IN THE MATTER OF the
Public Utilities Act, RSNL 1990,
Chapter P-47 (the *Act*) as amended; and

IN THE MATTER OF a General Rate
Application (the "Application")
by Newfoundland Power Inc.
("Newfoundland Power") to establish
Customer electricity rates for 2013 and 2014.

To: The Board of Commissioners of Public Utilities (the "Board")

CONSUMER ADVOCATE'S FINAL WRITTEN SUBMISSIONS

February 5, 2013

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I. COST OF CAPITAL

A. Fair Return Overview

As was the case in 2009, at the heart of this GRA is the question, "What is a Fair Return for Newfoundland Power?" It is the central issue in this proceeding.

The Fair Return Principle as explained by the Board in P.U. 19 (2003) is as follows:

> **1. Fair Return**
>
> **Regulated Utilities are given the opportunity to have a fair rate of return. To be considered fair, the return must be:**
>
> - **Commensurate with return on investments of similar risk;**
> - **Sufficient to assure financial integrity; and**
> - **Sufficient to attract necessary capital.**
>
> **The fair return principle is consistent with both Section 80(1) of the Act and Section 3(iii) of the EPCA.**

Newfoundland Power's application requests a return on equity of 10.4% in 2013 and a 10.5% in 2014. This is a gross overstatement of Newfoundland Power's Fair Return.

That would put Newfoundland Power's return on equity in 2013 and 2014 140-150 basis points above the 9.00% that was awarded by the Board in 2009 in Newfoundland Power's last GRA. The cost of equity capital has decreased relative to 2009, as Newfoundland Power's cost of capital witnesses acknowledged during the hearing before the Board.

Given that the current allowed ROE for 2012 is 8.80%, not far off the 9.00% ordered in 2009, the real question is not whether Newfoundland Power's fair return should increase, but rather how much it needs to be lowered.

The Consumer Advocate's cost of capital expert, Dr. Laurence Booth, has estimated the fair return for Newfoundland Power for 2013 to be 7.50%, the mid-point in a range of 6.95% to

8.00% on a 40% common equity capital structure – consistent with the capital structures approved for every other Fortis-owned utility in Canada.

The Consumer Advocate recommends that the Board adopt this recommendation. Dr. Booth's recommendation reflects the low risk nature of electric utilities in the context of current market conditions and the realities faced by investors in firms that are not protected by regulation and that are not free from competition, such as Newfoundland Power is. As Dr. Booth testified,

> **. . . I don't think it's very easy to get independent economists projecting long run returns on a capital market, the equity market greater than seven, seven and a half percent, which if you convert to an arithmetic basis is looking at nine, nine and a half percent. So giving ten and a half percent to what everybody recognizes is at very worse an average risk Canadian utility, given the current capital market conditions, I'd ask them just to question themselves, "If I was to earn that in my RRSP or if I was to earn that in my deferred benefit pension plan, what does that mean?**

The Consumer Advocate would respectfully urge the Board to reflect on this very basic question in its deliberation as to what constitutes a fair return for Newfoundland Power.

B. Dr. Laurence Booth

The Consumer Advocate asked Dr. Laurence Booth to review Newfoundland Power's rate application and associated evidence and to offer an opinion as to the fair rate of return on common equity (ROE) for 2013 and 2014, to review whether the Board should use an ROE adjustment mechanism for future years and to recommend an appropriate common equity ratio. Dr. Booth, it is submitted, is highly qualified by virtue of his education, training, research and experience to provide his opinion to this Board.

As will appear by his C.V. at Appendix "A" to his Pre-filed Evidence, Dr. Booth is a Professor of Finance at the Rotman School of Management at the University of Toronto where he holds the CIT Chair in Structured Finance, a Chair he has held since 1999. Dr. Booth is a graduate of the London School of Economics and holds a Master's Degree in Business Administration and a Doctorate in Business Administration from Indiana University. Dr. Booth's main research interests centre on the cost of capital, international corporate finance and capital market theory. His main teaching interest is domestic and international corporate finance. Dr. Booth's C.V. demonstrates that he has published numerous papers in a variety of academic journals, including papers specifically dealing with the cost of equity capital, Canadian capital market history, estimation of risk premiums, risk and return in capital markets and equity risk premiums in the US and Canada. Dr. Booth has also authored or co-authored a large number of non-journal publications. In addition, Dr. Booth has prepared evidence and testified as an expert financial witness before utility regulators across Canada, including before the Board at Newfoundland Power's 2010 GRA.

The Consumer Advocate submits that Dr. Booth testified in a clear, cogent and direct manner. In our submission, Dr. Booth was an expert witness, who was very helpful to the Board in terms of the issues that the Board has before it in this case.

No attempt will be made to try to encapsulate all of what Dr. Booth had to say to the Board both in his pre-filed evidence and *vive voce* testimony. Indeed, we have also made reference to Dr. Booth's evidence in connection with other sections of this Submission which follow. However, we would propose to highlight the following areas arising from Dr. Booth's evidence:

i. Recommended Allowed Return
ii. Equity Risk Premium Test
iii. Market Risk Premium
iv. Beta Estimate
v. Dr. Booth's use of DCF

i. <u>Recommended Allowed Return</u>

Dr. Booth's fair return estimate for Newfoundland Power in 2013 is a ROE of 7.50. The 7.50% is the mid-point in a range of 6.95% to 8.00%. His recommendation includes a .40% adjustment for credit spreads and a .80% adjustment for Operation Twist. For 2014 and later years, Dr. Booth recommends an ROE adjustment mechanism that adjusts for 75% of the change in the forecast long Canadian bond yield and 50% of the change in the credit spread, subject to a minimum long Canadian bond yield forecast of 3.80%. Dr. Booth also made an alternative recommendation to fix the ROE for the indefinite future at 8.25% (Booth Report, p. 2).

ii. Equity Risk Premium Test

Dr. Booth utilizes a Capital Asset Pricing Model (CAPM) – a form of risk premium model. The CAPM specifies that the risk premium is comprised of the market risk premium (MRP) times the security's relative risk or beta coefficient.

The CAPM is widely used. It captures two of the major "laws" of finance: the time value of money and the risk value of money. The time value of money is captured in the long Canadian bond yield as the risk free rate. The risk value of money is captured in the market risk premium.

Dr. Booth points out in his report (p. 46) that he does not use a simple CAPM estimate for his recommendation. Dr. Booth's simple CAPM Estimates for 2013 would place the return between 5.75% to 6.80% based on 3.00% forecast long term Canadian bond yield for 2013. Dr. Booth states that the CAPM estimate is appropriate under "normal" circumstances, since it uses a normal or average market risk premium and assumes that conditions in the bond market are also driving conditions in the equity market; that is, that the correct "opportunity cost" for an equity investor is the bond market plus a risk premium. However, at the current time conditions in the Canadian bond market are being driven by the U.S. Federal Reserve's Operation Twist and panic on the part of foreign investors looking for a safe haven for their Euros.

Dr. Booth states the only thing which is abnormal about Canadian capital markets is the depressed nature of the long term Canadian Bond yields. Dr. Booth testified that current long Canadian bond yields around 2.50% does not represent an equilibrium interest rate or a rate that is determined by ordinary investors. Instead, currently it is an interest rate that is determined by the actions of the Federal Reserve Board and European Central Bank. In August of 2011, the Federal Reserve set out to specifically "twist" the yield curve to push down long-term borrowing rates by "quantitative easing" – which Dr. Booth described as printing money to buy $85 billion of securities every month ($45 billion in mortgage backed securities and $40 billion in government securities). Dr. Booth testified that just prior to Operation Twist, the Royal Bank of Canada's June 2011 forecast for the long Canada bond was back to the 4.5% to 5.0% range. (January 17, p. 192)

Dr. Booth testified that he does not regard it as appropriate that Newfoundland Power should have a fair ROE determined by the actions of the Federal Reserve. Dr. Booth assessed how much of the change in the long term bond yield has been caused by the actions of the global policy makers. He studied the yield on the TSX preferred shares index (January 17, p. 194). Dr. Booth stated that the preferred shares are the index on a distinctly Canadian investment because of its tax treatment – it is not an attractive investment for foreign investors. Dr. Booth said that preferred shares are essentially a "made in Canada" interest rate. Yields in the preferred share market did not come down to the same degree as on government and corporate bonds following Operation Twist. While acknowledging that it is difficult to precisely estimate the impact of Operation Twist, Dr. Booth estimates the Operation Twist impact on the Canadian Bond market as approximately 80 basis points, which is approximately the spread increase of preferred yields over "A" bond yields since September, 2011.

Dr. Booth supports using a credit spread adjustment of .40% as noted earlier (Report: pp. 49-52). Research at the Bank of Canada referred to in Dr. Booth's report has provided insight into the cause of the change in spreads between corporate and Government of Canada yields. Dr. Booth reports that this research shows that 63% of the change is caused by changes in liquidity. Dr. Booth states that liquidity-caused changes can be ignored as far as changing the allowed ROE since they do not affect equity holders as liquidity in the equity market generally increases during a flight to quality. Dr. Booth states at p. 52:

> **This leaves only 37% of the change in spreads due to the pure default risk that may also affect the equity holders and thus the fair ROE. In my judgment this supports the use of a 37% adjustment of the allowed ROE to changes in spreads between utility and capital bond yields. Given the imprecision of "37%" since 2010 I have been recommending a 50% adjustment to changes in corporate (utility) yield spreads to pick up the credit market effect.**

In the result, Dr. Booth notes (p. 52) that at the current time "A" spreads are at 180 bps or 80 bps more than normal on average for the business cycle and this would indicate that the fair ROE should increase by .40% for this credit market effect. Dr. Booth regards the adjustment as serving to convert CAPM into a conditional CAPM where the CAPM holds conditional upon the state of the financial markets.

iii. Market Risk Premium

Dr. Booth stated that the first component to CAPM is the determination of the "market risk premium, or more to the point what is the expected return on the capital market as a whole." This comes before looking at the relative risk of the utility compared to the market as a whole (January 17, p. 177).

Dr. Booth's estimate of the market risk premium is 5% - 6% (p. 45). This estimate is drawn from Canadian capital market history back to 1924. While Canadian data points to a market risk premium under 5%, Dr. Booth also gives weight to U.S. data. Dr. Booth's estimation of the market risk premium is detailed at Appendix B to his report. Dr. Booth summarizes that his statistical analysis described in Appendix "B" indicates that the Canadian market risk premium has been about 5.0% while that for the U.S. has been about 1% higher, or 6%. Dr. Booth also gives significant weight to survey results published by Professor Fernandez whose survey of 7,192 financial analysts, companies and professors of finance is summarized at p. 11 and 12 of Appendix "B". The survey published on June 19, 2012 shows that of the 2,223 U.S. respondents the average market risk premium estimate was 5.5% (median was 5.4%) and for the 94 Canadian respondents the average market risk premium estimate was 5.4% (median was 5.5%).

The use of judgment by cost of capital witnesses is necessary. In the Consumer Advocate's submission, Dr. Booth's judgment as regards the basis for making his market risk premium estimate of 5-6% is well grounded and consistent with the preponderance of received judgment as noted in the Fernandez survey. Notably, Newfoundland Power's cost of capital witness, Ms. McShane puts the market risk premium at 8.00%, well above the average and median response of U.S. and Canadian respondents.

Additionally, the reasonableness of Dr. Booth's market risk premium estimate of 5%-6% is confirmed by recent independent economic opinion in Canada. As Dr. Booth notes (at p. 12 of Appendix "B") on October 19, 2012, TD Economics published a report, "An Economics Perspective on Canadian Long Term Financial Returns." Dr. Booth notes that the TD analysis places long run Canadian equity returns at 7.00%, the same as in the U.S. and internationally (on a geometric basis) with bond returns at 3.0% for the Dex universe bond index (which includes corporate and government bonds). Dr. Booth states that the implication is for a long run market risk premium of 4.00% of equities over bonds and slightly higher over government bonds. Adjusting the returns to arithmetic returns would move the equity risk over bonds to about 5.5% with that over long Canadian bonds slightly higher at about 6.0%. Dr. Booth's market risk premium estimate is well anchored in other reputable data sources.

Also notable is the direction of the market risk premium for the United States. Professor Fernandez reports the trend over time in the estimate of the average market risk premium for the U.S. as follows:

2008	2009	2010	2011	2012
6.3%	6.4%	6.0%	5.70%	5.50%

Ms. McShane has the market risk premium actually increasing to 8.00% in her evidence in this proceeding. In her May 10, 2009 written evidence which she testified that she was preparing in the immediate aftermath of the March 2009 market situation, she had the market risk premium at 6.75%.

Finally, support for Dr. Booth's estimate of the market risk premium of 5-6% is also found in the report of Mr. MacDonald who also states that the MRP should be in the range of 5%-6% (McDonald Report; p. 32, line 630-1). Mr. MacDonald also cites and relies upon the Fernandez Survey in his report.

iv. Beta Estimate

Dr. Booth judges the relative risk of a Canadian Utility to be 45-55% of that of the market as a whole (p. 46). This beta range is based on the long run relative risk of Canadian utilities; it is not based on recent observations. As Dr. Booth explains in his Appendix "C", recently the relative risk has been very low since Canadian utilities have demonstrated their low risk nature by maintaining their value throughout the financial crisis and its aftermath. This is clear not only from the actual beta estimates but also from the graphs of utility performance relative to the broad Canadian market index, since this is essentially what betas estimate. In this way Dr. Booth judges the going forward relative risk of an average Canadian utility to be in their historic range of 0.45-0.55, since he does not expect a repeat of the financial crisis in the near term.

Dr. Booth therefore judges the going forward utility risk premium to be 2.25% to 3.30% representing the combination of the low end of the relative risk adjustment and the low end of the market risk premium (.45% and 5%) combined with the top end of both (.55 and 6%) (p. 46). The Consumer Advocate submits that Dr. Booth's relative risk adjustment is reasonable. In contrast other witnesses use a mechanical adjustment formula that was developed by Professor Marshall Blume based on the behavior of all stocks in the capital market, where by definition the average beta is equal to 1.0. Dr. Booth points out that the only study that has addressed the beta adjustment for utility stocks, that by Professor Gombola and Kahl referenced in his Appendix "C", shows that utility betas do not adjust towards 1.0 but instead adjust towards their long run average value consistent with Dr. Booth's recommendation. Despite this evidence being in Dr. Booth's testimony in his 2009 testimony, and well as that earlier this year, of which all the other witnesses are aware, none of them used the correct mechanical adjustment methodology. Instead each used the Blume adjustment which increases the beta coefficient for low risk utilities the most. Mr. MacDonald, for example, uses a beta of 0.60 which he arrives at by applying the Blume adjustment without any discussion of whether this is appropriate for low risk utilities or looking at the historic record to see whether the betas of Canadian utilities have ever "moved toward 1.0" Ms. McShane uses a variety of beta techniques but likewise assumes a Blume adjustment to get her beta estimate of 0.65-0.70, which is vastly in excess of any beta range actually experienced by Canadian utilities in the past 20 years. Furthermore as Dr. Booth shows in his Appendix "C", basic data providers, like the Financial Post, the Royal Bank of Canada, Google, Yahoo etc., do not adjust their own beta estimates in the way assumed by the other witnesses.

The Consumer Advocate recommends that the Board put most weight on the actual experience of Canadian utilities over the last 20-30 years and the fact that neither of the witnesses put forward by Newfoundland Power nor Mr. MacDonald have shown utilities follow the Blume beta adjustment process: there is simply no evidence to support such an adjustment.

v. <u>Dr. Booth's Use of DCF</u>

In terms of DCF Dr. Booth pointed out (January 19, pp. 64-65) that it is one of the two fundamental methods for determining the fair ROE. He stated, for example, that he has several chapters in his recently published finance textbook on DCF methods as well as risk premium methods such as the CAPM (p. 64, line 20-21). He testified that with his late colleague, Dr.

