and sales tax. Not all rate payers are taxpayers and vice versa." So I guess, I mean, we're in agreement here that a rate payer doesn't necessarily mean a taxpayer?

Page 75

MR. ROLPH:
A. Correct.
MR. O'BRIEN:
Q. Okay. "They have different interests. For example, rate payers have not guaranteed Hydro's debt." Why is that important?
MR. ROLPH:
A. I just used it as an example.
MR. O'BRIEN:
Q. Okay. Is it of any consequence to you in the analysis of whether or not Hydro should charge a markup to any services provided to Nalcor or to one of its other affiliates?
MR. ROLPH:
A. Given the magnitude of the transactions, no.
MR. O'BRIEN:
Q. Okay. Later on you say "the Government of Newfoundland" -- and this is at line 17, "the Government of Newfoundland and Labrador has guaranteed Hydro's debt. Consequently, should Hydro default on its debt obligations, the Government is obligated to step in and pay

Page 76

Hydro's debt obligations using revenue generated or Provincial debt supported by taxpayers. As a result, taxpayers have a vested interest in ensuring that rate payers pay a rate that enables Hydro to meet its debt obligations." Is that something that the Board should be considering here, is the vested interest of a rate -- of a taxpayer in determining whether or not a markup should be applied for services provided by Hydro to an affiliate?
MR. ROLPH:
A. No, I don't believe so.
MR. O'BRIEN:
Q. Okay. So you're in agreement with me that the focus for the Board here should be the rate payer and balancing the rate payer's interest with that of -- and I guess there's no concern about balancing the rate payer's interest with the taxpayer's interest?
MR. ROLPH:
A. Could you ask that question -
MR. O'BRIEN:
Q. Sure. And I'm just sort of trying to get a flavour for your reasoning here as to whether

or not there's a concern here that the Board should have in the forefront of its mind when considering whether a markup should be applied, say in Hydro's situation, whether or not the Board has to balance the interests of a rate payer versus the interest of a taxpayer.

MR. ROLPH:

A. Oh, the Board should be concerned with the rate payer.

MR. O'BRIEN:

Q. Okay. So apart from that, why then does it matter if Hydro is owned -- is publicly owned, say owned by Nalcor which is a public corporation? What does that matter versus say an investor-owned situation?

MR. ROLPH:

A. Because the rate payers would end up paying a higher rate if there was a markup theoretically at the margin.

MR. O'BRIEN:

Q. But if the rate payer -- if Hydro provided a service with a markup, then the rate payer wouldn't pay higher.

MR. ROLPH:

A. That is true.

(10:32 a.m.)

MR. O'BRIEN:

Q. Okay. In terms of materiality, there's a number of points throughout your report you talk about materiality and I want to have just a quick discussion on that. If we can turn to page 57, Table 22? So in your report, there's a number of instances where you talk about whether or not there might be a difference in cost and it's not a material difference, that sort of thing. I just wanted to ask you about your -- this particular table, if we can scroll up just a little bit, and this is under the -- might have to go to the previous page. Yeah, you talk about a sensitivity analysis that you did to determine whether or not there were material impacts. Can you just walk me through how you did that analysis?

MR. ROLPH:

A. Effectively what I did was look at the current revenue requirement based on the costs and then increased the cost by an incremental amount to determine how much more costs or how much less costs would have to be incurred in

order to move the -- change the 8.9 cent per kilowatt hour number.

MR. O'BRIEN:

Q. And the 8.9 cent per kilowatt hour, that's -- what does that reflect?

MR. ROLPH:

A. That reflects the revenue requirement in the 2015 test year and the estimated usage and dividing the two.

MR. O'BRIEN:

Q. Is this of Newfoundland Power?

MR. ROLPH:

A. Hydro.

MR. O'BRIEN:

Q. Hydro. In line 11 and 12 there -- or sorry, 9 to 12, "to demonstrate the rate increase sought by Hydro is not very sensitive to the potential refinements to Nalcor's intercompany policy -- pricing policy identified in Section 4, I undertook the following sensitivity analysis. In Table 21, I present my estimate of the effective rate per kilowatt hour required by Hydro to achieve its estimated revenue requirement for NPI." What's NPI?

MR. ROLPH:

A. Correct.

MR. O'BRIEN:

Q. What's that? What is NPI?

MR. ROLPH:

A. Newfoundland Power.

MR. O'BRIEN:

Q. Okay. "During the 2015 test year to be 8.9 cents."

MR. ROLPH:

A. So the revenue requirement was the amount for Newfoundland Power.

MR. O'BRIEN:

Q. Right, and this -

MR. ROLPH:

A. And the estimated usage.

MR. O'BRIEN:

Q. And why did you do an analysis like this? Have you seen that type of analysis before?

MR. ROLPH:

A. There's a balancing act between planning and implementing a transfer pricing policy and what you want to be able to accomplish from a transparency perspective and then in terms of is it always prudent to put in a whole bunch of time and effort to accomplish that. What I

Page 81

really was trying to demonstrate in this thing that despite the fact that there might be some implementation issues with respect to the way that the policy that has been planned and written has transpired that those changes weren't very material, were not going to be material.

MR. O'BRIEN:

Q. Okay. And that was the understanding I got, you were looking for an analysis to say how can I look at the materiality here to say well, there may be implementation problems here, but ultimately the outcome is probably not going to be material if we do get into a full audit type of an analysis. Is that right?

MR. ROLPH:

A. That's correct.

MR. O'BRIEN:

Q. Okay. And I just wanted to know, just in terms of the sensitivity though, you come to a conclusion that it would take a three million dollar adjustment in cost to get to a materiality situation? Is that what your conclusion is?

Page 82

MR. ROLPH:

A. That's what my calculation determined, yes.

MR. O'BRIEN:

Q. So ultimately, there could be three million dollars going either way before you would say there was a materiality issue with how implementation of these pricing methods would raise concern?

MR. ROLPH:

A. That's what my calculation indicated.

MR. O'BRIEN:

Q. And you're satisfied that three million dollars is something -- do you think that's a low number, a high number? Is it something the Board should -

MR. ROLPH:

A. In the context of the shared services, that's a -- that would be a very high number, considering that it's higher than most of the actual shared services itself.

MR. O'BRIEN:

Q. And that's what I was going to get to, I guess. The shared services that we see that are being claimed are -- that would be almost one-third in some years. Is that right?

Page 83

MR. ROLPH:

A. Correct, yes.

MR. O'BRIEN:

Q. Okay. And how would you square that circle then in terms of whether or not there's a materiality here, if we've got a one-third swing?

MR. ROLPH:

A. I think I would square that by saying we need to balance transparency with just prudency. So, we need to -- the Board needs to think about how much time and effort will they require of Hydro in order to ensure that they're accurately implementing the transfer pricing or their affiliate pricing policies. There's a bit of a cost benefit to that.

MR. O'BRIEN:

Q. Okay. So if you look at it from the perspective of your sensitivity analysis, the materiality would require three million dollars, but if you look at it from the perspective if you compare it to what's actually being charged and what's actually being recovered, it might be a much more significant figure, if you look at it in that

Page 84

-- with that approach. You're looking at a three million dollar figure either way of a nine million dollar claim.

MR. ROLPH:

A. If there was three million that was missing in the system.

MR. O'BRIEN:

Q. Exactly, yeah.

MR. ROLPH:

A. Yes. Based on the evidence that I saw, it would be difficult, I think, to get to three million dollars.

MR. O'BRIEN:

Q. To get to that figure, okay. One of the other things I wanted to ask you about is your comments about reviewing and reporting protocol, I guess. Your recommendation would be to have a reporting protocol to the Board annually. Is that right?

MR. ROLPH:

A. That's correct.

MR. O'BRIEN:

Q. And is it something that you think from a practical perspective would be difficult for Hydro to do quarterly or semi-annually?

Page 85

MR. ROLPH:
A. It's again relative to the size of the transactions, I think that doing it from a quarterly perspective would be a little onerous.
MR. O'BRIEN:
Q. Okay.
MR. ROLPH:
A. If the transactions were much larger and had the potential to have a material impact, then I might think about doing it on a quarterly basis.
MR. O'BRIEN:
Q. And are you focused on materiality again here or would you be focused more on a figure, if you were going to say if the transaction was a larger figure, that might be something you'd report?
MR. ROLPH:
A. It's a question of a couple of things. So is there evidence that the transfer pricing policy has been implemented properly before.
MR. O'BRIEN:
Q. Right.
MR. ROLPH:

Page 86

A. And then that would -- so almost from a risk sensitivity scenario. If you've had issues in the past with a particular area, you may want to pay more attention to that particular area and otherwise, you would audit them on a less frequent basis.
MR. O'BRIEN:
Q. Okay. And would your comments concerning transparency and the availability of all the information here, you've indicated there's a few areas where you thought further information was required, would that enter into your mind set as to how often reporting should be required?
MR. ROLPH:
A. It would.
MR. O'BRIEN:
Q. And just elaborate on that.
MR. ROLPH:
A. I think from an implementation perspective, until some of these things are clarified and also considering the size of the transactions, I would look at things from an annual basis and then once there's some protocols put in place that have been audited and people are

Page 87

comfortable that they're being followed, then you could -- because again, of the size of the transactions, instead of looking at it on an annual basis, you may want to consider at some future time a different reporting timeframe.
MR. O'BRIEN:
Q. So it may depend on the outcome of the annual reviews as to whether or not you have a longer period before you'd review or a shorter period in the future?
MR. ROLPH:
A. Right. So I can draw on my income tax audit experience.
MR. O'BRIEN:
Q. Sure.
MR. ROLPH:
A. If an audit has gone poorly because of information concerns, the Canada Revenue Agency typically comes back more frequently and the larger your transactions are, the more frequently they will audit them.
MR. O'BRIEN:
Q. And if you had a situation where you've gone say annually and there's been no concerns there, is it something you would stretch out

Page 88

any further?
MR. ROLPH:
A. Some taxpayers have to be audited every year. There's a program called large tax file program, so regardless of the size of their transactions, they get the pleasure of the company of a Canada Revenue Agency on an annual basis. There's others that once they've demonstrated that they have their transfer pricing in place, they will wait for three years and then audit three years in a row and make appropriate adjustments.
MR. O'BRIEN:
Q. Okay. I don't have any further questions for Mr. Rolph.
CHAIRMAN:
Q. I think Mr. Johnson we're over to you.
MR. BRAD ROLPH, CROSS-EXAMINATION BY THOMAS JOHNSON, Q.C.
JOHNSON, Q.C.:
Q. Yes, thank you, Mr. Chairman. Mr. Rolph, my name is Tom Johnson, Consumer Advocate in these proceedings.
MR. ROLPH:
A. Hello.
JOHNSON, Q.C.:

Page 89

Q. I have questions for you arising out of your report and your evidence. Just to start off, Mr. Rolph, I understand both from your report and from what you've confirmed in direct evidence this morning that when you were preparing your report and considering and evaluating Hydro's methods and their reasonableness that you looked at your own experience and expertise and you also looked at managerial and cost accounting literature, industry practice, tax administration guidance to develop your framework, right?

MR. ROLPH:

A. That's correct.

JOHNSON, Q.C.:

Q. And just, I guess, the question that I would have is why did you not consider the Board's previous orders, because there's been a fair bit of juris prudence on Board awards, et cetera, Board orders in this jurisdiction regarding Newfoundland Power's affiliate costing and I guess the question I would have is why you wouldn't have considered the Board's previous orders regarding Newfoundland Power as a source of guidance when you were

Page 90

developing a framework upon which to evaluate the reasonableness of the methods used by Hydro. Can you comment on that?

MR. ROLPH:

A. In the context of related party transactions reliable benchmarks, I would not ordinarily look at related party transactions and the guidance that the Board has provided with respect to those particular transactions between those related parties. It provides me with guidance but I wanted to take a more pure transfer pricing arms-length approach to it to the framework.

(10:45 a.m.)

JOHNSON, Q.C.:

Q. But aren't some of the same issues at play as between Newfoundland Power and its parent? I mean they're not in an arms-length relationship either, nor is Hydro and Nalcor in an arms-length relationship. So, I'm still left wondering why the regulatory landscape here wouldn't have been more prominent in your evaluation of the reasonableness of Hydro's approach.

MR. ROLPH:

Page 91

A. I think it just was a little too close to home. So, if you're trying to determine what the -- in my mind, what the right answer should be, the actions of the Board in the past shouldn't really cloud my -- or help to form my determination or the approach that I took.

JOHNSON, Q.C.:

Q. So, what role would you suggest that the Board give to its prior orders and the guidelines that, for instance, Newfoundland Power has been using for pricing services? What role should that be given in evaluation, in your view, by the -- when the Board is taking all this onboard, as it were, and assessing the reasonableness of Hydro's situation?

MR. ROLPH:

A. It's an indication of what -- how they've dealt with the issue in the past.

JOHNSON, Q.C.:

Q. So it's no more than that in your judgment?

MR. ROLPH:

A. I think it's one piece of a number of evidence that they can consider.

JOHNSON, Q.C.:

Page 92

Q. Okay. So in your reply -- if we could bring up the reply to NP-PUB-030 for a second? Here's where Newfoundland Power asked you if you believed that the Board should consider the inter-affiliate code of conduct between Newfoundland Power and its affiliates, and I think this response would indicate that this would be anecdotal type of evidence. Was that -- I think what -- I'm looking for the word. Yes, line 14.

MR. ROLPH:

A. Right, so it's an indication of what industry practices are.

JOHNSON, Q.C.:

Q. Yeah. So -

MR. ROLPH:

A. Or of what one industry practice is.

JOHNSON, Q.C.:

Q. Right. So, the information from utilities besides Newfoundland Power, would that be anecdotal as well?

MR. ROLPH:

A. That would also be transactions between related parties that provide evidence of what they're doing and whether the Board considers

Page 93

that to be an appropriate way of doing things is up to the Board.

JOHNSON, Q.C.:

Q. Mr. O'Brien brought you through some of the principles this morning that have been applied in the Newfoundland Power context and I take it you're aware, Mr. Rolph, that -- from your review of the Newfoundland Power policy that in fact not only should benefits be transparent and demonstrable but that they should be maximized to the advantage of rate payers? Do you recall that?

MR. ROLPH:

A. I don't recall the word "maximum" but that notion, yes.

JOHNSON, Q.C.:

Q. Yeah. Just take that subject to check that that's one of the underlying principles of Newfoundland Power's policy. And now, Mr. Rolph, I recognize that you've not done much work in the regulated environment, but would you -- can I get you to comment on the -- that there should be some level of consistency when we're talking about utilities in the same regulatory environment when it comes to these

Page 94

matters?