Berkowitz, he used to present DCF estimates for a sample of Canadian companies. However, most of these companies no longer exist so using DCF methods for Canadian companies is problematic, as confirmed by the fact that neither Dr. Vander Weide nor Mr. MacDonald use DCF estimates on Canadian utilities, while Ms. McShane has to use her three stage model for her DCF estimates since otherwise the analyst growth estimates significantly exceed the growth rate in the economy. Dr. Booth has started to look at DCF estimates from both US companies and from the Standard and Poor's composite data for electric and gas utilities (His Appendix D). However, given the substantive differences between the U.S. and Canadian capital markets and utility regulation he looks at these estimates as a check and as he indicated before the BCUC these estimates need to be reduced by 90-100 bps.

In contrast, Dr. Booth does use DCF methods to estimate the fair return for the capital market as a whole and this is an important element in anchoring his risk premium estimates. In this he is being entirely consistent with the TD Economics Report and the report by Mercer, Newfoundland Power's consulting actuaries, for Newfoundland Power's defined benefit pension plan. With an overall expected equity market return of about 9.0% (7% compound or long run) this is used by Dr. Booth to confirm his market risk premium and his Operation Twist adjustment.

C. Ms. McShane, Dr. Vander Weide and Mr. MacDonald

i. Results and Weightings

a. Ms. Kathleen McShane

Ms. McShane recommended 10.5% as a fair return on equity for Newfoundland Power for 2013 and 2014. Ms. McShane also states that in her opinion Newfoundland Power's proposed capital structure which contains approximately 45% common equity remains reasonable. Table 30 of her report provides the results of her cost of equity tests:

TABLE 30

Cost of Equity Tests	Cost of Equity
Risk Premium Tests	
Risk-Adjusted Equity Market	8.9%
Discounted Cash Flow-Based	9.5%
Historic Utility	10.25%
Discounted Cash Flow Test	9.4%

Ms. McShane gave equal weight to each of her three risk premium tests, which she averaged and gave the average a 50% weighting while also placing 50% weighting on her DCF test result (January 14, p. 19-21). She then added 1.0% as an allowance for financing flexibility to arrive at 10.50%. Her allowance for financing flexibility was .50% in Newfoundland Power's 2009 GRA, which the Board approved. If the same .50% allowance was used, her overall estimate would be 100 basis points lower than the 11.00% overall estimate put forward in 2009 by Ms. McShane.

Ms. McShane uses an alternative approach (which employs and gives weight to the "comparable earnings test" for which she suggests using a .50% allowance for financing flexibility). As no regulatory board in Canada has put reliance on comparable earnings, we will not discuss it further.

b. <u>Dr. James Vander Weide</u>

Dr. Vander Weide, the Company's other Cost of Equity witness, has recommended that Newfoundland Power be allowed to earn a return of 10.4% on an equity ratio of 45% in 2013 and 2014.

Table 3 of his report provides the results of his Cost of Equity tests

Table 3

Method	Model Results
Discounted Cash Flow	10.2
Ex Post Risk Premium	9.9
Ex Ante Risk Premium	11.1
Average	10.4

Dr. Vander Weide gave each of his three methods equal weighting (January 17, p. 31). Dr. Vander Weide's 10.4% recommendation includes a .50% allowance for financing flexibility (January 17, p. 153).

c. <u>Mr. Troy MacDonald</u>

Board Staff's cost of capital witness, Mr. Troy MacDonald, in his report recommended 8.91% as a fair return on equity for Newfoundland Power for 2013 and 2014. Mr. MacDonald also stated that Newfoundland Power's forecast common equity ratio of 45% for 2013 and 2014 was reasonable.

Table 1 of his report provides the results and weightings of the methodologies used:

Table 1 – Fair ROE Conclusion

Methodology	Conclusion	Weighting
CAPM	6.84%	33.33%
DCF	9.63%	33.33%
ERP	10.26%	33.33%
Conclusion	**8.91%**	

ii. <u>The "Historic Utility Test"/"Ex Post Premium Method"/"ERP"</u>

These methods though variously labeled amount to the same approach and are similarly flawed. Notably, for Ms. McShane and Mr. MacDonald, the method produces the highest cost of equity estimates of their methods.

At its heart, this approach is supposed to estimate what the go-forward utility equity risk premium is. Ms. McShane's report states for instance (p. 90) that historic experienced market returns for utilities provide "an additional perspective on a reasonable expectation for the forward-looking utility equity risk premium." Ms. McShane's report states that reliance on achieved equity risk premiums for utilities as an indicator of what investors expect for the future is "based on the proposition that over the longer term, investors' expectations and experience converge." Under this approach, Ms. McShane arrives at a <u>utility</u> risk premium of 6.75% (p. 93) and Dr. Vander Weide and Mr. MacDonald arrive at a utility risk premium of 6.7% (p. 35) and 6.72% (p. 29), respectively.

Common to the approaches of Ms. McShane, Dr. Vander Weide and Mr. MacDonald is subtraction of the "Average Bond Yield"[1] from the Average Stock Return.

Table 2 below from Dr. Vander Weide's report (p. 35) reveals how he arrives at his 6.7% estimate for the utility risk premium:

TABLE 2
EX POST RISK PREMIUM RESULTS

COMPARABLE GROUP	PERIOD OF STUDY	AVERAGE STOCK RETURN	AVERAGE BOND YIELD	RISK PREMIUM
S&P/TSX Utilities	1956-2011	11.99	7.33	4.7
BMO CM Utilities Stock Data Set	1983-2011	16.01	7.24	8.8
Average				6.7

Clearly, when we see the 8.8% utilities risk premium over the 1983 to 2011 period in Dr. Vander Weide's Table 2, we need to recognize that the historical fact that interest rates were very high in the early 1980s and have declined very steadily since.[2] The historical return data presented in Revised Table 2 shows that over both the 1956-2011 period and the 1983-2011 period, utility investors made higher returns than the overall market. In the latter period, the BMO Utilities group had returns that averaged 16.01% while over the same period the TSX Composite had a return of 10.6% - and experienced Risk Premiums of 4.91% and -.50 respectively. It would be illogical to think that utilities that have long been regarded as "safer" than the "average company" would have warranted an additional 5.4% risk premium over the entire TSX over this period. At best, this constitutes evidence that regulators have over-estimated the risk adjusted cost of equity for utilities.

Ms. McShane admitted that as recently as 2007 and for many years prior, she used the returns from returns method to estimate the utility risk premium.

[1] While Ms. McShane calls it the "Bond Income Return" she admitted that it is effectively the yield (Transcript, January 14, p. 182)

[2] See Long Canada Yield Graph prepared by Dr. Laurence Booth at Information #18 which was put to Dr. Vander Weide on Cross-Examination on January 17, p. 79

To illustrate the impact of deducting returns from returns (as opposed to yields from returns as done by these witnesses) "Revised Table 2" was put to Dr. Vander Weide during cross-examination. It is reproduced below:

Revised Table 2

		Stock Return	**Bond Return**	**Risk Premium**
TSX Utilities	**1956-2011**	**11.99**	**7.96**	**4.03**
TSX Composite	**1956-2011**	**10.53**	**7.96**	**2.57**
BMO Utilities	**1983-2011**	**16.01**	**11.10**	**4.91**
TSX Composite	**1983-2011**	**10.60**	**11.10**	**-0.50**

We observe that using the returns for returns method, utility risk premium would decrease from 6.7% in Table 2 to 4.47% (i.e. 4.03 + 4.91 = 8.94 ÷ 2 = 4.47%).

Using a 4.47% utility risk premium instead of a 6.7% utility risk premium would decrease:

- Ms. McShane's Historic Utility Cost of Equity from 10.25% to 7.97% (4.46% + 3.5% forecast long Canada), which based on her weightings would decrease her overall estimate from 10.5% to 10%;

- Dr. Vander Weide's Ex Post Risk Premium from 9.9% to 7.69% (4.46% + 2.73 forecast long Canada + .50 allowance for flotation costs) which is based on his weightings would decrease his overall estimate from 10.4% to 9.66%; and

- Mr. McDonald's ERP from 10.26% to 8% (4.46% + 3.04% risk free rate + .50 allowances for flotation costs) which based on his weightings would decrease his overall estimate from 8.91% to 8.07%.

The Ms. McShane/Vander Weide/MacDonald approach is basically identical to the approach Ms. McShane espoused before the AUC in the 2011 General Cost of Capital proceeding.

In relation to Ms. McShane's Historical Utility evidence the AUC stated:

3.5.1 Historic returns

96. In her evidence, Ms. McShane examined the historic returns for utilities. According to Ms. McShane, the historical average utility return, in both Canada and the U.S., has clustered in the 11.0 to 12.0 per cent range. She submitted that investors tend to base their expectation on experienced returns and that there was no long-term upward or downward trend. She submitted that the utility returns had varied by approximately 50 per cent of the change in long-term government bond yields.

97. Ms. McShane also used this historical data on the experienced returns of utilities to provide an additional equity risk premium estimate derived from the observed equity risk premiums achieved by utilities. This resulted in an equity risk premium of 6.25 to 6.5 per cent. At Ms. McShane's forecast Canada bond yield of 4.25 per cent, the indicated utility cost of equity was approximately 10.50 to 10.75 per cent or 11.5 to 11.75 per cent after adding her recommended 1.0 per cent for flotation.

98. The UCA noted that Ms. McShane had provided evidence indicating that utility investors have made returns that are higher than the overall market and stated that, at best, this was evidence that regulators have over-estimated the risk-adjusted cost of equity (and thereby provided a return that is too high).[79]

99. The Commission agrees with the UCA that part of the reason for higher historic returns may be that allowed returns have been above the actual ROE that investors expected and required for investments of comparable risk. The Commission finds that the evidence on historic returns is inconclusive with respect to the return investors expect on comparable investments. (footnote omitted)

The Consumer Advocate likewise would respectfully submit that in this proceeding there is no reasonable basis to conclude that the "Historic Utility", "Ex Post Risk Premium" or "the ERP" puts forward reliable evidence with respect to the return investors expect on a utility like Newfoundland Power. It deserves no weight.

iii. <u>Discounted Cash Flow Tests</u>

Dr. Vander Weide and Mr. MacDonald each utilized the Discounted Cash Flow Test on their respective U.S. samples of utility holding companies. Ms. McShane utilized the DCF Test on her U.S. and Canadian utility samples.

There are also substantial problems with the DCF tests as performed in this proceeding by Ms. McShane, Dr. Vander Weide and Mr. MacDonald. The resultant estimates of the cost of equity are not substantiated and over-state the cost of equity.

a. <u>Ms. Kathleen McShane</u>

Table 29 of Ms. McShane's Report (p. 97) clearly demonstrates that the results of the DCF analysis is influenced to a significant degree by whether one uses the constant growth, sustainable growth or the three stage method. As will be discussed shortly these three estimation methods used by Ms. McShane mean that her DCF estimate falls from simply using analyst growth estimates (constant growth) to tapering them to the long run growth rate in the economy (three stage) to using the actual forecast ROE and financial parameters of the company that generate future growth. This is a clear indication that not only are these short run analyst growth estimates unreasonable estimates for long run growth, but that using the long run GDP growth rate also over estimates a reasonable long run growth rate.

Table 29

	Constant Growth		
	Analysts' EPS Forecasts Growth	**Sustainable**	**Three-Stage Model**
U.S. Utilities	9.4%	8.6%	9.1%
Canadian Utilities	11.0%	N/A	8.6%

The constant growth mean and median dividend growth rates for Ms. McShane's U.S. utilities are 5.1% and 5.3% respectively (McShane report, Schedule 17). The sustainable growth mean and median dividend growth rates for her U.S. utilities are each 4.5% (Schedule 18). The three-stage model has mean growth at 5.1% in stage 1, 5.0% in stage 2 and 4.9% in stage 3. Ms. McShane utilizes a forecast U.S. GDP growth rate of 4.9% over 2013 – 2023. Meanwhile, for Ms. McShane's Canadian utility sample the constant growth mean and median growth rates utilities are 7.5% and 7.0% respectively (Schedule 20). Ms. McShane did not have the data to use the sustainable growth model with respect to her sample of Canadian utilities. The three-stage model has mean growth at 7.5% in stage 1, 5.9% in stage 2 and 4.3% in stage 3. Ms.

McShane utilizes a forecast Canadian GDP growth rate of 4.3% over 2013 – 2022 (Schedule 21).

b. Dr. James Vander Weide

Dr. Vander Weide utilizes only the constant growth DCF model in his evidence. Including a .50% financing allowance his Exhibit 6 – "Comprehensive Group of U.S. Utilities" produced a 10.3% result and his Exhibit 7 – "U.S. Utilities with Mostly Regulated Assets and S&P Bond Rate Equal to or Greater than BBB" produced a 10.1% result. The average dividend growth rate for his Exhibit 6 and Exhibit 7 companies were 5.2% and 5.1% respectively (January 17, pp. 64-5).

c. Mr. Troy MacDonald

Mr. MacDonald utilizes a two stage model for his U.S. Sample. His first stage uses analyst forecasts for 3 years. His second stage uses long run nominal U.S. GDP growth of 4.9% out forever.

Mr. MacDonald takes the constant growth ROE of 9.21% and the two stage ROE of 4.05% and averages these to arrive at 9.13%, adds .50% for financing flexibility to arrive at a DCF estimate of 9.63%.

No evidence whatsoever has been put forward by Newfoundland Power's witnesses or Mr. MacDonald to substantiate that the companies they include in their samples have historically been able to achieve dividend growth rates anywhere near what their forecast growth models are premised upon. There is no evidence on the record to substantiate that either the Canadian or U.S. utilities were in fact able to achieve the GDP growth rate historically. [January 16, pp. 25-26]

The reason why the multi-stage DCF models produce lower ROE estimates than the constant growth model is because analysis' forecasts used in the constant growth models exceed forecast GDP growth. [January 14, p. 203]

Dr. Vander Weide was specifically asked in the RFI process (CA NP 267 (c) (d)) for data which would have permitted the parties and the Board to determine whether Dr. Vander Weide's chosen firms were able to achieve growth rates as put forward in this proceeding and whether their achieved historic growth exceeded GDP growth. Dr. Vander Weide in reply stated that he did not examine historical dividend growth data and during cross-examination suggested that the Consumer Advocate go to "publicly available sources of information and gather the data yourself."

During cross-examination, evidence filed by Ms. McShane in the recent 2011 AUC General Cost of Capital proceeding showed (Information No. 10) that the companies in Ms. McShane's U.S. sample in the Alberta proceeding (which included several companies utilized by Ms. McShane in this proceeding) were shown to not have been able to achieve dividend growth rates that met compound U.S. GDP growth. For the period 1990 to 2010, the U.S. firms achieved only 2.7% average growth in dividends per share, compared to compound growth of GDP of 4.7%.