MR. ROLPH:

A. I believe that there is a level of consistency. I think all of the codes of conduct have at their core what I will describe as the arms-length principle. You describe or the industry describes it in different language perhaps, but in the essence, we want to make sure that the costs that are being paid or charged by a regulated industry is an appropriate amount for the goods or services that they're buying or selling.

JOHNSON, Q.C.:

Q. And of course, you'd be aware, I take it, that Newfoundland Power charges a markup on services for affiliates?

MR. ROLPH:

A. Yes, I'm aware of that.

JOHNSON, Q.C.:

Q. Yeah, okay. And should that -- but that doesn't -- does that influence your view at all as to whether Newfoundland Hydro should charge a markup?

MR. ROLPH:

Page 95

A. No, it does not actually.

JOHNSON, Q.C.:

Q. It doesn't at all? Okay. And why doesn't that influence your judgment as to whether a markup should be applied?

MR. ROLPH:

A. Because every transaction is actually different and the appropriate transfer price for one related party transaction is not necessarily akin to another related party transaction. So, in looking at intercompany transactions, it's very important to look at the terms and conditions of that particular intercompany transaction and the functions that are being performed by each of the parties that are involved, the level of assets that each are using and the risks that each of them are bearing and it's only in putting the transaction in that context that you'll be able to determine whether the transfer price in that circumstance is good, bad or indifferent.

JOHNSON, Q.C.:

Q. Okay. Now, just bring you to your view that unless the recipient of the common service

Page 96

rendered is an energy project involving private interest, not marking up the common service related costs is reasonable in your view, and you say the same thing about corporate services, but then you go on to suggest that if there is going to be a markup, it should -- in your report, you said it should be between two and five percent, but you indicate now it should be five percent, basically on the OECD. Now, just want to understand this concept that you've outlined in terms of drawing a distinction as you have between, you know, government and private interests on the markup.

And if you just go to page 31 of your report for a moment, and in particular, at line 11. You say "in the context of energy projects involving private interest, the absence of a markup on the cost of rendering common services or corporate services for the direct benefit of these private energy projects would lower the amounts charged for such services and increase the profits generated by these projects to the benefit of private interest. This outcome would create" what you call "an inappropriate subsidy at the expense of Hydro and its customers."

Now, can you explain, just so I can understand this a bit better, why not charging a markup on services to an energy project with private interests would create an inappropriate subsidy, but not charging a markup to projects that are taxpayer owned would not create an inappropriate subsidy?

MR. ROLPH:

A. It has everything to do with the fact that the -- in the one case, the project is trying to generate profits and in the other case, they're actually not. So, if it's trying to generate a profit and by providing a -- performing a function that is helping to generate that profit, I should share in the profit, and the only way that I can share in that piece of the profit is to add a markup.

JOHNSON, Q.C.:

Q. So are you making the assumption that because the Crown is involved that they're not interested in the bottom line that comes back to their shareholders, the taxpayer?

MR. ROLPH:

A. I'm making the assumption that because it's a cost based approach, they're not looking to make profit, but achieve costs -- make sure that they're paying for their cost over the long term.

JOHNSON, Q.C.:

Q. Maybe if we could stop here, Mr. Chairman. We're close to 11.

CHAIRMAN:

Q. Certainly.

JOHNSON, Q.C.:

Q. Thank you.

MR. ROLPH:

A. Thank you.

(BREAK - 10:58 a.m.)

(RESUME - 11:34 a.m.)

CHAIRMAN:

Q. I guess, Mr. Johnson, you may continue, sir.

JOHNSON, Q.C.:

Q. Thank you. I understand I was talking a little bit quiet there, so I'll try to speak up. Mr. Rolph, we were having discussion pertaining to the subsidies in the context of government and non-government involvement in projects and, but would you -- I take it that

you would agree with me however that from the standpoint of the rate payer, the subsidy itself doesn't go away depending upon whether the project we're speaking about is public or part public, part private? Would that be a fair statement?

MR. ROLPH:

A. Well, it depends on the context that you take the shared services concept. Is it -- it's not something that Hydro does as its business, so is it a situation where Hydro is actually sharing in the costs of those services with a group of corporate affiliates or are they providing a service for a profit to those guys. I think in this case it's probably better described that they're providing a shared service and that's the language that is certainly used. So in that context, I think it's not one in which I would think that there'd be a markup put on top of it, also particularly because there's no tax implications for doing so.

JOHNSON, Q.C.:

Q. Let us say that the -- just take an example where -- because what you're suggesting is

that in the event of there being a private interest involved with a project, they would -- Hydro would charge them a different cost?

MR. ROLPH:

A. Right.

JOHNSON, Q.C.:

Q. A higher cost, right, and I guess from the standpoint of the rate payer, wouldn't the rate payer always want the higher cost? Isn't that what would be beneficial from the rate payer's point of view, if they're in -- if Hydro is charging for these services?

MR. ROLPH:

A. Correct, the higher price would be more beneficial to the rate payer in this scenario.

JOHNSON, Q.C.:

Q. And would the rate payer have a reason to be more tolerable of receiving less in the instance of a service being provided to a fully Crown owned corporation as opposed to a project that involves a mixture of Crown and private?

MR. ROLPH:

A. From a pure rate payer perspective, perhaps not, unless of course the company that it is

Page 101

transacting with is also providing services to it and puts a markup on top of it and it's a higher cost net.

JOHNSON, Q.C.:

Q. Yes, okay. Now you've indicated in your report that the tax guidance that you would -- that your report speaks about is not particularly applicable or in fact is not applicable to the Hydro and Nalcor situation on account of the fact that neither pay any taxes, right?

MR. ROLPH:

A. It's guidance, yes.

JOHNSON, Q.C.:

Q. Yes, that's right. Now this guidance of the OECD and the CRA and the IRS, just elaborate on what are the concerns particularly of the -- because I understand the OECD developed guidance and that was basically--principly to deal with tax administrators around the world. Is that right?

MR. ROLPH:

A. Yes, the group that is involved with -- or at the OECD, they call it Working Party Six and it's a group of tax administrators from the

Page 102

member countries of the OECD and they get together in an effort to try to do or create transfer pricing policies that will be applicable to all the tax administrators or that they will all use.

JOHNSON, Q.C.:

Q. So Canada is obviously a member of OECD.

MR. ROLPH:

A. It is. In fact, the leader of Working Party Six is Canadian.

JOHNSON, Q.C.:

Q. Is that right? Okay. And would this be an individual from CRA itself?

MR. ROLPH:

A. Yes, it would be.

JOHNSON, Q.C.:

Q. Okay. So on this Working Group Six, what position would this person, for instance, hold in CRA? Do you know that?

MR. ROLPH:

A. Currently that individual holds the corporate rulings.

JOHNSON, Q.C.:

Q. Corporate rulings, okay. So let me just understand, get you to elaborate a bit further

Page 103

on why tax administrators like the CRA and the IRS, et cetera, what gets them excited about this prices -- the prices that are charged across borders, et cetera, and as between taxpaying entities. Just if you could elaborate on their concern?

MR. ROLPH:

A. Certainly. What gets the Canada Revenue Agency excited is Canadian corporations who move transactions through tax havens, such as the Barbados, where they transfer a number of profits related to those transactions and leave them in the Barbados, which is probably about a two percent, two and a half percent tax rate, versus the current Canadian tax rate of roughly 26 percent.