This evidence precisely highlights Dr. Booth's concern as expressed at the hearing. Dr. Booth observed that "conceptually DCF and risk premium models are equally valid as ways of estimating the fair rate of return." [January 18, p. 66] But he pointed out that it is "very important that any estimates of future growth for a utility reflect reasonable constraints on the fact that these are slow growing mature companies." He concluded,

> **And that's where you need historic data to verify any future estimates of growth and that's one criticism clearly I have against some other evidence that's before the Board, <u>that none of those standard checks have been done</u>." [p. 67-68] (emphasis added)**

Canadian regulatory boards have expressed concern about the potential for optimism in analysts' forecasts. Ms. McShane acknowledged that some of the analysts are from the "sell side" of the market (January 14, p. 203). Ms. McShane's report at p. 96 takes the view, "That as long as investors have believed the forecasts and have priced the securities accordingly, the resulting DCF costs of equity are an unbiased estimate of investors' expected returns." The Consumer Advocate would urge caution in assessing this argument. This proposition was rejected by the AUC in its 2011 Generic Cost of Capital decision which concluded at paragraph 86 as follows:

> **86. In 2009, the Commission expressed concern about the potential upward bias in analysts' growth estimates.[75] However, Ms. McShane argued that, as long as investors believe the optimistic forecast, they would price the securities lower (resulting in a lower dividend yield) and the DCF test would still be an unbiased estimate of investor required returns. She indicated that this proposition had been successfully tested and described three tests, including the fact that such growth estimates have averaged less than GDP growth.[76] <u>In the Commission's view, this line of reasoning does not resolve the issue because there is no evidence that investors believe optimistic forecasts. Therefore, the Commission remains concerned with the potential upward bias in analysts' growth estimates</u>. (footnotes omitted – emphasis added)**

The Consumer Advocate submits that inadequate substantiation has been put forward by Newfoundland Power's cost of capital witnesses and Mr. MacDonald to ground the Board's reliance upon the DCF tests' results in this proceeding. What we can glean from the DCF tests is that they over-state the fair return for Newfoundland Power.

D. <u>U.S. Utilities and U.S. Data</u>

In this case, as in Newfoundland Power's 2010 General Rate Application, we are seeing a considerable degree of reliance by the Company's cost of capital witnesses on U.S. data. To a lesser, but still significant extent, Mr. MacDonald has relied on the same as well.

We will shortly encapsulate our views on the U.S. companies put forward in these witnesses' samples. But more fundamentally, the issue goes beyond whether a particular set of U.S. companies are comparable to Newfoundland Power. The issue for the Board is to consider whether on the record of this proceeding there is sufficient evidence to support a finding that Canada's and the U.S.'s regulatory, institutional, economic and financial environments and their impact on the resulting opportunities for investors and for rate regulated companies are comparable. In fact, Ms. McShane expressly agreed in her reply to CA NP 286 that this was precisely what this Board should consider.

In fact, as can be seen from the preamble to CA NP 296, the Régie recently addressed its mind to this very formulation of the issue and found that the evidence before it would not allow it to make such an affirmative finding. In this case likewise there is not sufficient evidence to support a finding that Canada's and the U.S.'s regulatory, institutional, economic and financial environments and their impact on the resulting opportunities for investor and for rate regulated companies are comparable.

Dr. Booth stated that the basic opportunity cost in the capital market is the long-term government bond yield and it has consistently been higher in the U.S. than it has in Canada since Canada solved its financial problems. Dr. Booth continued:

> **It's one of the reasons why I look at the US and say, well even if the utilities are exactly the same in risk, they're coming from a US capital market and rates of return are higher in the US, not just historically in terms of risk premiums, but also objectively in terms of current interest rates. And this is not something you need an expert witness on, all you have to do is pick up a newspaper. [January 17, p. 193]**

Dr. Booth stated (January 17, p. 199) that in his judgment the U.S. is a riskier capital market and stated that the U.S. is more competitive than Canada. In Canada we tend to regulate more such as in our banking system.

Dr. Booth stated that you can draw estimates from any capital market and as long as you make the appropriate adjustments, then they are useful. He stated, "It's not that US evidence isn't useful, it can be useful, but the question is do you take it without making adjustments." This is precisely what Ms. McShane and Dr. Vander Weide maintain – that no adjustments are required.

Dr. Booth then continued:

> **In my judgment, there's three things in looking at US, first of all undeniably long term bond yields are higher in the United States, government treasury yields are at least 50 basis points than they are in Canada, so you start out saying, well the rate of return should be higher in the US. You then look at market risk premiums, historic evidence of the market risk premiums being higher in the US. I think a lot of that has gone away, how much of it is gone away is difficult to work out, but certainly if you believe past experience is useful for the future, undeniably market risk premiums are being higher in the United States. Thirdly, you look at the relative Canadian utilities. So before the BCUC in 2009, I said you can use US evidence, but you have to adjust, and at that time I said US estimates need to be downward adjusted by 90 to 100 basis points. The US downwardly - - sorry, the BCUC downwardly adjusts Ms. McShane's DCF estimates by 50 to 100 basis**

points and the basis of the downward adjustment was the fact that I felt that long term bond yields were higher in the US, the market risk premium was higher in the US and probably the relative risk of utilities is higher in the US. So the issue is not whether you can get information from the US, the question is whether a reasonable person would look at that and feel that there is adjustments that need to be made.

This brings us to considering the companies that Ms. McShane, Dr. Vander Weide and Mr. MacDonald have put forward in this proceeding as comparable to Newfoundland Power. In reality, we do not regard the situation with the U.S. comparables put forward in this GRA as being significantly different than those put forward in the last GRA. The evidence in this case as in 2009 still shows significant differences in virtually all of the comparables. While Ms. McShane and Dr. Vander Weide argue that their U.S. comparables are reasonable proxies, there remains, as was found by the Board at the last GRA, overwhelming evidence of a lack of balance as it is clear that on almost every measure Newfoundland Power would still have to be considered less risky than the U.S. comparables. That essential fact has not changed despite the manner in which Ms. McShane has re-packaged her evidence. Dr. Vander Weide's samples are, with respect, hopelessly non-responsive to the Board's admonitions in P.U. 43 (2009).

First, Ms. McShane's U.S. sample contains a total of 13 companies, 7 of which were used in 2009. [CA NP 280]

Second, of the 6 companies dropped from Ms. McShane's 2009 sample, for not meeting her selection criteria, 4 of them are now in Dr. Vander Weide's sample at Exhibit 6, amongst others that are considered by Standards and Poor's to be amongst the weakest rated utility companies in the United States. [CA NP 281, CA NP 356, January 17, pp. 135-138]

Third, Moody's is on record consistently stating that it considers Canada's <u>business and regulatory</u> environment to be supportive relative to the United States.

Fourth, the samples are not in the same low risk utility segment that Newfoundland Power is in. Newfoundland Power is a transmission and distribution company. Therefore, it is in a utility segment that is recognized to be less risky than gas distribution, and vertically integrated utilities. The only U.S. firm in either Ms. McShane's or Mr. MacDonald's sample that is a transmission and distribution company is Consolidated Edison (CA NP 315). Five of the companies in Ms. McShane's sample are vertically integrated utilities (Allete, Aliant, Southern, Wisconsin Energy and Xcel (CA NP 317). Four of these vertically integrated companies are in Mr. MacDonald's seven company sample. Four of Ms. McShane's companies are gas distribution companies (AGL, Atmos, Northwest Natural, Piedmont and WGL Holdings) (CA NP 317). Ms. McShane considers her final company, Vectren, to be primarily a distribution utility with generation net plant of $700 million of total assets of $4.9 billion (CA NP 317). Mr. MacDonald's remaining two companies are Atmos and Integrys. Atmos is a gas distribution company and Integrys is a combination gas and electric company (CA NP 316). Ms. McShane stated that Southern and Xcel own and operate nuclear generation facilities (January 16, p. 61).

Fifth, Newfoundland Power is a completely regulated utility. It has no unregulated assets or earnings. A number of the companies in Ms. McShane's sample have significant levels of unregulated revenue – from segments that are not protected from competition (CA NP 310). In addition, it is clear that companies with relatively small percentages of assets that are non-regulated can have considerable earnings on the non-regulated side of the ledger. Vectren, for example, in 2011 had $1 billion in unregulated income while its regulated side had $1.5 billion in income. Even companies whose unregulated activities are connected to utility or energy, such as AGL's – these are subject to market forces and downturns. For instance in the Moody's report on AGL of December 2011 at CA NP 315, it states:

> **NON-UTILITY BUSINESSES FACING HEADWINDSB**
>
> **AGL's non-utility businesses – in particular, the wholesale energy marketing (gas transportation and storage services to large industrial customers), gas storage development, and containerized shipping – are all riskier than the core LDC businesses. Although these activities have established track records, they have all been hit by the cyclical downturn in demand which is not likely to ease, at least, for a few years. The shipping business came with the Nicor acquisition, and we do not believe it will be core for AGL over the long term.**
>
> **With shale gas production surging, flat basis differentials and low seasonal spreads are weighing on the company's marketing and storage businesses. Containerized shipping, historically a cash generator even in recessionary times, has experienced not operating losses for the first time in recent memory due to volumes declines.**

The point is that investors whose returns in part are derived from non-regulated operations are subject to the impacts of risk factors that do not face an investor whose returns are solely derived from regulated activities. As admitted by Ms. McShane, unregulated operations can expose a company to higher risk than regulated operations because the company may have a lesser ability to recover the costs of the unregulated operations from its customers than the costs of its regulated operations (CA NP 309).

Sixth, Newfoundland Power has a customer base that is comprised of largely residential customers. Newfoundland Power highlighted in its presentations to DBRS and Moody's in February, 2011 (Undertaking 10) that 87% of total customers are residential customers and 61% of electricity sales are to residential customers. Under the heading "Other Key Indicators", Newfoundland Power stated in its presentation:

- **90% of new home construction installed electric heat in 2010**
- **85% of commercial electricity sales are to customers in the service sector**
- **Over 62% of customers utilize electric space heating; leads to fairly strong seasonal pattern.**

Aliant and Allete which are two of Mr. MacDonald's seven companies derive a significant portion of their margins from industrial customers. The industrial bases of these companies have been commented upon by their bond raters (CA NP 313). All of the companies in Ms. McShane's samples report industrial sales or revenues, with Alliant and Allete being most significant. On the factor of customer base, Newfoundland Power obviously has less exposure to industrial sales than any of the U.S. companies put forward and more exposure to residential markets than many of the U.S. companies (CA NP 311; Transcript January 16, pp. 111-118).

Seventh, Newfoundland Power is relatively free of competition. Moody's 19 July 2011 Credit Opinion states that Newfoundland Power "dominates" the market, "which is geographically isolated and effectively protected from potential competition." In the first instance, gas distribution companies generally speaking tend to face more competition than an electric distribution company (January 16, p. 130). Vectren's 10-K refers to the U.S. utility industry undergoing "Structural change for several years resulting in increasing competitive pressure faced by electric and gas utility companies." (January 16, p. 131; Information item No. 17, p. 9) It was evident during the cross-examination of Ms. McShane that most of the companies in her sample face more competition than Newfoundland Power (January 16, pp. 128 – 145). Companies identified as facing greater competition than Newfoundland Power include companies in Mr. MacDonald's sample such as Alliant Energy, Atmos Energy, Integrys and Southern Company.

Eighth, Newfoundland Power has full weather normalization protection. DBRS, for instance, notes that the company "Continues to benefit [1] from a weather normalization reserve (WNR) account that stabilizes earnings during extreme weather conditions." (DBRS – September 10, 2012, Exhibit 4) It is evident from the cross-examination of Ms. McShane that a number of companies in her sample are not as protected from weather effects as Newfoundland Power is. Information Item No. 15 was comprised of 10-K excerpts pertaining to descriptions of weather related risk on sales and revenues. In the 10-Ks, the companies clearly state the extent to which they are protected from weather effects. The cross-examination of Ms. McShane on this topic is found at pp. 67 to 87 on January 16.

Ninth, Newfoundland Power operates under a forward test year regime. It is not a matter of debate that the electric utility industry regards the forward test year more favourably than the historic or partially historic test year (Edison Electric Institute Study: Forward Test Years for US Electric Utilities, August 2010, Information No. 11). In reply to CA NP 330, Ms. McShane also acknowledges that "All other things equal, a forecast test year would be viewed as the least risky, followed by a partially forecast test year, a historic test year with known and measurable changes and a historic test year."

It is interesting to note that Dr. Vander Weide filed his July 2012 testimony for Empire Electric before the Public Service Commission of Missouri in Undertaking No. 13. At pp. 13 – 14 he testifies:

> **Q. How can regulators reduce the risk of Regulatory Lag?**
>
> **A. Regulators can reduce the risk of regulatory lag by various means, such as employing fuel adjustment clauses, <u>using forward-looking test years</u>, and including construction work in progress in rate base.**
>
> **Q. Does the Commission set rates based on a Forward-Looking Test Year?**

A. **<u>No. Rates in Missouri are based on an historical test period, adjusted for known and measurable changes for a six-month period beyond the end of the historical test year</u>." (emphasis added)**

It is clear from the record that while some of Ms. McShane's companies operate fully in forward-test year jurisdictions, a number do not (CA NP 329; January 16, pp. 102).

As noted above, regulatory lag is related to the type of test year used. Ms. Perry indicated that regulatory lag is not an issue for Newfoundland Power. Moody's Special Comment of June 2010 (CA NP 369, Attachment 2, p. 4) states:

> **However, the relationship between a utility's allowed return on equity and its ability to recover its costs and earn an adequate return is not as simple or clear cut as it may appear. A utility may have a low allowed ROE but be permitted to recover many of its operating costs through automatic adjustment clauses and other trackers, reducing risk and mitigating the impact of a low ROE. On the other hand, a utility may be permitted a high allowed ROE, but because of the higher than average risks associated with operating within this jurisdiction, the absence of such cost recovery provisions, overly long rate cases, or significant regulatory lag, may never actually earn its allowed return. According to the Edison Electric Institute, the average regulatory lag in the utilities industry is 11 months, close to where it has been for most of the last two decades. Adequate liquidity reserves on the part of utilities should mitigate some of the risks associated with regulatory lag.**

Tenth, Newfoundland Power has very little earnings volatility, as demonstrated in Dr. Booth's report (p. 86). Dr. Booth compared the volatility of Newfoundland Power's earned ROEs since 2002 to 2011 to those earned by 14 U.S. integrated electric utilities. Newfoundland Power's volatility in ROE is by far the lowest with a standard deviation of its ROE of just .64% whereas for the U.S. utilities it ranges from 1.31% to 7.96%. Dr. Booth stated (p. 87) the U.S. electric utilities have much more income or ROE volatility than Newfoundland Power, which explains their greater stock market risk. Notably, Allete, Edison and Southern had a standard deviation of its ROE of 3.30%, 7.96% and 1.47% respectively, all higher than Newfoundland Power's. Each of these companies are in Ms. McShane's and Mr. MacDonald's samples. These three companies as well as Western Energy (with a standard deviation of 4.07%) are also in Dr. Vander Weide's smaller U.S. sample. Out of the fourteen U.S. Electricity Utilities whose ROEs Dr. Booth examined, ten are included in Dr. Vander Weide's Comprehensive U.S. Utility Group (Exhibit 5). Ms. McShane was asked whether annual ROE volatility was of relevance to the cost of capital. She stated, "Well, I think one of the things that investors would look at would be return volatility, also look at the level of the ROE and how those two relate." (January 16, p. 122). Ms. McShane was asked whether a company with less earnings volatility would typically be indicative of lower risk. Ms. McShane replied:

> **Well, if you have - - I mean, if you have lower return year to year volatility, it may indicate that you've got lower short term risk." [January 16, p. 123]**

As was the case in 2009 in the last GRA, Newfoundland Power would have to be considered as less risky than the U.S. samples on nearly every measure.

E. <u>Weight of Expert Cost of Capital Evidence</u>

The Board has before it the evidence of four Cost of Capital witnesses. The Consumer Advocate submits that the evidence of Dr. Booth is entitled to the greatest weight. As Dr. Booth explains the legal definition of a fair ROE comes from Mr. Justice Lamont's definition in Northwestern Utilities, which the Supreme Court of Canada heard as a result of a regulatory decision arising from "changed conditions in the money market." What is critical is that the fair ROE is not something independent from the state of the capital markets. Here the Board should consider what has changed from 2009 when it last heard evidence on the cost of capital. In cross examination it was put to Ms. McShane (the only other witness that discusses capital market conditions in a substantive way) that her 2009 evidence was prepared during the very worst of the financial crisis (January 14, p. 126, lines 9-13). Since that time the value of the Toronto Stock Exchange's composite index has increased substantially and the volatility index has collapsed. As Ms. McShane admits she has previously referred to the volatility index as a "fear index" and when she prepared her testimony it had averaged over 40 over the first quarter of 2009 while it is currently at 13 (January 14, p. 129, line 9). There is no question that the capital market conditions have dramatically improved since the time she prepared her testimony and while it is true that there were signs of improvement at the time of the 2009 hearing, Ms. McShane did not change her recommended ROE so substantially no improvement was reflected in her judgment in 2009 before the Board (January 14, p. 125).

In contrast Dr. Booth is the only witness that has substantively looked at the development of capital market conditions since 2009 both in terms of the credit risk adjustment he has used since 2010 and his recognition of the impact of the U.S. Operation Twist. He references the Governor of the Bank of Canada in noting that the Canadian financial system is firing on all cylinders and the only problem is low long Canada bond yields. Yet as Dr. Booth points out that this "problem" is actually a reflection of the strength of the Canadian government's finances, as one of the few AAA rated countries left, and the flip side is that Canadian utilities, like members of the Fortis group, are now borrowing 40 and sometimes 50 year debt at incredibly low interest rates. How this can indicate anything other than a significant drop in the fair ROE is difficult to understand.

While both Dr. Vander Weide and Ms. McShane are prepared to acknowledge that their present recommendations are 50 to 60 basis points decreased relative to 2009, their own DCF-based equity risk premium tests reveal that relative to 2009 – there has been a much more significant decrease in the DCF equity cost. For instance, one observes a decrease in the DCF cost of equity of 180 basis points (i.e. 11.1% down to 9.30%) from 2009 to 2012 in Ms. McShane's DCF-based equity risk premium study (McShane Evidence – Schedule 14, p. 1 of 4; January 14, pp. 161-163). In the case of Dr. Vander Weide, one observes that the DCF return in March of 2009 stood at 12.50%, at October of 2009 stood at 11.20% and as of June 2012 stood at 9.30%, a decrease of 320 basis points from March 2009 and 190 basis points since the Board heard the evidence in the last Newfoundland Power GRA. As Dr. Booth stated upon cross-examination by Ms. Greene, Q.C. – it is important for the Board to look not just at how, for instance, Ms. McShane's recommendation has dropped 50 or 60 basis points since the last GRA. Dr. Booth recommended that the Board:

> **Look at not their recommendations, but the actual details at which they arrive at those recommendations, the DCF estimates on the monthly basis for both Dr. Vander Weide and Ms. McShane. They indicate that their DCF estimates have dropped not by half a percent but they've dropped by two-three percent since 2009 and they averaged it in with all the other estimates to hide that, but the fact is, but the fact is, their estimates indicate a very significant drop in the DCF equity cost.**
>
> **[Transcript, January 18, p. 144, lines 15-23]**

This is a critical observation. This hard evidence of a substantial drop in the DCF cost of equity over the past 3 years should not permitted to be obscured whether through new means of carrying out the historic utility equity premium test or the doubling of the allowance from .50% to

1.00% for financing flotation costs as Ms. McShane has done. The historic utility method as used by Ms. McShane, Dr. Vander Weide and Mr. MacDonald produce results that are not representative of the go-forward risk premium for a utility. Their DCF tests are not backed up by any substantiation as to whether the companies in the samples have ever achieved dividend growth rates approaching GDP growth.

The Consumer Advocate would respectfully submit that unlike the company's cost of capital witnesses, Dr. Booth's recommendation for the fair ROE is actually tethered to the real world. It is one thing for company witnesses to come before the Board with a multitude of tests and methods, but the fundamental question is whether the results are reasonable. It is necessary to pause and consider that we are dealing with the fair ROE determination for a low risk utility. TD Economics, Royal Bank of Canada, and Mercers have all been cited in Dr. Booth's evidence. These institutions are independent. Dr. Booth put it in this way:

> **So I would say it's not just me in this hearing room and it's not just three other witnesses. We also have evidence from the Royal Bank of Canada, TD Economics and others, and I would say to the Board if it says "well, look, Booth was very impressive but Ms. McShane was dynamite on the stand. She did a great job. Dr. Vander Weide, well, look at all of his estimates. They were very good." And Mr. MacDonald, I'm sure he'll do a great job, and if they think oh, it's a [saw] off, then I think they should go and look at what TD Economics and the Royal Bank of Canada and Mercer are saying because they're not here as expert witnesses. They're just providing information readily for all of their clients and I don't think it's very easy to get independent economists projecting long run returns on a capital market, the equity market greater than seven, seven and a half percent, which if you convert to an arithmetic basis is looking at nine, nine and a half percent. So giving ten and a half percent to what everybody recognizes is at very worst an average risk Canadian utility, given the current capital market conditions, I'd ask them just to question themselves "if I was to earn that in my RRSP or if I was to earn that in my defined benefit pension plan, what does that mean?" [January 18, pp. 133-4]**

The assessment of whether Dr. Booth's judgment is "too low" and whether Ms. McShane and Dr. Vander Weide's assessments are "too high" should also be viewed in the context of the hard evidence of the market to book ratios. Dr. Booth testified that every utility in Canada has got a market to book ratio of about 1.4 to 1.8. This means that every single equity dollar that the utility invests in rate base is worth $1.40 at a minimum and generally it is $1.80 to $2.00. Dr. Booth stated, "It means that investors are very, very happy with allowed ROEs in Canada. So am I disturbed that my recommended ROE is less than that adopted by the boards? I would say no. I would say the observation in the capital market of market to book ratios indicates that my recommendation, if anything, is a little bit on the high side." (January 18, pp. 138-9).

The Consumer Advocate submits that while all four cost of capital witnesses exercise judgment, Dr. Booth's judgment has been demonstrated to be constrained by facts.

F. Capital Structure

The capital structure targeted by Newfoundland Power is as follows:

Debt	54%
Preferred Equity	1%
Common Equity	45%

[Reference: Table 3-12, p. 3-29 of Volume I of Application and Company Evidence]

The Consumer Advocate recommends that the board for ratemaking purposes reduce the common equity component to 40% and replace the 5% common equity with preferred shares. As the Board noted in P.U. 19 (2003), this does not require intrusion into the company's actual decisions regarding the utility's actual capitalization. The Board stated:

> **It is clear the Board's role is not to second-guess management on its financial decisions regarding the utility's actual capitalization. The Board's approach, however, will be to consider an appropriate capital structure upon which to estimate the cost of capital for ratemaking purposes.**

Newfoundland Power's capital structure with 45% common equity is higher than any other Fortis utility in Canada and higher than Fortis Inc. Fortis Inc.'s Interim Management Discussion and Analysis dated November 1, 2012 (Information No. 6) was discussed during Ms. Perry's cross-examination. Page 22 of the document demonstrates that the other Fortis utilities in Canada including FEI, FEVI, FEWI and Fortis B.C. Electric are at 40%. Fortis Alberta is at 41%. Maritime Electric in PEI is at 40% and Canadian Niagara Power and Algoma Power in Ontario are each at 40%. The parent company itself has 34.6% common equity, 8.3% preferred shares and 57.1% debt. With each of its subsidiaries having 40% common equity or more, Ms. Perry agreed that the parent with about 35% equity is financing its equity investment in its subsidiaries with securities other than straight common equity. [January 15, p. 66]

Dr. Booth testified that he could see no objective reason why Newfoundland Power has a 45% common equity ratio when its sister companies in the Fortis group all have 40% to 41% (January 17, p. 163). He stated that he was not recommending that the 5% in common equity be immediately replaced with debt; instead he recommended 5% preferred shares.

In Dr. Booth's report (p. 80) he addresses the fact that preferred shares, unlike bonds, are similar to equity and paid out of after tax income and support the credit rating, as they do not add fixed interest. Dr. Booth provided an example in his report whereby for illustrative purposes if one assumed a 3.41% yield on preferred shares, the yield would be less than half the cost of the present cost of equity of 8.80%. The saving relative to the current 8.80% allowed ROE would be about 5.4% after tax or 7.20% pre-tax assuming a conservative 25% tax rate. This would reduce the revenue requirement by about $3 million. Dr. Booth observed that DBRS reports Newfoundland Power's credit metrics for 2011 to be as follows:

	2011
EBIT Interest Coverage	2.88 x
Cash Flow to Debt	18.1%

Dr. Booth states that for 2011 the loss of EBIT of $3,000,000 would have reduced interest coverage rates from 2.88 X to 2.80X and the cash flow to debt from 18.1% to 17.5%. These are not significant changes. The use of preferred shares was referred to by Dr. Booth as a "halfway house" between going to the same ratios as other Fortis utilities, a measure he described as reasonably prudent (January 17, p. 163).

Ms. Perry contended that such is the size of Newfoundland Power that an issue of $42 million would have difficulty being placed in the public market. The Consumer Advocate does not see any reason why Newfoundland Power cannot privately place preferred shares and would request that Newfoundland Power be asked to get two quotes from investment dealers as to the cost of such an issue for approval by the Board along with the appropriate pre-tax spread over the cost of long term debt. Alternatively, and in the interim, the Consumer Advocate recommends that for ratemaking purposes Newfoundland Power be deemed to have issued 5%

preferred shares at the same cost as the recent, November 2012, issue by Fortis, which had a 3.80% dividend yield. As DBRS notes (DBRS Criteria: Preferred and Hybrid Criteria for Corporate issuers, December 2012, page 7 – in a report referenced to by Newfoundland Power in NP CA 24) "DBRS will typically treat preferred shares and hybrids as debt when the ratio of preferred equity and hybrids to common equity exceeds 20%." With Dr. Booth's recommendation the ratio will only be 15% (5% new and 1% old preferreds to 40% common equity). He makes no specific recommendation on the type of preferred shares but notes that Fortis recent issue gave the company the option to refund them after five years.

The Board's staff cost of capital witness, Mr. MacDonald testified that the financial integrity of Newfoundland Power would not be impaired by having 40% common equity and 5% preferred shares and states that it is important to constantly consider the equity level and whether it is appropriate. He testified that the concern he had **"around the 45 percent and lowering it to 40 was simply more looking at some of the macroeconomic environment that we're working in today. So, for example, the sovereign debt crises, particularly in the US, and I was looking at that and determining that it was appropriate to maintain it at 45 percent until we had some clarity on those issues." [January 18, p. 218, see also p. 245]**

In our respectful submission, the macroeconomic concerns are not such as to continue to justify Newfoundland Power having 45% common equity when its sister utilities have 40% and they are subject to the same macroeconomic issues as Newfoundland Power and for that matter any other firm in Canada. Dr. Booth testified during his direct testimony (January 17, pp. 162-3) that in the 2009 hearing of the 2010 GRA, **"We had not yet fully emerged from the worst recession and the worse financial crisis in 70 years, and I pointed out at that time I wasn't going to change my recommendation for the common equity ratio. Now three years later, the Governor of the Bank of Canada has indicated the financial system in Canada is firing on all four cylinders – sorry, all cylinders, and when we look at Newfoundland Power, I can see no reason why it has a 45 percent, and I look at other regulated electric companies in Canada and they all have lower common equity."**

Mr. MacDonald's report acknowledges that the current market environment reflects significant recovery from the global financial crisis (MacDonald Report, p. 31, lines 622-3). At present with 45% common equity and 55% debt Newfoundland Power's financial risk is lower than that of companies with more debt and less equity in their capital structures. In P.U. 19 (2003) this

Board, at p. 31, accepted the following two definitions of Financial Risk as being both consistent and reasonable:

Financial Risk

Refers to the additional variability of earnings induced by the employment of fixed cost financing, that is, debt and capital stock.	**Risks that arise through the corporation's financing and capital structure.**

Dr. Vander Weide's report (p. 13) states that financial leverage (which is measured by the percentage of debt and equity in a capital structure) increases the risk of investors in electric and gas utilities. His report states:

> **Q 30 Why does high financial leverage affect the risk of investing in an electric utility's stock?**
>
> **A 30 High financial leverage is a source of additional risk to utility stock investors because it increases the percentage of the firm's costs that are fixed, and the presence of higher fixed costs increases the variability of the equity investors' return on investment. (emphasis added)**
>
> **Q 31 You note above that investors require a higher rate of return on more risky investments than less risky investments. Because financial risk is a key component of total risk, does a company with greater financial risk generally have a higher required rate of return on equity?**
>
> **A 31 Yes. Holding business risk constant, a company with higher financial risk would have a higher required rate of return on equity.**

Dr. Vander Weide testified on the stand that he would **"normally think of risk as - - financial risk as something that increases the variability in the return on equity as a result of leverage in the capital structure, and that is normally how finance people consider it."** Dr. Booth was in agreement with Dr. Vander Weide on this point (January 18, p. 80). As Dr. Booth expressed it, **"as far as the equity holder is concerned, the imposition of debt imposes fixed changes and it magnifies the return to the common shareholder. . ."** But Dr. Booth stated:

When you look at utilities, you got to ask what is it magnifying and the fact is, it isn't magnifying anything because utilities do not have negative returns in the sense of below their allowed ROE. So I don't see any evidence that the actual imposition of debts for any Canadian utility over the last 20 years has magnified the risk to the common shareholders, not in terms of the short run, ability to earn the allowed ROE or the impact on the shareholder." [January 18, pp. 80-81]

As regards Business Risks, the Board in PU 19 (2003) p. 31 accepted the following definitions of Business Risk as being both consistent and reasonable:

<u>Dr. Morin</u> **<u>Business Risk</u>**	**<u>Drs. Winters and Waters (1998)</u>**
Refers to the relative variability of operating profits induced by the external forces of demand for and supply of the firm's products, by the presence of fixed costs, by the extent of diversification of lack thereof of services, and by the character of regulation.	The basic risk that the utility's operating income may not be sufficient to service all its obligations, including the provision of the return on equity the investor regards as fair and expects to receive, in one or more future periods.

In PU 19 (2003) the Board concluded that Newfoundland Power was of "average business risk compared to other utilities." Ms. Perry was asked if Newfoundland Power considered its business risk to be greater than the average of the Canadian utilities. She indicated that she wanted to say yes but was not sure that she qualified to do so (January 15, p. 52) She went on to cite demographics, the size of Newfoundland Power and its low growth profile that weighed into her belief that Newfoundland Power has certain business risks not faced by others.