JOHNSON, Q.C.:

Q. Okay. And is it only -- is their concern strictly a tax haven concern or is it more than that?

MR. ROLPH:

A. No, it's more than that. So, all the tax administrators are interested in their revenue base, protecting the revenue base. So even with transactions with the United States, for

Page 104

example, Revenue Canada will try to create a position that would put more taxable income in Canada than it would -- than what would be otherwise in the United States.

JOHNSON, Q.C.:

Q. And so how -- so given that general tendency of people at CRA to protect the tax base, how does that translate into their concerns over transfer pricing?

MR. ROLPH:

A. They would be looking at whether Canadian companies are charging too little for goods that are exported to foreign subsidiaries or whether they're being -- Canadian companies are being charged too much for goods that they are acquiring from foreign jurisdictions. The same examples would be true for goods and services -- or services, sorry.

JOHNSON, Q.C.:

Q. Yeah, and I think in your evidence as well, you indicated that there would be a concern for minority shareholders. Did you mention that as well?

MR. ROLPH:

A. There would be, yes.

Page 105

JOHNSON, Q.C.:
Q. And could you elaborate on what that concern was?
MR. ROLPH:
A. Minority shareholders, when they get bought out, the valuation of the company is based on the financial performance of the entity that they happen to own and if that entity happens to be a member of a multi-national corporation as opposed to owning the top company, the transfer pricing could be set such that that entity is under performing and therefore undervalued at the time that the shareholders get bought out.
JOHNSON, Q.C.:
Q. And is that a concern of the working group as well?
MR. ROLPH:
A. That's not a concern of the working group. That's a concern of the minority shareholders.
JOHNSON, Q.C.:
Q. Right, okay. Yes, all right. Now you recommended that when Hydro renders services to Nalcor or one of its other lines of business for the benefit of an energy project

Page 106

involving private interests that the cost of rendering the services should be marked up by an arms-length amount which you now would put at five percent as proposed by the OECD, right. Now, and the -- as I understand it, that recommendation of OECD for that percentage markup, that's for what they term as a markup being applicable to low value added services. Is that -
MR. ROLPH:
A. That's correct.
JOHNSON, Q.C.:
Q. That's correct, okay, and do they have another figure for higher value added services?
MR. ROLPH:
A. They do not.
JOHNSON, Q.C.:
Q. They don't, okay. And so are you -- is it your view that all of the services that are being priced as between Nalcor and Hydro, that these are all low value?
MR. ROLPH:
A. The human resource, safety and health and the information system services that are being provided all fall within the definition that

Page 107

the OECD has prepared to define low value adding services.
JOHNSON, Q.C.:
Q. I see, okay. But I take it your recommendation for five percent being applicable to any entity involving a private interest that we've discussed, that would be an across the board recommendation for any services? Is that right?
MR. ROLPH:
A. Not for any services, no. If it's a higher value service, then there would be a higher markup put on that service.
(11:45 a.m.)
JOHNSON, Q.C.:
Q. Okay. So what sort of markup would you be talking about in that instance?
MR. ROLPH:
A. A markup higher than five percent. It depends particularly on the service that's being provided.
JOHNSON, Q.C.:
Q. I see. And is that all the guidance you can provide, that it would be some -- that it would be higher than five percent?

Page 108

MR. ROLPH:
A. Without analysing the particular or knowing the particular service that you're referring to or actually analysing the comparables that I would use to derive a proxy or benchmark, it's difficult to just simply give you a markup.
JOHNSON, Q.C.:
Q. Okay. And so if we look at your recommendation of a five percent markup on services and work, et cetera, that's being provided to an entity that has some private interest, do you believe that the five percent would be sufficient to prevent an inappropriate subsidy at the expense of Hydro's customers?
MR. ROLPH:
A. I do.
JOHNSON, Q.C.:
Q. You do? And what's the basis for your belief? Is it strictly what OECD says in the tax guidance area?
MR. ROLPH:
A. What OECD has proposed is their basis. My experience in looking at a variety of general

service providers and the markups that they would make, there is a range of markups that companies make. Not everybody makes five percent, but I think that five percent would be a reasonable amount.

JOHNSON, Q.C.:

Q. So are you saying that you would expect something in the order -- because previously your report had said that something in the order of two to five percent markup would be recommended and so are you saying that that's the level of markup that you would see, for instance, if two non arms-length parties were dealing with each other? Like five percent above cost?

MR. ROLPH:

A. Fully burdened costs, yes.

JOHNSON, Q.C.:

Q. Okay.

MR. ROLPH:

A. Remember, it's low value costs or low value services, so you're not going to have a high return for a low value service.

JOHNSON, Q.C.:

Q. Okay.

MR. ROLPH:

A. There are a number of other services that aren't defined in that list that are higher value services.

JOHNSON, Q.C.:

Q. But even low -- even what you're terming as low value services, a five percent markup, while might pass muster with the OECD in terms of dealing with the tax authorities, but it would strike me as being a fairly low markup as between non arms-length parties, even for these services.

MR. ROLPH:

A. Arguably there's some of the services that they've defined that you could say are higher value and could get a markup. As I indicated earlier, it's guidance and it is guidance that tax authorities are relying on in order to make sure that they're getting their fair share of tax dollars and I think that's something that in this context we should consider.

JOHNSON, Q.C.:

Q. And when you say -- and I guess sort of it begs the question as to what degree of concern

should there be about adopting an approach that was borne out of, you know, international tax concerns and, you know, these concerns that, you know, IRS and CRA has about getting their share, et cetera, about transposing that into a regulated environment, particularly one where, you know, rate payers are supposed to be getting demonstrable benefit and, for instance, in the case of Newfoundland Power, you know, their code, a maximization of rate payer benefit by transactions. Can you comment on that?

MR. ROLPH:

A. Having worked in the area of transfer pricing for 20 years, I can tell you there's been a considerable amount of work done by organizations to try to get to guidance that is actually quite reasonable. So, as a practitioner, if the codes were based on those principles and that guidance, I would take great comfort with it.

JOHNSON, Q.C.:

Q. I wonder -- you've indicated that you had a copy of Newfoundland Power's inter-affiliate code of conduct at your disposal. I wonder if

you would file that for the record in this proceeding? Undertake to file that?

MS. GLYNN:

Q. It's not an issue, but I'm wondering if it's already on the record.

JOHNSON, Q.C.:

Q. Is it already on?

GREENE, Q.C.:

Q. It's not on the record in this proceeding, I don't think, but in terms of -- it's certainly available. I mean, it's been approved by the Board, so yes, we can certainly file it.

JOHNSON, Q.C.:

Q. Yeah. I'm not sure if it -- if it was attached to a Board Order, I wouldn't have been asking for it, but I wonder if -

GREENE, Q.C.:

Q. No, it wasn't attached. It was done -- the Board had directed that it be compiled and codified back in Newfoundland Power's 2008 hearing and consequently, in communication between the Consumer Advocate and Newfoundland Power, they agreed upon the code of conduct which was submitted to the Board in 2011.

MS. GLYNN:

Page 113

Q. So there's no issue with filing that.
GREENE, Q.C.:
Q. No.
JOHNSON, Q.C.:
Q. No, because it's just -- just to confirm it wasn't on this record, so we might as well put it on the record.
GREENE, Q.C.:
Q. And it wasn't attached to a Board order either.
JOHNSON, Q.C.:
Q. Right, yeah, okay, if we could.
MS. GLYNN:
Q. Undertaking noted.
JOHNSON, Q.C.:
Q. Good. Okay. Those are my questions. Thank you.
CHAIRMAN:
Q. So I guess, Mr. Coxworthy, we're over to you.
MR. BRAD ROLPH, CROSS-EXAMINATION BY MR. PAUL COXWORTHY
MR. COXWORTHY:
Q. Yes, thank you, Mr. Chair. Good morning, Mr. Rolph. My name is Paul Coxworthy and my colleague, Dean Porter. We represent a group of Industrial Customers served by Hydro.

Page 114

MR. ROLPH:
A. Good morning, Mr. Coxworthy.
MR. COXWORTHY:
Q. I wanted to start with page 27 of your report, the section that deals with an area which Mr. Johnson was just exploring with you, the OECD principles. And earlier in your report, you outlined a part of your review and arriving at an opinion as to the reasonableness of Hydro's methodology, in terms of transfer pricing. One of the areas that you reviewed was industry practice, and in that section, you list a number of Canadian public -- or Canadian utilities. I don't know that they're all public but it would be characterized as Canadian utilities. Can you tell us from that review to what extent any of those utilities used these OECD principles that you discuss starting at page 27, in terms of establishing transfer pricing between their affiliates?
MR. ROLPH:
A. They don't explicitly state that they're using the OECD guidelines. When I looked at the guidelines that they had created, the essence of what the OECD has done is embedded in those

Page 115

codes.
MR. COXWORTHY:
Q. Including with respect to, again what Mr. Johnson was just asking you about, the concept of when a price markup is appropriate or not?
MR. ROLPH:
A. Yes.
MR. COXWORTHY:
Q. Turning to page 28 then of your report, and throughout this section, you make several references to Chapter 7 of the OECD transfer pricing guidelines. I've been able to find online a July 22nd, 2010 draft. I wasn't able to find a date associated with your footnotes. Maybe it's there somewhere and I've missed it. Is that the draft that we're discussing or that your footnoting referring to?
MR. ROLPH:
A. It wouldn't have been a draft that I was referencing, but it was the 2010 OECD transfer pricing guidelines.
MR. COXWORTHY:
Q. I guess that's just my misunderstanding. I saw at the end of the footnote, the public discussion draft. Of course, that's referring

Page 116

to another document?
MR. ROLPH:
A. Yes, that's referring to another document. So, as I described earlier, the OECD has been reviewing transfer pricing and international tax laws as part of its base erosion and profit shifting initiative and has published 15 documents, I believe, and that's what I'm referring to in that footnote as one of the documents.
MR. COXWORTHY:
Q. Thank you. Mr. O'Brien asked you some questions from page 28 of your report in relation to shareholder activity related costs provided by OECD and in your report, you refer to those as examples. Are there other examples found in Chapter 7 of the OECD transfer pricing guidelines of shareholder activity related costs? Would we find other examples or other illustrations beyond the five that are there?
MR. ROLPH:
A. No, I don't believe that you will.
MR. COXWORTHY:
Q. Mr. O'Brien did ask you a question with

Page 117

respect to corporate reorganization and whether in the context of a corporate group with parents, subsidiaries and affiliates whether corporate reorganization costs is something that should be considered to be a shareholder activity related cost or otherwise a cost that is properly chargeable down to the affiliates, subsidiaries, if I can make that distinction.

MR. ROLPH:

A. Yes, so the latter. No, hold on, the -- hold on. Can I get you to -

MR. COXWORTHY:

Q. Sure, repeat the question.

MR. ROLPH:

A. - repeat the question.

MR. COXWORTHY:

Q. Absolutely.

MR. ROLPH:

A. Thank you.

MR. COXWORTHY:

Q. So with respect to in a corporate group, parents with subsidiaries or affiliates, corporate reorganization costs with respect to reorganizing that group, are those costs

Page 118

properly considered under the OECD principles, shareholder activity related costs or are they properly considered as costs that could be charged down to the affiliate or subsidiary by the parent?

MR. ROLPH:

A. They're considered shareholder costs.

MR. COXWORTHY:

Q. Mr. O'Brien also elicited some response from you with respect to steward-- I'm sorry, stewardship costs.

MR. ROLPH:

A. Yeah, stewardship.

MR. COXWORTHY:

Q. I'm going to have trouble with that word, I can tell.

MR. ROLPH:

A. Me too.

MR. COXWORTHY:

Q. How are those distinct or are they, from shareholder activity related costs?

MR. ROLPH:

A. I believe that one is a subset of the other. So, the stewardship costs, there'll be other stewardship costs. One of them would be these

Page 119

shareholder activities.

MR. COXWORTHY:

Q. Okay. So stewardship is the top line sort of category and shareholder related -- so what other -- are the other ones not shareholder related costs, the other cost group under stewardship?

MR. ROLPH:

A. So another example would be a consolidated audit of the corporate group as something that you would not -

MR. COXWORTHY:

Q. Would you charge that down to an affiliate or subsidiary?

MR. ROLPH:

A. You would not charge that down.

MR. COXWORTHY:

Q. No. So are any stewardship costs properly charged down to an affiliate or subsidiary?

MR. ROLPH:

A. No.

MR. COXWORTHY:

Q. I would like to ask for an undertaking through this witness at this point, if it's possible to produce Chapter 7 of the OECD transfer

Page 120

pricing guidelines, which are extensively referred to in your footnotes in this section of your report, and any updates. You referred that there may have been some papers or further documents produced that would update some of the information in relation to Chapter 7. Would it be possible for you to produce those as well?

MR. ROLPH:

A. Yes, it would.

GREENE, Q.C.:

Q. Noted as an undertaking on the record.

MR. COXWORTHY:

Q. Thank you. Mr. Johnson asked you some questions about transfer pricing and the principles behind it. I wanted to explore that a little bit better, maybe just for my own understanding. And this may be a simplistic view and it may be only one of the issues that arise with transfer pricing, but I guess as I conceptualize it in the multi-national context, if you have a parent company in a country with a high tax regime, I put it high corporate tax regime, but a subsidiary in a low cost regime, there could be some

Page 121

advantages to that corporate entity as a group to shifting costs from one to the other.

MR. ROLPH:
A. Correct.

MR. COXWORTHY:
Q. And transfer pricing, correct me if I'm wrong, is establish some principles as to when it is reasonable to transfer costs from one to the other? Is that a fair way of summarizing the intent of transfer pricing principles?

MR. ROLPH:
A. The intent is to ensure that the prices paid for the physical goods, the intangible assets or the services that are bought and sold between the related parties in your context are a price that two parties who would otherwise be arms-length parties have a -- would have agreed to in the circumstances.

(12:00 p.m.)

MR. COXWORTHY:
Q. And so reasonableness is not necessarily the measure. It's more a market driven analysis?

MR. ROLPH:
A. It's more a market -- it is more of a market driven analysis. Although there is a

Page 122

reasonableness aspect to that, what is reasonable in one circumstance may not necessarily be reasonable in another.

MR. COXWORTHY:
Q. Well, you know, I guess I'll use perhaps a prosaic example. Auditing services, I mean, you could have a subsidiary that has a choice. It could either -- perhaps the parent company has an auditing department and it could use its services or it could go to a Grant Thornton, an external source, and you can arrive at a market price, at a reasonableness, but comparing what would you have had to have paid Grant Thornton for that audit price, as opposed to what the subsidiary is paying to the parent for that same auditing service. Is that one way of establishing the reasonableness of transfer pricing?