Dr. Booth states the following in his report (p. 4):

Q. DO YOU HAVE SOME OVERALL REMARKS?

A. Yes. In answer to CA NP001A NP referred to its pre-filed testimony (page 5) and the statement:

> **"Financial market conditions have changed dramatically in recent years. Newfoundland Power's principal business, regulatory, and financial risks, have not changed materially over this time."**

> **An almost identical statement is on page 3-16 of the current application. I would accept that NP has average business risk, an assessment that NP seems to accept[1] and also that it has lower financial risk, which NP also seems to accept[2]. NP is reluctant to accept that Canadian regulators, such as the AUC, as a matter of policy use financial risk to offset business risk so that all their utilities can be allowed the same ROE[3]. However, this has been the explicit policy of the AUC and the NEB, whereas other boards like the OEB and the BCUC have made risk adjustments through both the common equity ratio and the risk premium over a generic ROE.**
>
> **However, it is a logical conclusion that if NP is an average business risk utility and has lower financial risk, then it should have either a lower allowed ROE than a benchmark Canadian utility or its common equity ratio should be reduced. The most recent benchmark allowed ROE is that by the AUC (Decision 2011-474, December 8, 2011) which allowed an 8.75% ROE for 2012. This was then applied to taxable electric distribution utilities on a 39% common equity ratio. More recently in September 2012 Nova Scotia Power Inc. (NSPI) settled on an ROE of 9.0% on 37.5% common equity. In contrast NP is currently on an ROE of 8.80% on 45% common equity. I would regard NP's financial parameters as being overly generous compared to these decisions and I have only refrained from making a capital structure recommendation previously due to the state of the capital markets. However, as time passes, and markets heal, the need for such a high common equity ratio also passes.**
>
> **[1] See CA NP003A.**
> **[2] See CA NP004A.**
> **[3] See CA NP002A.**
>
> **(emphasis added)**

To follow up on Dr. Booth's point, in the Consumer Advocate's submission, there is no objective justification for Newfoundland Power to have one of the highest common equity ratios in Canada in order for it to be considered an overall average risk Canadian utility. In December of 2012, Ms. McShane was out before the BCUC recommending 10.5% on 40% common equity for FEI while on Newfoundland Power's 45% common equity, she is recommending the same ROE – 10.5% (January 14, p. 64). As brought out during the hearing in cross-examination of Ms. McShane – the various sectors in the utility business were ranked by Ms. McShane in her August 2012 report on a generic basis in terms of risk. This evidence was part of the evidence required as part of the BCUC's minimal filing requirements for the generic cost of capital hearing it conducted in December of 2012. In fact, Ms. McShane's testimony on cost of Capital for the

Fortis BC utilities dated August, 2012 (Information No. 5) stated that the utility sectors ranges from lowest to highest business risk were as follows:

Lowest	-	Electricity Transmission
	-	Electricity Distribution
	-	Natural Gas Distribution
Highest	-	Vertically Integrated Electric Utilities

[Reference: Information No. 5, pp. 45-48]

According to Ms. McShane's recent evidence before the BCUC, natural gas has less end uses than electricity. Throughput is generally more weather sensitive for natural gas distributors than for electricity distribution utilities. Industrial processes that use natural gas can frequently switch to other sources of energy. Heating load gas utilities have more exposure to declining throughput due to factors such as smaller and more energy efficient houses than electricity distributors. In FEI's case, a natural gas distributor, its capture rate in new multi-unit dwellings continues to be materially lower than in single family housing (30% vs. 70%) (p. 49). FEI's customer usage rates continue to fall. (p. 50). FEI's estimates show that usage rates of new residential customers is almost 50% lower than that of existing customers. Natural gas's share of the BC residential market is just under 50%, compared to over 60% in Ontario and over 80% in Alberta. These challenges are indeed referred to in Fortis Inc.'s 2011 Annual Report (CA NP 522). Ms. McShane's evidence in BC stated at p. 52:

> **The competitive pressures on natural gas in BC that stem from the abundance of low cost hydroelectric resources and the evolving housing composition are amplified by energy policies. Designed to fight climate change, provincial energy policies and associated regulators promote reduced and more efficient energy use, discouraging the use of fossil fuels, and promote the development and use of clean energy technologies and renewable resources. By the time of the 2009 application, the province had introduced its 2007 Energy Plan and related legislation that committed to greenhouse gas ("GHG") emission reduction targets and imposed the carbon tax on fossil fuel, including natural gas. The policies and legislation have both direct and indirect impacts on the use of natural gas. The carbon tax directly raises the commodity price of natural gas. The carbon tax on natural gas was $.50/GJ in 2008, and reached $1.50/GJ in 2012, where it will remain, pending the government's comprehensive review of the tax.**

FEI's operating risks outlined in Ms. McShane's report (at p. 54) included outages, gas leaks, severe weather and natural disasters. FEI is stated to operate in "remote and rugged terrain, which are subject to damage from a variety of natural events (e.g. avalanches, landslides, forest fires)." Meanwhile, FEI's regulatory risk (at p. 55) included since 2009 "increased regulatory lag and uncertainty that stem from the changing energy environment, particularly for natural gas. More FEI activities, focused on new initiatives, are subject to regulatory oversight, entailing more frequent, protracted and contentions proceedings. With the requirement that the Commission consider applications in the context of the province's energy policies, in particular the 2010 Clean Energy Act, the regulatory environment has been more complex and less predictable."

Notably for FEI's capital structure, Ms. McShane stated at p. 56, "Consequently, in the context of the trend in business risk, FEI's <u>deemed 40% common equity ratio</u> remains at the low end of a reasonable range." (emphasis added)

Ms. McShane was asked her opinion as to how she would judge Newfoundland Power's business risks relative to FEI's. She stated (January 14, p. 95) that "if you put aside the issue of size, where FEI is a much larger utility, FEI is of somewhat higher fundamental business risk than Newfoundland Power." She stated that "FEI has more risk with the size issue aside. I think they're relatively similar if you consider the size issue."

Ms. McShane's position essentially means that Newfoundland Power's size erases all of the advantages that Newfoundland Power enjoys by way of business risk – from its being in a low risk utility sector (T&D), to its being market dominant with little competition, to its supportive and predictable regulatory environment – to the point that it is of relatively similar risk with a gas distribution utility that is losing market share, experiencing declining usage and government tax policy that is dis-incenting the use of its products, all the while facing increasing regulatory uncertainty. Presumably institutions such as DBRS are aware of Newfoundland Power's size and yet Newfoundland Power's <u>low business risk</u> has been consistently confirmed and its ability to earn its allowed return has been amply demonstrated year after year.

The Consumer Advocate submits that there is no truly objective basis in the present circumstances to accept 45% of common equity in Newfoundland Power's capital structure for ratemaking purposes. There is no objective evidence that in all the circumstances

Newfoundland Power requires 45% to be an "average risk Canadian utility." Dr. Booth's preference shares proposal represents a balanced and reasonable approach to lowering Newfoundland Power's common equity ratio for ratemaking purposes.

G. Automatic Adjustment Formula

The Board is faced with two choices: a fixed ROE as is requested by Newfoundland Power, or the introduction of a modified automatic adjustment formula (AAF) as recommended by Drs. Booth and Mr. MacDonald.

In terms of the AAF the Consumer Advocate would point out that Dr. Booth's addition of a .50% adjustment to credit spreads has been accepted by the Régie and the OEB, and as his report indicates would have broadly replicated the actions of regulators across Canada in 2009 in their awards in the wake of the financial crisis. In this both, he and Mr. MacDonald are in agreement, as indeed was Ms. McShane in testimony before both the NEB and the Régie in 2010 (January 16, pp. 161-2).

For the adjustment to changes in long Canada bond yields, the Consumer Advocate agrees with Dr. Booth's recommendation of a 75% change or that the Board maintain its existing 80% change. The main reason for this is consistency with prior decisions of the Board as interest rates revert to normal. This was the explicit decision of the Régie in adopting Dr. Booth's 75% change over the 50% change recommended by Ms. McShane in Decision D-2010-147 (Undertaking No. 14). Further in undertaking U-17 it is clear that even though Mr. MacDonald did not go back as requested to back-test his formula, to 1993 his recommended AAF would involve the same over-estimation and inconsistency with prior Board decisions that the Régie rejected.

Finally we come to how to deal with the current situation of exceptionally low interest rates. Mr. MacDonald suggests that there be a "no change" range around the allowed ROE. However, the Consumer Advocate agrees with Newfoundland Power (Mr. Kelly's cross-examination of Mr. MacDonald, January 18, pp. 210-213) that such a band means that there can be a dramatic jump in the allowed ROE caused by minor changes in the forecast long Canada bond yield that triggers a significant ROE change. Instead the Consumer Advocate recommends the floor for the long Canada bond yield forecast be set at 3.80% as recommended by Dr. Booth. This ensures that unless the long Canada bond yield substantially increases and moves back to the normal range, there is no change in the allowed ROE. In effect the ROE is fixed. In this Dr. Booth and Ms. McShane are in broad agreement where she sets the "floor" at 4.0%. In this case the ROE would only be changed if the credit spread falls indicating that capital market conditions are returning to normal.

II. OPERATING COSTS

A. <u>OPEBs – Impact of New Provincial Regulation</u>

U-11, Table 1 presents the calculation of the proposed 2013 and 2014 test year OPEBs Expense. The first line of the table shows the U.S. GAAP Cost ($5,991 for 2013E and $5,984 for 2014E).

The source for these values is the actuarial report from Mercer (Mercer Report) which is attached to undertaking U-11. The relevant values for 2013 and 2014 appear on the line labelled "Net periodic benefit cost (income)", which is the last line in the section labelled "Components of net periodic benefit cost".

It is clear from the Mercer Report that the values being used are derived using an analysis of the OPEBs that does not involve a forecast of expenses based on explicit consideration of relevant cost drivers such as the reduction in drug costs that has been legislated by the Province in the <u>Interchangeable Drug Products Formulary Regulations 2012</u> which came into force on April 16, 2012. The assumptions on which the calculated OPEBs Expense is based are also shown in the attachment to the undertaking. They are listed in the section labelled "Assumptions". The lines showing the "rate of compensation increase", "Health care inflation – Select" and "Health care inflation – Ultimate" are all high level measures that reflect long term trends and do not capture specific cost drivers. This interpretation of the assumptions was confirmed by Ms. Perry at (Jan 16) page 19 lines 3-9, where she states that Mercers simply uses historical data to "extrapolate forward for purposes of accounting." An extrapolation of historic data could not, and did not, reflect the downward impact of the legislated reduction in generic drug costs.

The Mercer approach is accepted and standard for purposes of financial reporting. However, this actuarial methodology was not designed to be a forecast that would meet the generally accepted standards for determining the forecast costs for a test year that should be recovered in rates set by a regulator. Any forecast of costs that are to be included in rates should reflect all known cost drivers that will result in higher or lower rates than are derived by simply extrapolating past costs. This extrapolation approach would never be accepted for forecasting energy demand, labour costs, or any other expense included in the company's revenue requirement. It is not acceptable for forecasting OPEBs costs either.

Based on the cross-examination of Ms. Perry, it is clear that the forecast of OPEBs expense was not updated to reflect the fact that a reduction in drug costs has been legislated by the Province. Ms. Perry acknowledged that "the impact of the regulations will or should be expected to reduce the cost of drugs inside the program" (January 15, p. 136, 6-8). Nevertheless, no adjustment was made, with the rationale being that "it's just simply not practical to forecast the impact because we have no claims experience." (p. 137, 3-5). In other words, without the claims experience, the company chose to assume the impact would be zero, although they expected there to be a reduction in costs. The Consumer Advocate submits that in forecasting any cost to be recovered in rates, the best available estimate of the impact of any known cost driver should be used, rather than assuming a known cost driver will have no impact.

While the information on the record may not enable us to forecast the impact of the reduced drug costs on the OPEBs expense precisely, and we all know that no forecast is precisely accurate, there is sufficient information to make a better forecast than assuming there will be no impact. Specifically, Ms. Perry has stated that "about 60 percent of our plan is geared towards generic drugs" (p. 138, 12-13). Ms. Perry also noted that "the range that Blue Cross provided is that they suspect that on certain drugs it [the price reduction] could be as high as 20 percent difference" (Jan 16, p.11, 2-4).

The Consumer Advocate therefore submits that it would be more reasonable to assume a 6% reduction in OPEBs Expense than no impact due to the reduced drug costs. This 6% figure is derived by assuming an average reduction in the cost of generic drugs of 10% (i.e., one-half of the 20% "as high as" figure) and applying that saving to the 60% of the total expense which is the portion that relates to generic drugs. It is submitted that based on the information on the record, assuming a 6% cost reduction is more credible than assuming no cost reduction due to the legislated savings in generic drug costs. The Consumer Advocate would note that the Province legislated this reduction in the price of generic drugs in order to benefit everyone in the Province who must pay for generic drugs. The Consumer Advocate submits that Newfoundland Power ratepayers are as entitled to enjoy this benefit of the legislated savings on a timely basis as any other company, such as Newfoundland Power, or individual who pays for generic drugs. The only way to pass this benefit through to ratepayers in a timely manner is to adjust the OPEBs expense that is included in rates for the 2013 and 2014 test years. The Consumer Advocate would also note that the Board need not be concerned that this adjustment may not be precisely accurate – the OPEVDA ensures that the actual costs will ultimately be passed through to ratepayers. However, in 2013 and 2014, the OPEBs Expense included in rates should be adjusted so that the best available estimate of the reduced OPEBs Expense is reflected in rates.

B. Retirement Allowances

Newfoundland Power's policy as regards retirement allowances for retiring employees is as follows:

> **Upon retirement, a regular Newfoundland Power Employee with ten or more years of service who qualifies qualify for and receives a Company pension will receive a retirement allowance.**
>
> **The retirement allowance is calculated by multiplying the regular employee's basic weekly salary by the number of completed weeks of continuous employment with the company to a maximum of twenty-four weeks; as of January 1, 2014, to a maximum of twenty-five weeks. [Reference: CA NP 506]**

While the payment of retirement allowance is a term of the Company's Collective Agreements, it is also a term of employment of non-unionized regular employees. **[Reference: CA NP 506]**

For both unionized and non-unionized employees from 2010 to 2014 (f) the annual retirement allowance payments are as follows:

2010	- $239,000.00
2011	- $666,000.00
2012 (f)	- $762,000.00
2013 (f)	- $631,000.00
2014 (f)	- $889,000.00

[Reference: CA NP 510]

In response to CA NP 490, Newfoundland Power provided information which outlines that by 2017, employees with 30 or more years of service are forecast to make up the smallest group of employees with Newfoundland Power. That group of employees will make up approximately

15% of the total workforce. By 2017, employees with less than 10 years of service will make up approximately 45% of the workforce.

In contrast, back in 2007, approximately 28% of Newfoundland Power's workforce had 30 or more years of service but employees with less than 10 years of service made up approximately 15% of the workforce. In 2012, 32% of the Newfoundland Power workforce has 30 or more years of service, while another 32% of its workforce has less than 10 years of service. This means that between 2012 and 2017 including during test years 2013 (f) and 2014 (f), there will be an increase of hiring new employees to facilitate employee turnover, primarily due to retirements. **[Reference: CA NP 490]**

The evidence demonstrates that for publically advertised positions between 2010 and 2012, Newfoundland Power received a very healthy number of applications from qualified applicants for the majority of positions advertised. A question regarding the number of qualified applicants applying for publically advertised recruitment in 2010 – 2012 was asked of Mr. Gary Smith, Vice-President, Engineering and Operations with Newfoundland Power by the Consumer Advocate during his testimony on January 25, 2013. After outlining to Mr. Smith the general contents of CA NP 421, the following exchange occurred:

> **Q. . . . So it seemed to me that in terms of the recruitment piece, that Newfoundland Power would have very little difficulty attracting talent, but perhaps the PLTs would be the biggest challenge that you have. Would that be a fair statement?**

In response, Mr. Smith stated:

> **A. I mean, the information certainly indicates we get quite a number of applications for positions, and as indicated, these would be qualified applicants which would make the minimum requirement of whatever might be in the job posting. It could be a college degree, university degree, whatever it might be. So, yeah, this would be a listing of people who met those qualifications and a number of people who have applied for these positions, and for some of them, yeah, there's lots of applications for sure. [Reference: Transcript of Evidence, Gary Smith, January 25, 2013, pp. 27-28]**

Further on in his testimony, Mr. Smith, in responding to a question from the Consumer Advocate regarding Newfoundland Power being an attractive employer in the community, stated:

We certainly see ourselves as an employer that people want to work for and you can see in the information in terms of the number of applicants. [Reference: Transcript of Evidence, Gary Smith, January 25, 2013 – pp. 35-36]

Mr. Smith went on to attempt to distinguish between the number of applicants and whether or not those applicants were people that Newfoundland Power would want to hire but Mr. Smith does not revise his statement that Newfoundland Power is an employer for whom people want to work.

As outlined in CA NP 506, Newfoundland Power states that "Payment of a retirement allowance is a term of the Company's Collective Agreements, and is also a term of employment of non-unionized regular employees". But clearly, there is no contractual obligations upon Newfoundland Power to provide the retirement allowance to new non-unionized hires. That is completely up to Newfoundland Power and there is no evidence that there is a need to continue to offer this benefit in order to attract and retain new employees. In fact, the evidence is clear that Newfoundland Power has very little difficulty attracting qualified applicants.

The Consumer Advocate submits that there is a growing trend away from the payment of retirement allowances. Recent examples of these trends include the confirmation on January 15th, 2013 that the Province of New Brunswick will phase out retirement allowances for government employees effective April 1, 2013. This confirmed the 2011 announcement of the discontinuance of retirement allowance for management and non-union employees hired on or after April 1, 2011. **[Reference: Government of New Brunswick, Department of Human Resources, memo, Corporate HR Initiatives, January 15, 2013, p. 2, Tab 1]** In July, 2012 it was announced that Federal government employees would no longer be able to accumulate their severance packages, and that while payouts would be made for the contingent liability, the accumulation of the package would no longer be available. Similarly, members of the Canadian Forces and the RCMP can no longer accumulate retirement allowances. **[Reference: Government of Canada. "Jobs, Growth and Long-Term Prosperity: Economic Action Plan 2012", p. 224, Tab 2; www.budget.gc.ca/2012/plan/pdf/Plan2012-eng.pdf.]**

In summary, the Consumer Advocate submits that workforce demographics indicate that the present time is an ideal time to address this practice. The Consumer Advocate submits that the evidence is clear that the removal of the benefit will not impact Newfoundland Power's ability to attract qualified applicants during the ongoing and pending workforce change. The Consumer Advocate further submits that historical precedent shows that the transition from a defined benefit pension plan to a defined contribution pension plan did not negatively impact Newfoundland Power's ability to attract qualified employees. In addition, the evidence is clear that there is a transition away from the granting of retirement allowances and that for the benefit of ratepayers, Newfoundland Power should act accordingly.

As a result, the Consumer Advocate respectfully submits that the revenue requirement for 2013 and 2014 should not include any recognition of future retirement benefit costs in the form of retirement allowances for non-unionized employees who commence employment with Newfoundland Power during the test years 2013 and 2014 or beyond.

C. <u>Executive Compensation – Short Term Incentive (STI)</u>

CA NP 440 outlines the salary policy for the four executive members of Newfoundland Power as well as the nine senior managers. The incentive target upon which STI is payable is also outlined therein. According to CA NP 440, the total available incentive pay for the Executive and Managers for the year 2012 is $674,970.00. This STI target is based on achievement of 100% of corporate and individual targets. Pursuant to PU 19 (2003), any target reached in excess of 100% by the Executive or Managers does not form an obligation on rate payers. Amounts in excess of 100% of target are deemed to be non-regulated and therefore the cost of same is borne by shareholders and not customers.

According to CA NP 451, "The underlying rationale for the STI plan is to incent senior management performance by making a significant portion of total compensation dependent on performance." Newfoundland Power's executives and top nine managers participate in the Company's STI plan.

Since the 2010 General Rate Application, there have been two changes to the STI plan. As outlined in CA NP 451 at Tables 1 and 2, the target percentage payout for the four executive members have been increased between 5% and 10% depending on the position and, as well, for the executive the weightings based on corporate or individual performance have also been changed. As a result of these changes, the target percentage payout for the President and CEO is now 50%, VP, Customer Operations and Engineering is 40%, VP, Regulation and

Planning is 35% and VP, Finance and CFO is 35% of base salaries. The current weightings between corporate and individual have been changed so that the President and CEO's weightings are based on a 70% corporate and a 30% individual weighting while the Vice Presidents' weightings are 50% corporate and 50% individual. **[Reference CA NP 451]**

The reason for the change in the target amounts was pursuant to the recommendation of the Hay Group as outlined in correspondence found in CA NP 439, Attachment D. As to the change for the weightings for the corporate versus individual portion of the targets, this occurred at the impetus of the President and CEO, Mr. Ludlow. After indicating in his testimony that any change to the STI program would be made through the Board of Directors upon recommendation from the governance and HR Committee, Mr. Ludlow indicated:

> **So, I decided upon looking at incumbents, contribution and impact, to take a recommendation to the governance committee of reducing the personal component or the corporate component and raising the individual and bringing it on a 50/50 split for the Vice presidents and it was just a slight adjustment of 5 percent on mine from 75 to 70, 75/25 to 70/30. And it was based upon where we are, the basis of our operation, and the contributions that three versus I guess at one point in the past could have been as high as six or seven executive members. So it was a personal thing, my professional judgment, that I decided to take that forward on that basis, Mr. Chairman. [Reference: Transcript of Hearing, January 10, 2013, p. 71]**

The Short Term Incentive Plan corporate target is made up of several categories and measures with specific weightings given to each of the categories and measures. Tables 1 through 5 at CA NP 443 outlines the applicable categories, measures, target percentages and weights. In particular, Table 5 which outlines the short term incentive plan corporate targets for 2012 is reproduced below:

Table 5
Short Term Incentive Plan
Corporate Targets for 2012

Category	**Measure**	**Target (100%)**	**Weight**
Reliability	Outage Hours/Customer (SAIDI)[14]	2.58	15.0%
Customer Satisfaction	% Customer Satisfaction[15]	88.5%	7.5%
	First Call Resolution	88.5%	7.5%

Safety	All Injury Frequency Rate	1.56	15.0%
Financial	Controllable Operating Cost[16] /Customer	$222.1	20.0%
	Earning	$31.5m	35.0%

As indicated in the above table, weighting is provided to specific categories and how those individual categories are measured is shown with each target percentage. As indicated at the bottom of Table 5 and as indicated in Tables 1 through 4, "Earnings" is a separate measure for which a consistent weighting of 35% has been given. This 35% weighting has remained unchanged since the corporate targets for 2008, however the target to be attained to enable that measure to be met has changed. For 2012, the earnings target is stated in Table 5 to be $31.5 Million. These targets are based upon reaching 100% of the indicated target amount.

In addition to the corporate targets referred to above, the determination of individual targets for the Short Term Incentive Plan for the executive and managers is also outlined in CA NP 443. As with the corporate targets, there are individual categories and weightings given to sub-divisions for executive members and, as well, general categories and weightings outlined for the managers' individual targets.

Of the individual targets outlined for the executive and managers, the President and CEO and the VP, Finance and Chief Financial Officer have as part of their personal performance targets a category entitled, "Financial Results" which is tied to a minimum earnings threshold. For the CFO, the weighting given to this category is 40% of the total individual portion of her target and for CEO, the weighting for this category is 35%.

For overall STI entitlement therefore, a significant portion of the corporate performance requirement and for the CEO and CFO, a significant portion of the personal performance target, is composed of either "Earnings" or "Financial Results".

The Consumer Advocate respectfully submits that just as STI payouts in excess of 100 percent are not payable by rate payers and in fact are the responsibility of shareholders, those portions of STI payouts that are based on financial results and/or earnings should not be the responsibility of rate payers but should likewise be the responsibility of shareholders. The beneficiaries of categories such as "Financial Results" and/or "Earnings" is the shareholder and not the customer. Accordingly, the shareholder should be responsible for the cost of making the payments to the executive and senior managers for the accomplishment of such an STI category and not the ratepayer.

The following exchange between the Consumer Advocate and Mr. Ludlow confirms this position:

> **Mr. Johnson:**
>
> **Q. I thought the question was very-called for a very obvious reply, Mr. Ludlow, that shareholder profit, that which turns into dividends to go back to shareholders, while there may be some aspect of benefit to customer in some sense, the primary beneficiary of the earnings is that of the shareholder, is it not?**
>
> **Mr. Ludlow:**
>
> **A. There is no question that the financial integrity or the earnings of the company go back to the – obviously, the common equity shareholders, yes, but in getting that and creating that earnings is a separate issue.**
>
> **Mr. Johnson:**
>
> **Q. Yeah, but the primary beneficiary of the earnings would be the shareholders?**
>
> **Mr. Ludlow:**
>
> **A. The dollars, yes. [Reference: Transcript of Hearing, January 10, 2013, p. 80]**

The Public Utilities Board of the Northwest Territories, in disallowing 50% of the "at risk" (i.e. performance based component) compensation that was based upon net income, on the basis that the interest of customers and shareholders might not be aligned, stated in Decision 13-2007 at page 94:

> **While the range is not in dispute, what is in dispute is which party should pay for the at-risk compensation: the shareholders or the ratepayers. It is the view of the board that any at-risk compensation that is included in the revenue requirement should result in clear benefits to customers.**
>
> **<u>The Board notes that under the Corporation's at-risk compensation program, 50% of the potential compensation amount is based on net income targets</u>, 25% is based on the achievement of individual objectives and 25% is based on the achievement of operational targets.**

The 50% of NTPC's at-risk compensation, which is based on net income, is based on the return on equity of the regulated business. The Board agrees with the HC that the potential exists for management to improve net income, and hence increase at-risk compensation, in manner that is detrimental to the ratepayers and exclusively to the benefit of the shareholders.

While NTPC argues that there is no evidence of this occurring, the Board is of the view that no such evidence is necessary for the Board to take action as it is the compensation model that is at question, not any specific actions of management. It is the Board's view that an at-risk compensation model that allows for actions that benefit the shareholders, but not the ratepayers, is not appropriate in NTPC's regulated business. (emphasis added) [Reference: the Public Utilities Board of the Northwest Territories, Decision 13-2007, p. 94, Tab 3]

In Ontario, the 2006 Electricity Distribution Rate Handbook makes specific reference to incentive plans. It states:

Distributor incentive compensation plans reward employees for meeting specific performance targets. The targets can include performance which benefits ratepayers, or which benefits primarily the shareholder.

Incentive payments related to benefits to shareholders will not be recoverable in the 2006 revenue requirement. An applicant seeking to include expenses related to employee incentive plans should include only the costs of incentives that reward the creation of ratepayer benefits. (emphasis added) [Reference: Ontario 2006 Electricity Distribution Rate Handbook, p. 42, Tab 4]

In Decision 2006-024 concerning ATCO Electric Ltd.'s 2005-2006 Transmission and Distribution General Tariff Application, the EUB (Alberta) denied the inclusion of ATCO Electric's proposed portion of the variable pay plan (VPP) focused on financial returns. The EUB found that that it was not appropriate to fund the portion of the VPP set up for fifteen senior employees through rates where the benefit of the variable pay plan primarily provided an increased return to the utility.

The EUB stated:

The Board considers that where the benefits will add to AE's efficiency and provide tangible benefits to customers, there may be merit to the applicable portion of the variable pay program being included in revenue requirement. However, where the benefit primarily provides an increased return to AE, the

> **Board considers that it is not appropriate to fund the portion of the variable pay program through rates.**
>
> **Therefore, the Board denies inclusion of the 50% of the variable pay program that focuses on financial returns. (emphasis added) [Reference: Alberta Energy Utilities Decision 2006-0024, ATCO Electrical General Tariff Applications, March 17, 2006, p. 74, Tab 5]**

The Consumer Advocate respectfully submits that the revenue requirement for 2013 and 2014 should not include the portion of the STI for Executives or Managers resulting from achieving targets relating to earnings. The achievement of these targets is for the primary benefit of shareholders and not ratepayers.

D. Conservation Plan

At Table 2-9, Newfoundland Power sets out customer energy conservation costs for Newfoundland Power from 2009 to 2014 (f) as follows:

Table 2-9
Forecast Costs
Customer Energy Conservation
2009 to 2014F
($000s)

	2009-2012F	2013F	2014F
General	3,081	1,026	1,088
Program	8,921	3,065	4,401
Total	**12,002**	**4,091**	**5,489**

For 2013 and 2014 total customer energy conservation costs are forecast to average approximately $4.8 million per year, an increase over the average annual costs of $3 million from 2009 to 2012 (f).

The Company's evidence (2-17) indicates that the increase in the Company's total customer energy conservation costs primarily reflects the expansion of customer energy conservation program offerings, as well as additional market research and customer education and support activities.

As part of its evidence, the Company has filed the joint Newfoundland and Labrador Hydro and Newfoundland Power Five Year Energy Conservation Plan: 2012-2016 (the 2012 Plan) dated September, 2012 (Volume 2, Exhibits and Supporting Materials, Reports, Tab 1). Further to the filing of the 2012 Plan by Newfoundland Power as part of its General Rate Application, Newfoundland and Labrador Hydro recently applied to the Board on January 14, 2013 for approval of the deferred recovery of the 2013 costs to be incurred by Hydro in association with the energy conservation program in 2013, which are estimated to be approximately $1.95 million.

The 2012 Plan was completed by both of the province's utilities in partnership. The 2012 Plan is the second such plan and follows on the 2008 Plan.

Given that the 2012-2016 plan impacts upon the customers of both Newfoundland Power and Newfoundland and Labrador Hydro and involves each of the utilities in extending program offerings to their customers, any assessment of the 2012 Plan must by necessity involve both utilities. The Consumer Advocate submits that an assessment of the 2012 Plan involving both Newfoundland Power and Newfoundland and Labrador Hydro should take place in the wake of its recent filing with the Board.

The Consumer Advocate is encouraged with the greater emphasis being placed on conservation and acknowledges that each utility reports growing customer participation in their programs. To date, Newfoundland Power reports that approximately 17,000 of its customers have participated in customer energy conservation projects since 2009. Visits to the *Take Charge!* website have also increased considerably to over 70,000 visits in 2011.
There is concern however that in circumstances where 96% of electricity customers indicated the primary motivation for trying to cut back on electricity use is to save money by lowering their electricity bill (Plan, p. 11., footnote 21) that the 2012 Plan reflects that spending will decrease over the 2012-2016 period in relation to the residential Insulation Program (Schedule "A", p. 2 of 2; Schedule "C", p. 2 of 3). This is a concern because the Insulation Program has resulted in the highest amount of energy savings of all programs in the portfolio. While the need to incentivize insulation in new housing stock has been lessened due to changes to building standards, the existing housing stock in the province still remains and given that insulation produces energy cost savings at the household level which are noticeable to customers in their monthly bills, it should be enhanced. As we see from the reply to CA NP 470, over the years

2013 (f) and 2014 (f), the Company's forecast costs on insulation are $589,000 and $514,000, down from $659,000 in 2012. We see in 2014, however, that the spending on Small Technologies is increasing from $118,000 in 2013 (f) to $1,565,000 in 2014 (f). The Small Technologies program proposed under the 2012 Plan will promote small technologies, such as CFLs, LED lighting, 'smart' power bars and Energy Star televisions, through instant rebate coupons and promotional events across the province. The 2012 Plan states (p. 18) that this program will appeal to a broad customer group as these technologies will not involve a major home renovation. While that statement is true, it is also true that as compared to the direct benefit to a heating customer from insulation installation in terms of a bill impact, the per household benefit would be much more modest with the Small Technologies Program.

The numbers of participants that Newfoundland Power is forecasting in each of its customer energy conservation programs from 2012 through 2016 are provided in Undertaking 24. For ease of reference it is reproduced below:

Table 1
Customer Energy Conservation Programs
(000's) (sic)

	2012F	2013F	2014F	2015F	2016F	Total
Insulation	1,153	907	831	873	917	4,682
Thermostats	1,800	2,376	1,988	2,427	2,068	10,659
ENERGY STAR Windows	2,000	1,475	864	907	952	6,198
HRVs		754	1,138	1,313	1,521	4,726
Small Technologies			36,913	40,605	44,665	122,183
Commercial Lighting	291	637	992	1,169	1,204	4,293
Business Efficiency		6	28	46	57	137
Total	5,244	6,155	42,754	47,340	51,384	152,877

According to the reply in the Undertaking, forecast participation in the Insulation and Energy Star Windows program for 2014 through 2016 includes only retrofit of existing homes.

The issue is why more aggressive targeting of this segment is not occurring. The answer to the undertaking indicates that while Newfoundland Power sets an annual target for energy savings from the conservation program portfolio, the Company does not set targets for program operation based on individual program participation.

The Consumer Advocate submits that more aggressive participant targeting can only serve to benefit customers. If such targets were set, management of each of the utilities would have goals to strive for, and results by which performance could be assessed.