MR. ROLPH:
A. That would be one way, although the question would arise as to whether the internal auditing folks are comparable to the Grant Thornton folks, and perhaps a premium might be paid for the Grant Thornton folks.

MR. COXWORTHY:

Page 123

Q. And the question might be what the audit is for. Perhaps you don't need the Grant Thornton, the Rolls Royce. Maybe the Camry is good enough, depending on the purpose of the audit. Is that a fair -

MR. ROLPH:
A. That's a fair distinction.

CHAIRMAN:
Q. Sounds like an ad to me.

MR. COXWORTHY:
Q. For Grant Thornton or for automobiles?

MR. ROLPH:
A. I was going to thank him, if I could.

MR. COXWORTHY:
Q. Thank you. And I guess I wanted to compare that to what this Board has to do in terms of looking at transfer pricing between an unregulated parent, non-regulated parent, and its regulated subsidiary in terms of -- you know, and this was spoken about a bit by -- or asked about by Mr. Johnson about the concerns, you know, what should get the Board excited as opposed to CRA about what, you know, what might occur in those types of scenarios. And in -

Page 124

CHAIRMAN:
Q. Excited?

MR. COXWORTHY:
Q. I'm trying to get there, Mr. Chair. Maybe I won't get there. Maybe I won't get there. Interested. Interested.

MR. ROLPH:
A. I'm waiting for the exciting and transfer pricing to get together.

CHAIRMAN:
Q. Be a dandy.

MR. COXWORTHY:
Q. And it seems to be that when you're advising a multi-national about transfer pricing and you're looking at what the tax authority in that jurisdiction is going to look at, that what you're concerned about is that they can justify that that is a reasonable expense, what's been charged out the subsidiary, that they can justify that to the tax authority because if that wouldn't maximize their tax return, might have reason to question the transfer of that cost?

MR. ROLPH:
A. Right, that's a fair assessment.

Page 125

MR. COXWORTHY:
Q. And is it fair to say that there's a band within which a reasonableness that is sought to be achieved, and when you give that type of advise, that it's not a number, that it's a band of reasonableness?
MR. ROLPH:
A. Yes, in transfer pricing terminology we call it a range of arms-length prices. So there would be a range of potential prices at which to - or to arms-length parties might transact.
MR. COXWORTHY:
Q. So when challenged by a tax authority about that, and you present them with a range, I mean, is it reasonable for the tax authority to say, well, look, we're only going to accept something at the bottom of that range as being something that was appropriate to charge now, not something within that band? What is the experience within the transfer pricing world in terms of how tax authorities look at that?
MR. ROLPH:
A. It is really dependent on the auditor. There are times in which they will try to justify a lower markup within the range if it's to their

Page 126

advantage, and other times if it's to their advantage, they'll try to support a higher number in the range.
MR. COXWORTHY:
Q. Sure.
MR. ROLPH:
A. There's a - so when one tax authority assesses a taxpayer in that context it's created a double tax scenario. So the taxpayer is, in essence, going to pay tax in two different jurisdictions. One of the things the OECD works towards is so that there's no double taxation. So the two countries get together and individuals who are responsible for each country, they'll agree to what the right amount will be. So if, for example, Revenue Canada reassessed the Canadian taxpayer with an unsupportable position, the US, if that was the country they were transacting with, could enter in negotiations with them and fight back and get either the right answer or a reasonable answer in the range that everybody could live with.
MR. COXWORTHY:
Q. I want to contrast that to the extent there is

Page 127

a contrast with here we're not talking about a tax authority scrutinizing the subsidiaries bottom line, you have a Board that's reviewing a regulated utilities bottom line, and in that context, and you may be aware of it, one of the tests that the Board has to apply is whether this is consistent with least cost service, least cost consistent with reliable service, least cost consistent with reliable service, and is there really any analog to that in the tax world, does a tax authority apply a least cost test to what costs are properly charged into a subsidiary from a parent?
MR. ROLPH:
A. There are occasions where the tax authority will object to the reasonableness of an expenditure or a business expenditure, and will try to demonstrate that that business expense was not reasonable.
MR. COXWORTHY:
Q. Was not reasonable, but will they be successful on the basis that it wasn't the least cost?
MR. ROLPH:

Page 128

A. I don't have enough experience with that particular concept to comment on that.
MR. COXWORTHY:
Q. I'd like to move on then, thank you, Mr. Rolph, again to an area that was explored by Mr. Johnson, and I think by Mr. O'Brien as well, and that's when is it appropriate for Hydro to charge a markup in terms of cost that it's charging to another company within the Nalcor Group, and you've drawn the distinction between where that charge in is to a line of business of Nalcor where there are also private interests involved, private shareholders or private partners. As I understood the explanation for that, and I may not be paraphrasing it correctly, I don't have the benefit of a transcript, so I'll ask you to help me if I'm not, but the rationale behind that is that Hydro ought to have an opportunity to share in the profit that presumably or hopefully is going to be earned by the line of business that has this private interests, and the only opportunity it has to share in that profit is to charge a markup?
MR. ROLPH:

Page 129

A. As a service provider to that group, yes.
MR. COXWORTHY:
Q. As a service provider, thank you, for that company. So I understand that, but I don't understand why you wouldn't charge a markup in all instances. If you're providing services to another entity that has objectives that are different from your own, let's leave aside whether it's profit motive, what is it about profit motive that justifies the markup when its other situations it doesn't?
MR. ROLPH:
A. It relates to the common asset in a sense of the taxpayers, so in essence they're trying to - my assumption is that they are trying to provide electricity at a cost that is the lowest for the group, so in that corporate structure the way that it is established, their focus isn't driving that profit element, it's making sure that the two entities in this case are getting the human resource services that they need. They could choose to do that in a couple of ways. Do they all themselves for internal purposes, or they could choose to share the group and share the cost. Since

Page 130

neither one of them are particularly interested in the profit element of it, charging back and forth for the profit element of it doesn't seem to make -
MR. COXWORTHY:
Q. Doesn't that rationale, though, at least risk conflating, perhaps improperly, the interest of taxpayers, which is the term you just used, and rate payers of Hydro, because you've already acknowledged their interests aren't necessarily the same?
MR. ROLPH:
A. They're not necessarily the same.
MR. COXWORTHY:
Q. And so given that, given that the interest of Nalcor, its shareholder, the Provincial Government, quite rightfully they may be interested in the interest of the taxpayer, but would you agree there won't always necessarily be alignment between the interest of the taxpayer and that of the rate payer?
MR. ROLPH:
A. There won't always be alignment.
MR. COXWORTHY:
Q. In a situation where there isn't that

Page 131

alignment, is that not another situation that at least is analogous to the private interest reason for a markup in that context?
MR. ROLPH:
A. I think that the interest in the two parties would have to be extremely divergent for that to happen, and although rate payers aren't tax payers, they're not very divergent.
MR. COXWORTHY:
Q. They are not, but if we talked about Nalcor, its interests are non-regulated, would you agree, to the extent they're not related to Hydro?
MR. ROLPH:
A. I would agree.
MR. COXWORTHY:
Q. So that's a divergence there, would you agree?
MR. ROLPH:
A. Agreed.
MR. COXWORTHY:
Q. And the taxpayers may or may not have an interest in least cost power as a group as compared to the rate payers, would you agree?
MR. ROLPH:
A. I don't know if I have enough experience to