Mr. Winston Adams' testimony before the Board provided a detailed critique of the Conservation Plan and brought forward a series of recommendations. Mr. Adams stated that his conclusion was that the plan as proposed is inappropriately funded and that the measures selected had no meaningful impact for the ratepayer. He concluded that the plan does little to reduce system peak loads, the high cost of which is placed on the ratepayers. He recommended that the utilities should be replaced by others to carry out the conservation and demand management initiative. He also stated that the rates which give discounts for more power use should be changed as they discourage conservation. Mr. Adams also pointed to 400 amp residential services as discouraging efficient heating systems. Mr. Adams referred to the potential energy and peak savings that could arise from air sealing homes and through the use of ductless heat pump units. He stated that mini split heat pump units reduce heating for our climate on average 65 percent. He stated that these units operate down to minus 15 Celsius with some models having the ability to operate down to minus 30 without back up supplemental heat. He stated that these units have been in use in Canada for 10 years and in Newfoundland for over 8 years and pointed to studies carried out in the U.S. Northwest, Connecticut and Massachusetts which showed successful results in terms of energy savings. Mr. Adams also described a pilot study carried out in the province involving existing houses which showed significant energy reductions resultant from the installation of ductless heat pumps.

The Consumer Advocate submits that the merits, shortfalls, criticisms, recommendations and areas of improvement that arise from the 2008 Plan and the recently filed 2012 Plan requires a process involving both utilities in a framework which allows for the proper examination of the various issues. The Consumer Advocate would recommend that the Board therefore initiate a process in consultation with the utilities and the Consumer Advocate that would allow an appropriate review of the Plans involving interested parties and providing an opportunity for input.

III. DEPRECIATION

A. Equal Life Group (ELG) v. Average Life Group (ALG)

The Consumer Advocate submits that although the ELG calculation procedure may well represent the best mathematical depreciation procedure in theory, there is a real and valid basis to question whether as applied in the real world of utility operation and rate making, it truly is the procedure that results in the best matching of the consumption and service value of the assets.

The starting point in the discussion of ELG versus ALG is identification of how each procedure works.

As Jacob Pous, in his written direct testimony of November 28, 2012 states:

> **The ELG procedure, as the name implies, segregates plants into estimated ELGs. Each group is assumed to be one year long. . . . Unlike the ELG procedure, the ALG procedure recognizes that it is impossible to predict with any degree of accuracy the number of poles or related dollars that will retire on an annual basis for the next 70 years into the future. The ALG procedure simply takes an average approach, recognizing that some items of property will retire long before the average, while others will last much longer than the average.**

The evidence clearly shows that there is a significant disagreement between the experts regarding the distinctions between, and benefits of, ELG and ALG. Despite the differences between the experts however, it is agreed, that depreciation expense for Newfoundland Power has been historically higher since 1978 under ELG depreciation than it would have been had ALG depreciation been used over that time frame. **[Reference: CA NP 625]**

It does not appear to be in dispute that in the United States, ALG is vastly more utilized and that in Canada both are used, though it would appear from U-21 that significantly more Canadian utility customers' rates reflect the use of ALG over the ELG procedure.

The Board has before it a Depreciation Study performed by Gannett Fleming, the written Direct Testimony of Jacob Pous in response, the Rebuttal Testimony of Gannett Fleming and that of Newfoundland Power and, as well, the Surrebuttal Testimony of Jacob Pous on behalf of the Consumer Advocate.

i. Higher Levels of Depreciation in Earlier Periods than Later Periods

The National Association of Regulatory Utility Commissioners (NARUC) in their publication entitled *Public Utility Depreciation Practices*, defines accelerated depreciation as a method that allows:

> **. . . larger depreciation accruals in the early years of an asset's life and diminishes accruals in later years compared to straight line methods. The various accelerated depreciation methods accomplish the same goal, i.e., to recover the investment over the life of the plant, but the timing of depreciation accruals is varied depending on the method selected. Accelerated depreciation is currently used for tax depreciation, but not for regulated book depreciation. [Reference: NARUC 1996 Publication at p. 313 and Direct Testimony of Jacob Pous, pp. 12-13]**

In response to this definition, Mr. Wiedmayer in his rebuttal evidence attempts to distinguish between "groups" and "assets" but at page 3 of 18 of his evidence, Mr. Wiedmayer acknowledges as follows:

> **Under the ELG procedure, the straight line depreciation accruals for a group of assets, such as a property account, may be higher in earlier periods and lower in later periods. [Reference: Rebuttal Evidence of John Wiedmayer, Appendix "A", p. 3 of 18]**

Mr. Pous, in response to Mr. Wiedmayer's position, states that Mr. Wiedmayer is making an understatement when he uses the word "may" and the Consumer Advocate agrees that ELG Depreciation, in its method, results in higher levels of depreciation in earlier periods than in later periods.

ii. Precision of Estimates Required

Mr. Pous stated in his evidence that in the event you could slice future transactions on a one year basis for the next 50 to 100 years and precisely estimate what assets would be retired in these one year slices, the ELG method would be superior. In reality however, the inability to predict the future produces a greater degree of error for ELG over ALG. Reality dictates that actual life for an item will most likely be either shorter or longer than what is presumed to be the life using either ELG or ALG. As indicated by Mr. Pous:

> **When the variance between future estimates and actual future events happens and required corrective action is taken, the ELG procedure magnifies the degree of error that has to be corrected and will result in greater fluctuation between depreciation studies. Moreover, if the error in the future estimation of life is that the items of plant actually last longer than predicted, the ELG procedure significantly accelerates the recovery of invested capital and causes the greatest level of need for modification in future depreciation analysis. <u>This is significant given that the utility industry has historically lengthened the expected average service life of investment in accounts over the past 40 years. Indeed, the company has followed the industry pattern of lengthening average service lives over time, at least since its 1995 depreciation study</u>. (emphasis added) [Reference: Written Direct Testimony of Jacob Pous, pp. 13, 14 and Response to CA NP 017, Attachment E]**

Mr. Pous, at page 17 of his Surrebuttal Evidence, after making direct reference to Figure 7 of Appendix "B" of Mr. Wiedmayer's Rebuttal Evidence which outlines the distinction between the theoretical and actual retirement states as follows:

> **This long and significant variance between forecasted and actual events, and the necessity to true up the error between forecasts and actuals, is the precision problem that is magnified by the ELG calculation procedure compared to the ALG calculation procedure. [Reference: Surrebuttal Testimony of Jacob Pous, p. 17]**

Both Mr. Wiedmayer and Mr. Pous recognize that neither ELG nor ALG will ever actually match consumption of the asset. The magnification of error as referred to above however, as can be seen in the difference between assumed annual patterns and actual annual patterns is greater in ELG than in the use of ALG. The use of ALG minimizes this potential error.

iii. <u>Time Sensitivity</u>

During the direct oral examination of Mr. Pous before the Board, the following exchange occurred:

> **Mr. Johnson:**
> **Q. Mr. Pous, is the ELG calculation procedure more time sensitive than the ALG calculation procedure?**

Mr. Pous:

A. Absolutely. Again, remember that graph, that bell shaped curve that we were looking at yesterday that had annual slices of retirement activity, and I believe Mr. Wiedmayer stated yesterday that, you know, after the one year where you recovered the $4,000 we were talking about for the first year, first age bracket, that would fall off. Well, in reality, it doesn't fall off.

In the real world, take for example what's going on here, in 2009, the study was the basis for the current depreciation study. Here we are in 2013. We're approximately three years after that analysis was performed. So the first three slices are already history, but they're still reflected in the rate. Now we're going to put them in rates charged to customers and we're not going to have another depreciation study for five years. So effectively, we're talking about possibly eight annual slices at the beginning of the curve, and remember, under ELG, those slices at the beginning of the curve have the highest depreciation expense impact.

In theory, they're supposed to drop off. In reality, every year you're going to recollect the same first eight years which have the higher impact that in theory were supposed to drop off, but in reality are still built in the same rate that are going to be charged to customers for a five to eight-year period. So ELG is very time sensitive. It's already out of date by the time you can put it into a rate case and it's tremendously out of date by the time you change it in the next rate case. [Reference: Transcript, Jack Pous, January 24, 2013, p. 93, line 12]

Mr. Wiedmayer, in response to the position of Mr. Pous relating to time sensitivity, takes the position that Mr. Pous' position ignores that utility property is constantly being added and retired. Mr. Wiedmayer takes the position that this constant turnover on an annual basis makes ELG depreciation rates far more stable than Mr. Pous suggests. Mr. Pous, in response, submits that his position already incorporates a factor regarding retirement activity and additions but similar to the precision required regarding other aspects of ELG the retirements and additions as referred to Mr. Wiedmayer do not happen in reality. As Mr. Pous states, "As new plant is added each year and retirements for various vintages occur each year, such activity does not occur in a precise or even a close to precise pattern than would retain the appropriate relationship developed for ELG annual vintage rates on an annual basis." **[Reference: Surrebuttal Testimony of Jacob Pous, p. 19, line 26]**

The Consumer Advocate submits that ELG calculation produces a depreciation rate that is already outdated at the time of its development and even more so at the time of its implementation. Unlike ELG, ALG is based on an average approach and as a result its sensitivity to time, all else being equal, is less than that of the ELG approach.

iv. Intergenerational Inequity

Intergenerational inequity results from the use of ELG as applied in practice. Mr. Pous, at page 89 of his evidence of January 24, 2013 at line 16, outlines the concept:

> **Customers have overpaid their fair share. Current customers are receiving the benefit currently of the overpayments historically by customers from 1978 through the present. Future customers will continue to receive additional benefits if you continue the ELG because current customers now will pay too much compared to what they should be paying. However, in order to get the situation back to where it should be, there is that crossover and we've talked about 11 to 15 years. So for an 11 to 15 year period, there will be a lower revenue requirement for customers that will taper away during that period in order to put the company back to where it should have been all along from a rate base standpoint. So customers will then start paying what they should have been paying all along. They've underpaid - - they've overpaid historically so that current customers underpay now. To right the ship, there has to be a crossover process yet again going the other direction. (emphasis added) [Reference: Transcript, Jack Pous, January 24, 2013, p. 89, line 18]**

As confirmed in response to CA NP 625, Newfoundland Power acknowledges as follows:

> **However, Mr. Wiedmayer agrees that depreciation expense for Newfoundland Power has historically been higher since 1978 under ELG depreciation than had ALG depreciation rates been used. [Reference: CA NP 625, line 20]**

As well, as confirmed by Mr. Pous in his direct written testimony,

> **In this proceeding, reliance on the ALG calculation procedure, as utilized almost exclusively by the energy industry, results in a $3,787,823.00 reduction in annual depreciation expense, plus an additional $3,275.383.00 credit reserve variance amortization, for a total reduction of overall depreciation expense of $7,063,206.00 based on plant as of December 31, 2010. [Reference: Direct Testimony of Jacob Pous, p. 19; CA NP 003]**

v. Summary on ELG v. ALG

As regards ELG vs. ALG, the Consumer Advocate submits his position is summarized by Mr. Pous:

> **There is no disagreement that the ELG calculation procedure is the "mathematically" or "theoretically" most correct procedure, but only under the very unrealistic and restrictive assumption that one can predict, with precision, the future in annual one-year slices by age brackets for as far as 50 to 100 years in the future. This is simply not possible or realistic. The difference that will occur between forecasted and actual events are magnified through the ELG calculation procedure when compared to the ALG calculation procedure. Moreover, given the array of averaging of many decades of vintage additions of differing types of investment, even within an account, and then applying subjective interpretations of both OLTs and ancillary information applicable to accounts, an average or single set of parameters is ultimately derived. It is inappropriate and inconsistent to apply great levels of precision to a grouping process (i.e., the ELG calculation procedure) that is not widely used, when the input value is based on a broad brush average. For the most part, the industry has evolved by recognizing the manner in which depreciation parameters are developed and has relied on a consistent application of the ALG calculation procedure to best reflect the overall results in depreciation rates. The Board should deny the accelerated ELG calculation procedure in favor of the industry standard ALG calculation procedure. The adoption of the ALG procedure will result in lower revenue requirements for an extended period of time in order to return rate base to a level where it should have been in order to comply with the matching principle and eliminate intergenerational inequity.**

B. Life Analysis

Mr. Jack Pous recommended adjustments to the following accounts as set out below, taken from p. 20 of Mr. Pous' report:

Account	Life-Curve Combination NP Proposed	Life-Curve Combination CA Proposed	Recommended Adjustment Years	Recommended Adjustment $
355.1 – Transmission Poles	47R2	51S0.5	4	$175,000
355.2 – Transmission Poles and Fixtures	47R2	51S0.5	4	$93,000
361.12 – Distribution Bare Aluminum	55R2.5	61R2.5	6	$325,000
361.2 – Distribution Underground Cables	45R3	57R2.5	12	$131,000
362.1 – Distribution Poles (Under 35')	48R1.5	57R1	9	$361,000
362.2 – Distribution Poles (35' and Over)	48R1.5	57R1	9	$1,347,000
365.1 – Services Overhead	44R2	51R2	7	$403,000
Total				$2,834,000

No attempt will be made to recite the various evidence on each account as the experts have addressed the same in their reports and at the hearing. However, in the Board's review of the evidence, the Consumer Advocate respectfully submits that the following points are relevant:

i. Input from Management and Weight of Depreciation Experts

Mr. Pous, in his report at p. 24, addresses the issue of Input from Management. Mr. Pous agrees that the depreciation analysts should recognize input from management but if the input is not substantiated or reflects a broad range of potential outcomes, then it must be given the predictive certainty it deserves based on its underlying support. Mr. Wiedmayer explained in his evidence (January 23, p. 123) that he confirmed with the engineering group that it is reasonable to use history as reflected in the company's accounting data to make a forecast in the future.

No one disputes that Gannett Fleming has a history of undertaking depreciation studies for Newfoundland Power and has met with its personnel. But caution is urged in terms of the Board thus concluding that on that basis – the weight should go to Gannett Fleming on each of the accounts at issue.

The Board will recall that Mr. Wiedmayer's report at p. 11-24 stated, "Generally, the information external to the statistics led to no significant departure from the indicated survivor curves for the accounts listed below." Included in the accounts Mr. Wiedmayer's report "listed below" are the accounts in issue in this proceeding. At the hearing, Mr. Wiedmayer stated that the only account that he would actually now exclude from the list falling under that observation, was the Underground Cables account – 361.2 (January 23, p. 124). Mr. Wiedmayer confirmed that the basis for removing the account was because of input from engineering management and other input from estimates of other electric utilities. At page 19-20 of the January 24th transcript, Mr. Wiedmayer explained that cable put in service before the 1990s had an expected life of 25 years but that the new type of cable is expected to have a service life of 40 years or more. He indicated that the company has about 40 percent of the older type of cable and 60 percent of the newer style underground cable in service. Mr. Wiedmayer stated at p. 20:

> **A. So that's what - this was an account that I did not necessarily - did not necessarily rely on the results of historical analysis, but there was other considerations that I used in determining my estimate, which I increased from an average of 40 years to 45 years.**

While Mr. Wiedmayer, as noted, confirmed with staff that it was reasonable to use history to make a forecast in the future, it does remain the case that other than for the underground cables account, the information external to the statistics led to no significant departure from the indicated survivor curves for the rest of the accounts at issue in this case.

The Services Overhead account (365.1)illustrates the point that care must be taken so as not to jump to the conclusion that discussions with management leads to better or more justified analysis of company retirement data. CA NP 84 asked as follows:

> **CA-NP-84 [Life] – Please provide a detailed narrative for each account, identifying what steps were undertaken to arrive at the proposed average service life and corresponding dispersion curve. The response should identify specifically what information was relied upon, what life analysis procedure was utilized, including clear identification of experience band, placement band, and intervals, and if the best fitting curve and life combination were not chosen, what other information was specifically relied upon to make modifications in order to establish the actual proposed life parameters. Further, provide all workpapers, assumptions, considerations, and material reviewed and relied upon in sufficient**

detail to permit replication of the Company's proposed average service life and dispersion curve combination by account.