Page 132

answer that question.
MR. COXWORTHY:
Q. Okay, that's fair.
MR. ROLPH:
A. I'd have to do some polling.
MR. COXWORTHY:
Q. I'm prepared to move on.
MR. ROLPH:
A. Okay.
MR. COXWORTHY:
Q. Thank you, Mr. Rolph. Sir, I'd like to turn to page 3 of your report, and this is, I guess, a summary or a setting out of your opinions starting on the previous page, page two, but I want to focus in starting on page 3, line 17, with respect to the corporate services that Hydro renders for its affiliates, or its affiliates render for Hydro. So in particular, the second, and in particular, I'm thinking about services provided by Nalcor to Hydro.
MR. ROLPH:
A. Okay.
MR. COXWORTHY:
Q. And one of the areas of service that you refer

Page 133

to, and it's referred to at various places, but I'll just turn to here, page 21, table 2 of your report, one of the areas of corporate services charged by affiliates to Hydro that you identify is the executive leadership services for the 2015 test year, approximately a quarter of it, more of a quarter of the overall services that are being charged in to Hydro, or expected to be, forecasted to be, and again in terms of your review of other public utilities that you did to prepare this report, other Canadian public utilities, are you able to comment on whether there is that extent of charge in of executive leadership services by any of those other utilities to their subsidiary or affiliate?

MR. ROLPH:

A. Yeah, I did not focus on that level of detail.

(12:15 p.m.)

MR. COXWORTHY:

Q. So again turning back to page 3, line 17, line 19, "Hydro and its affiliates render corporate services that would ordinarily be considered inter-group services". Based on what - on what is your opinion based that those

Page 134

executive leadership services are services that would be ordinarily considered to be inter-group services? If it's not based on your review of the public utilities experience or the information you were able to glean, what is it based on?

MR. ROLPH:

A. In my experience in a corporate setting, the senior executives of the parent company often are responsible for other subsidiaries and share their time between the two entities, so those services time are allocated.

MR. COXWORTHY:

Q. So these would be private companies. The second bullet under this section where you express the opinion, "Hydro and its affiliates derive value from the corporate services rendered by its affiliates", and I presume you include in that the executive leadership services, is that part of your opinion?

MR. ROLPH:

A. That would be part of my opinion.

MR. COXWORTHY:

Q. When you say derives value, I was trying to square that with answers to questions that

Page 135

were posed to you by Mr. O'Brien when he was putting to you the principles that apply to Newfoundland Power when they do these inter-company charges, and one of them - perhaps we could turn rather than relying on my memory to PU-19, 2003. I think it was page 57. So the second (ii), "A utility should have the right to manage its affairs, but it must demonstrate to the satisfaction of the Board that all affiliate transactions are prudent", and I understood, correct me if I'm wrong, that at least part of the prudency test that they didn't pay too much for that service.

MR. ROLPH:

A. Fair enough, yes.

MR. COXWORTHY:

Q. More than was reasonable.

MR. ROLPH:

A. Yes.

MR. COXWORTHY:

Q. So when you express the view that Hydro and its affiliates derive value for corporate services, are you expressing any opinion as to the prudence of that expense?

MR. ROLPH:

Page 136

A. No, I think the value is more in terms of benefit, so they derived the benefit from the services that were being provided, and as a result of that benefit there should be a charge.

MR. COXWORTHY:

Q. So whether there was good value obtained for that service, are you expressing any opinion on that?

MR. ROLPH:

A. No, I'm not expressing any particular opinion on that.

MR. COXWORTHY:

Q. Are you expressing any opinion as to whether that was a cost effective means of obtaining that value?

MR. ROLPH:

A. No, sir.

MR. COXWORTHY:

Q. And then going on then again in the same bullet, "Hydro would have been willing to pay for these services had they been rendered by an independent enterprise or would have performed the activity on its own behalf in-house", again when you're expressing that

Page 137

opinion, are you expressing any opinion as to whether what Hydro has actually paid for those services in the past, or what it is forecast to pay for those services in the future, whether that's reasonable, the actual amount paid?

MR. ROLPH:

A. It was more specifically the service itself and not the amount of the service.

MR. COXWORTHY:

Q. In other words, the type of service you would expect to pay something for?

MR. ROLPH:

A. Correct.

MR. COXWORTHY:

Q. It's not something you wouldn't expect to get for free, either you would pay for it by incurring an internal cost or by paying someone external for it?

MR. ROLPH:

A. Precisely.

MR. COXWORTHY:

Q. But you're not expressing any opinion there as to what has been actually paid by Hydro being reasonable or cost effective to obtain that service?

Page 138

MR. ROLPH:

A. No, I am not.

MR. COXWORTHY:

Q. If we could turn to Section 5.1 of your report, Mr. Rolph, and this was your sensitivity analysis with respect to transfer pricing. Am I right in thinking that in that section you are focusing on what Hydro charges its affiliates for services that it provides to its affiliates? That's the focus of that section?

MR. ROLPH:

A. Actually, I believe I was looking at both the transactions that Hydro charged and paid.

MR. COXWORTHY:

Q. So both ways?

MR. ROLPH:

A. Both ways.

MR. COXWORTHY:

Q. Okay, and on page 57, line 9, you state, "Accordingly, the potential understatements of the amounts charged by Hydro for rendering cost of services to its affiliates as described in Section 4.2.12 of this report would not be material". Although I don't believe it's stated explicitly, are you saying that similarly if Hydro was overpaying for services that it was receiving from its affiliates, are you expressing any opinion with respect to whether those would be material or not?

Page 139

MR. ROLPH:

A. I didn't - in my evaluation, I didn't see any indication that charges coming down was inappropriate, so I didn't comment on those.

MR. COXWORTHY:

Q. When you say you didn't comment, you didn't assess that?

MR. ROLPH:

A. Yes.

MR. COXWORTHY:

Q. That's what I thought, you had not gone there, and thank you for clarifying that. You did, I think in the context of this section, and again in response, I think, to some questions from Mr. O'Brien, you talked about, and I think you felt that this could be applicable to this Board, that in applying or ordering additional measures on Hydro to achieve great

Page 140

transparency with respect to these inter-company charges, that at some level you have to do a bit of a cost benefit analysis. One of the things you would take into account is the materiality of, you know, if there actually was a difference, and that that might stay the Board's hands in terms of there's all sorts of nice things you might put in place for transparency, but at some point you got to stand back, look at how much that would cost and say, look, in terms of the potential benefit of achieving all that transparency, it's not worth it, is that fair?

MR. ROLPH:

A. Those are considerations that the Board will need to take into consideration.

MR. COXWORTHY:

Q. My question would be, though, given your experience at least with private sector companies, and if you have any information with respect to public utilities from your review, I'd ask you to add that there, when what we're talking about is charges from Nalcor into Hydro, and if what's sought to be achieved is greater transparency there as to

Page 141

whether those are appropriate and reasonable, wouldn't it be reasonable that those charges, that additional expense be borne by Nalcor, not by Hydro?

MR. ROLPH:

A. Maybe yes, maybe no.

MR. COXWORTHY:

Q. You don't have enough information to answer that question? Do you have an opinion, do you have an opinion on it?

MR. ROLPH:

A. Actually, from a commercial perspective, if I'm paying an invoice, I'm going to want to know what I'm paying for. So if an invoice was supplied presumably from Nalcor to Hydro, that's one piece of evidence. How that number gets - how the amount gets determined based on the billing rate times, hours that the person actually worked on, adds enough - or adds more support to the credibility, and so I don't know that it's an unreasonable request on the part of Hydro that they receive from Nalcor this type of documentation to just substantiate the expense in the first instance.

Page 142

MR. COXWORTHY:

Q. And it would be Nalcor in the first instance that would bear the cost of providing that information, not Hydro?

MR. ROLPH:

A. Yeah, I don't charge my clients to -

MR. COXWORTHY:

Q. That's a prosaic example I was getting around to. When I render a bill to my client and they come back and they say, look, there's not enough detail there, this is the detail we require, typically that's not something I get to charge back to my client, whatever additional time and effort and cost involved in providing that.

MR. ROLPH:

A. Agree.

MR. COXWORTHY:

Q. Is that typical experience?

MR. ROLPH:

A. That's my experience.

MR. COXWORTHY:

Q. Thank you, Mr. Rolph. I have no further questions.

CHAIRMAN:

Page 143

Q. Mr. O'Reilly, sir.

O'REILLY, Q.C.:

Q. Thank you, Mr. Chair.

MR. BRAD ROLPH - CROSS-EXAMINATION BY O'REILLY, Q.C.:

O'REILLY, Q.C.:

Q. Good afternoon, Mr. Rolph. My name is Tom O'Reilly, and with me, Mr. Denis Fleming, and we represent the interest of Vale Newfoundland Limited in this GRA hearing. I don't have many questions, but being the last on a pecking order, the low fruit is already gone and I'm in a sitting position, so I do have just a couple of brief - I guess, to get your views on something, and let us deal with the issue of materiality, and you deal with that at Section 5 of your report. You talk about materiality of affiliate transactions. I'm familiar with that terminology as it applies to audited financial statements. What is material when an auditor performs an audit on a commercial business and it reviews the financial statements, they express an opinion on reasonableness, and, therefore, materiality comes in. Is there a definition for materiality in the context of what we're doing

Page 144

here, and that is the Board's job is to set a rate, and something as being material in a rate setting scenario? Is there a definition or would you see a difference?

MR. ROLPH:

A. I actually don't think I would see a difference.

O'REILLY, Q.C.:

Q. Okay.

MR. ROLPH:

A. It's not something that I have direct experience with, but -

O'REILLY, Q.C.:

Q. You mean, in the rate setting situation scenario?

MR. ROLPH:

A. Right.

O'REILLY, Q.C.:

Q. You don't have a breadth of experience in that?

MR. ROLPH:

A. Right.

O'REILLY, Q.C.:

Q. Now as I understand, as a result of your review, and I'm paraphrasing here,

Page 145

transactions are going both ways, you're looking at it - you're looking at what the regulated company, Hydro, charges to its unregulated affiliates, and then there are charges coming the other way. There's the unregulated institution's affiliates, they charge into the regulated, into Hydro, and I understood that in the case of the former, that is where there are charges - as a result of your analysis, the charges that are coming out of Hydro to the affiliates for the services that Hydro performs for those, may not be fully burdened? In other words, there may be some costs that haven't been recognized in those charges, but in your opinion they are not material, the differences are not material, is that correct?

MR. ROLPH:
A. The differences are not material to cause the rate that would be determined through this process.

O'REILLY, Q.C.:
Q. To be affected, okay.

MR. ROLPH:
A. The level of materiality from a transactional

Page 146

perspective is something that the Board is going to have to come to an amount.

O'REILLY, Q.C.:
Q. I'm sorry?

MR. ROLPH:
A. I said the level of materiality that the Board has in terms of how far off an inter-company transaction can be before they're not going to be concerned about it from a transparency perspective, is going to be something that they're going to have to address.

O'REILLY, Q.C.:
Q. Okay, the other set of transactions are coming from the unregulated, from Nalcor, into Hydro, and Mr. Coxworthy recently asked you about those charges. You said that you were satisfied that the services that were performed had value for Hydro, but you did not express, nor did you investigate as to whether or not those services were reasonably priced?

MR. ROLPH:
A. Based on the -

O'REILLY, Q.C.:
Q. Or reasonably costed, whatever - however you want to use that, is that fair?

Page 147

MR. ROLPH:
A. I didn't determine whether it was good value or bad value.

O'REILLY, Q.C.:
Q. Right, okay, and again referring to what is material, if the cost from Hydro to Nalcor not fully burdened, there may be some costs there that as cross-subsidization to the unregulated business, not material, but if we added those to the potential of what the over cost, if there is an over charge to the extent that the services being provided by Nalcor to Hydro are in excess of - less than value, might that have at least the potential of being material, those two combined? Would you allow that? In other words, they may affect the rates, your definition?

MR. ROLPH:
A. They would have to be wildly out of -

O'REILLY, Q.C.:
Q. Pardon me?

MR. ROLPH:
A. They would have to be wildly wrong.

O'REILLY, Q.C.:
Q. Wildly wrong?

Page 148

MR. ROLPH:
A. I believe.

O'REILLY, Q.C.:
Q. Beyond the capacity of the numbers that we're talking about here?

MR. ROLPH:
A. Yes.

O'REILLY, Q.C.:
Q. What?

MR. ROLPH:
A. Yes.

O'REILLY, Q.C.:
Q. It would have to be? That is looking at figures, for example, in Table 2 of - paragraph 2.5.11, those numbers, with the unburdened charges together wouldn't have the potential to affect the rates? This is your opinion?

MR. ROLPH:
A. Unless the evidence that Hydro has provided is not accurate, it would be difficult to get to that level.

O'REILLY, Q.C.:
Q. But, I mean, we know that these are the numbers that are here, okay, and I'm asking

Page 149

you to assume that those numbers are correct.
What I'm saying is that even if all of those numbers were off by 100 percent in terms of their value to Hydro, that it wouldn't still have the effect of being potentially material to affect rates?

MR. ROLPH:
A. I didn't make any efforts to audit or verify these numbers, so I wouldn't be in a position to indicate whether they are wildly wrong or not.

(12:30 p.m.)

O'REILLY, Q.C.:
Q. Okay, I think that's all I have, Mr. Chairman. Thank you very much, Mr. Rolph.

CHAIRMAN:
Q. Okay.

VICE CHAIR WHALEN:
Q. No questions. Thank you, Mr. Rolph.

CHAIRMAN:
Q. Do you have any?

GREENE, Q.C.:
Q. No, thank you, Mr. Chair, I have no rebuttal.

CHAIRMAN:
Q. Sir, thank you very much.

Page 150

MS. GLYNN:
Q. We are going to break for today, and we will start with -

CHAIRMAN:
Q. Okay, thank you, we're adjourned until tomorrow morning.

(UPON CONCLUDING AT 12:33 P.M.)

Page 151

CERTIFICATE

I, Judy Moss, hereby certify that the foregoing is a true and correct transcript of a hearing in the matter of Newfoundland and Labrador Hydro's General Rate Application heard on the 19th of October, A.D., 2015 before the Commissioners of the Public Utilities Board, St. John's, Newfoundland and Labrador and was transcribed by me to the best of my ability by means of a sound apparatus.

Dated at St. John's, Newfoundland and Labrador
this 19th day of October, A.D., 2015
Judy Moss