In relation to the Services Overhead account, the reply given to this RFI states:

Account 361.11 – W/P COPPER & 361.15 – DUPLEX & 365,1 – OH SERVICES
Previous Estimates: 39-S11.5

Discussion

These three accounts are combined for life analysis. The majority of dollars in these three accounts is in overhead services. The primary causes of retirements for services are similar to those of conductor, and include damage, ice storms, load growth and reliability reasons. Services are also retired when customers require a higher load.

Bands analyzed for this account include the overall experience, as well as the most recent 30, 20 and 10 year bands. A band with placements since 1967 was also analyzed. The life indications for the overall band are 42-47 years. More recent bands indicate longer average service lives.

RECOMMENDATION

The data indicates longer lives for this account. The 44-R2 survivor curve represents a very good fit of the significant data points.

As Mr. Wiedmayer admitted (p. 128), knowing that the primary causes of retirement for services included damage, ice storms, load growth and reliability reasons does not let us know how she arrived at his particular 44 year recommendation. Similarly, the statements, "Bands analyzed from the account include the overall experience, as well as the most recent 30, 20 and 10 year bands. A band with placements since 1967 was also analyzed. The life indications for the overall band are 42-47 years. More recent bands indicate longer average service lives." do not, as admitted by Mr. Wiedmayer, tell us how he arrived at his recommendation versus any other service life. The statement, "The 44-R2 survivor curve represents a very good fit of the significant data points" obviously calls for judgment of the depreciation analyst. The point is that there is no automatic superiority of Gannett Fleming relative to Mr. Pous to opine on what represents a good fit of the significant data points or to analyse data bands. In fact, it was evident from both Mr. Pous' Surrebuttal Report and the cross-examination of Mr. Wiedmayer that Mr. Wiedmayer in fact criticized Mr. Pous for excluding data points that Gannett Fleming itself has a "rule of thumb" to normally exclude. **[Reference: Surrebuttal Testimony of Jacob Pous; Transcript - January 24, 2013, pp. 7-13]**

As regards the analysis of data bands, for instance, obviously judgment is necessary as well. Mr. Wiedmayer was critical of Mr. Pous' use of the 1967 to 2009 experience band in his analysis of the Distribution Pole accounts – 362.1 and 362.2. **[Reference: Wiedmayer Rebuttal – Appendix B, p. 22 of 27]**

However, it does clearly state in the notes disclosed in CA NP 84 (p. 15) that "The 1967 – 2009 band represents the data since the merger of Newfoundland Power's predecessor utilities, and is considered the most representative of future life expectations for this account." Mr. Wiedmayer testified that (January 24, 2013, p. 27) that the overall band covering retirements that took place over 1948 to 2009 indicated a shorter life (i.e. at p. 15 of CA NP 84 – "The indications for the overall band are for an average service life of 45 to 50 years"). The 1948 to 2009 retirement band would have included poles installed in the 1930s and 1940s – in fact going back to 1933 – which were not treated. On an actuarial basis alone, Mr. Pous' report (p. 35) indicates that Gannett Fleming's recommendation significantly understates the Average Service Life. Added to that is the improvements in treatment to wood poles and Mr. Pous' observation that beginning in 1967 and continuing through 2009, the vast majority of the investment in the account appears to be associated with treated poles (p. 36). Indeed, Mr. Wiedmayer confirmed that just 2% of poles in the field were untreated today (January 24, p. 30).

The Consumer Advocate would respectfully submit that Mr. Wiedmayer's evidence on the accounts in issue should be given no preferred weight. Each of the recommendations should be viewed in the context of the support that exists for the same – whether put forward by the Company's witness or by Mr. Pous.

ALL OF WHICH IS RESPECTFULLY SUBMITTED THIS 5th day of February, 2013.

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Date : January 15, 2013 / Le 15 janvier 2013

To/Dest. : Management and non-union employees in Parts I, II and III / Personnel de gestion et employés non syndiqués des parties I, II, III

From/Exp. : Jane Garbutt, Deputy Minister, Department of Human Resources / Sous-ministre, Ministère des Ressources humaines

Copies : Human Resources Directors / Directeur(trice)s des ressources humaines

Subject/objet : Corporate HR Initiatives / Initiatives ministérielles en matière de ressources humaines

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As you know, government is in the process of renewal. Every function, service, and aspect of what government undertakes is being examined to ensure it is being delivered in an efficient and effective manner. For this initiative to be successful, every expense must be examined. The wages and benefits paid to employees exceed 2.43 billion dollars and represent a significant portion of Provincial spending.

As such, Board of Management recently approved a number of initiatives to meet government's objectives of living within our means, ensuring sustainability, and restructuring and modernizing government.

This memorandum is to advise of the following initiatives with respect to compensation for management and non-union employees.

1) Wages

The current Management and Non-Union Pay Plan expires on March 31, 2013. A revised plan will be implemented which will better reflect wage increases as they relate to the economic

Comme vous le savez, le gouvernement participe à un processus de renouvellement. Tous les services, fonctions et éléments entrepris par le gouvernement font l'objet d'un examen pour s'assurer qu'ils sont offerts de la façon la plus efficace possible. La réussite de cette initiative nécessite aussi l'examen de toutes les dépenses. La rémunération et les avantages sociaux versées aux employés dépassent 2,43 milliards de dollars et représentent une partie signifiante des dépenses provinciales.

Par conséquent, le Conseil de gestion a récemment approuvé un certain nombre d'initiatives visant à répondre aux objectifs du gouvernement, notamment : vivre selon nos moyens, assurer la viabilité, ainsi que restructurer et moderniser le gouvernement.

L'objectif de cette note de service est de signaler les initiatives suivantes concernant la rémunération du personnel de gestion et des employés non syndiqués.

1) Salaires

Le régime de rémunération actuel du personnel de gestion et des employés non syndiqués arrive à terme le 31 mars 2013. Un régime de rémunération révisé sera mis en œuvre. Il tiendra mieux compte performance of the province. Under the revised pay plan, any wage adjustments will be effective October 1, 2013. Additional details will be shared with employees once the pay plan is completed.

2) Retirement Allowance

In 2011, retirement allowance was discontinued for management and non-union employees hired on or after April 1, 2011.

Moving forward, the Province will phase out retirement allowance. Accumulation of service for the purpose of calculating retirement allowance will cease after March 31, 2013 for management and non-union employees.

Effective April 1, 2013, all management and non-union employees with a continuous service date before April 1, 2011 will be provided the option of:

a) receiving an immediate cash payout of retirement allowance, based on completed years of service and salary on March 31, 2013; or,

b) deferring the payment of retirement allowance until retirement, based on completed years of service on March 31, 2013 and salary at the time of retirement.

Employees will have until September 30, 2013 to choose their preferred option. **A comprehensive package will follow in February to assist individuals in making an informed decision.**

These changes to retirement allowance will also be pursued with public sector unions for bargaining employees.

3) Attendance at Work and Workplace Health and Safety

Sick leave is an insurance that provides employees with a level of protection against the loss of salary during periods when they are unable

des augmentations salariales dans le contexte du rendement économique de la province. Tout ajustement salarial découlant de ce nouveau régime entrera en vigueur le 1 octobre 2013. De plus amples renseignements seront communiqués aux employés une fois que le nouveau régime sera terminé.

2) Allocation de retraite

En 2011, l'allocation de retraite a été interrompue pour les cadres et les employés non syndiqués embauchés le 1 avril 2011 ou après.

Le gouvernement provincial éliminera progressivement l'allocation de retraite. L'accumulation des années de service dans le calcul de l'allocation de retraite prendra fin après le 31 mars 2013 pour le personnel de gestion et les employés non syndiqués.

À compter du 1 avril 2013, tous les cadres et les employés non syndiqués ayant des antécédents de service continu avant le 1 avril 2011 auront les choix suivants :

a) toucher immédiatement leur allocation de retraite sous forme de paiement comptant, dont le calcul repose sur les années de service et le salaire au 31 mars 2013;

b) différer le versement de leur allocation de retraite jusqu'au moment de la retraite, dont le calcul reposera sur le nombre d'années de service au 31 mars 2013 et sur le salaire au moment de la retraite.

Les employés auront jusqu'au 30 septembre 2013 pour choisir l'option qu'ils préfèrent. **Une trousse complète suivra en février afin d'aider les individuels à prendre une décision éclairée.**

Ces changements à l'allocation de retraite feront également l'objet de discussions avec les syndicats du secteur public.

3) Assiduité au travail et santé et sécurité au travail

Les congés de maladie représentent une assurance offrant aux employés une certaine protection contre la perte de salaire pendant les périodes où ils ne to report to work due to illness or injury.

peuvent pas se rendre au travail en raison d'une maladie ou d'une blessure.

Usage of sick leave is high across government and presents an area for improvement. To ensure the long-term sustainability and appropriateness of the sick leave program, collectively we must ensure it is used only when absolutely necessary. We all want to ensure sick leave is available during the unfortunate circumstances when it is truly needed.

L'utilisation des congés de maladie est élevée dans l'ensemble du gouvernement et présente des possibilités d'amélioration. Afin d'assurer la viabilité à long terme et la pertinence du programme de congé maladie, nous devons veiller collectivement à ce qu'il soit seulement utilisé quand il est absolument nécessaire. Nous voulons tous que les congés de maladie soient à notre disposition dans des circonstances malheureuses quand ils sont vraiment nécessaires.

The Province will work with those employees who experience difficulties with regular attendance. This initiative will involve two central pieces. The Province will undertake a comprehensive Attendance at Work and Workplace Health and Safety review. These will involve a focus on active case management, training for supervisors, and standardized absence reporting. These initiatives will be applicable to both bargaining and management and non-union employees.

Le gouvernement provincial travaillera avec les employés qui éprouvent des difficultés à assurer une assiduité régulière au travail. Cette initiative comptera deux volets essentiels. Le gouvernement provincial entreprendra un examen complet de l'assiduité au travail, et de la santé et de la sécurité au travail. De plus, l'accent sera mis sur la gestion active de cas, la formation des gestionnaires et la production de rapports normalisés sur les absences. L'initiative s'appliquera tant aux employés syndiqués qu'aux cadres et aux employés non syndiqués.

A savings target of $20 million has been identified based on a 20% reduction in sick leave usage across Parts I, II and III by March 31, 2015. Working together, the Province believes this target is reasonable and achievable. If the target savings are not realized, a reduction in the current sick leave benefit will have to be considered.

Le gouvernement s'est fixé pour objectif d'économiser 20 millions de dollars en réduisant de 20 % les congés de maladie dans les parties I, II et III d'ici le 31 mars 2015. Le gouvernement provincial est convaincu que, grâce à la collaboration de tous, cet objectif est non seulement raisonnable, mais aussi atteignable. Si cet objectif en matière d'économies n'est pas atteint, il faudra étudier la possibilité de réduire le nombre de jours de congé maladie accordés.

4) Performance Management

Merit increases (below control point maximum) and re-earnable increments (pay for performance) were frozen for management and non-union employees beginning on May 2, 2011.

Employees who received a merit increase in calendar year 2011 will be eligible for a merit increase in calendar year 2014 for the work performed in 2013.

Employees who did not receive a merit increase in calendar year 2011 will be eligible to receive a

4) Gestion du rendement

Les augmentations au mérite (sous le point de contrôle maximal) et les augmentations réoctroyables (rémunération au rendement) des cadres et des employés non syndiqués font l'objet d'un gel depuis le 2 mai 2011.

Ainsi, les employés qui ont reçu une augmentation au mérite pendant l'année civile 2011 seront admissibles à une augmentation au mérite pendant l'année civile 2014 pour le travail réalisé en 2013.

Les employés qui n'ont pas reçu une augmentation au mérite pendant l'année civile 2011 y seront merit increase in 2013 for the work performed in 2012 if they meet the following criteria:

- are currently paid below the control point maximum of the pay level; and
- have undergone a documented review of satisfactory performance for work in 2012/2013.

Normal increases for satisfactory performance within the pay level will apply; ordinarily 2 steps.

Pay-for-performance (re-earnable increments) remains frozen, pending the development and implementation of a new performance and leadership management program in fiscal 2013/2014.

We understand that there will be questions surrounding these initiatives and we ask for your ongoing patience and co-operation as we move toward implementation. We want to thank you for your continued significant contribution to the province during these challenging times.

Please contact your respective Human Resources branch if you have any questions.

Note to Managers: Please forward a copy of this memorandum immediately to employees who do not have access to a computer or who may be absent from the office.

Thank you for your ongoing cooperation.

admissibles en 2013 pour le travail réalisé en 2012 s'ils répondent aux critères suivants :

- Ils sont actuellement rémunérés sous le point de contrôle maximal de l'échelle salariale; et
- Le travail qu'ils ont réalisé pendant 2012-2013 a fait l'objet d'un examen documenté et s'est avéré satisfaisant.

Les augmentations normales pour un rendement satisfaisant au sein de l'échelle salariale s'appliquent; normalement deux échelons.

La rémunération au rendement (augmentations réoctroyables) fait toujours l'objet d'un gel en attendant la création et la mise en œuvre d'un nouveau programme de gestion du rendement et du leadership au cours de l'exercice 2013-2014.

Nous sommes conscients que ces initiatives susciteront des questions. Nous vous prions de faire preuve de patience et de coopération alors que nous les mettons en œuvre. Nous vous remercions de votre importante contribution à notre province pendant ces temps difficiles.

Veuillez communiquer avec votre direction des Ressources humaines respective si vous avez des questions.

***NOTA* à l'intention des gestionnaires : veuillez faire parvenir une copie de cette note de service aux employés qui n'ont pas accès à un ordinateur ou qui sont absents du bureau.**

Nous vous remercions pour votre collaboration habituelle.

Original signed by / Originale signée par

Jane Garbutt
Deputy Minister / La sous-ministre
Department of Human Resources / Ministère des ressources humaines

CANADA

JOBS GROWTH AND LONG-TERM PROSPERITY

ECONOMIC ACTION PLAN 2012

Tabled in the House of Commons
By the Honourable
James M. Flaherty, P.C., M.P.
Minister of Finance

March 29, 2012

CANADA'S ECONOMIC ACTION PLAN

Administrative Services Review—Moving Forward

Building on the administrative services review from Budget 2010, the Government set out a direction in Budget 2011 to improve services and realize efficiencies by examining government-wide solutions that standardize, consolidate and re-engineer the way it does business. As discussed above, the Government is moving forward with the creation of Shared Services Canada, with a mandate to lower costs by streamlining information technology networks, data centres and email systems.

Moving forward, the Government will pursue additional standardization and consolidation opportunities, continuing to improve the way it delivers services to Canadians while generating operational savings. For example, as discussed in Chapter 4, the Government plans to improve services to seniors, while reducing its own administrative costs, by putting in place a proactive enrolment regime that would eliminate the need for many seniors to apply for Old Age Security and the Guaranteed Income Supplement if they meet the eligibility requirements.

Parliamentary Expenses

The House of Commons Board of Internal Economy and the Senate Board of Internal Economy, Budgets and Administration have undertaken reviews of Parliamentary spending in order to find efficiencies and provide better value for taxpayers. These boards have found efficiencies through new policies and process improvements, and submitted their results to the Government.

Public Sector Compensation

The Government is also taking specific action to bring federal public service compensation in line with that of other public and private sector employers. This includes eliminating the accumulation of severance benefits for voluntary resignation and retirement, which to date has been eliminated for about 230,000 unionized and non-unionized federal government employees, including members of the Royal Canadian Mounted Police, the Canadian Forces and all executives in the core public administration. Other federal public sector employers are pursuing similar approaches.

Starting on April 1, 2012 and on a go-forward basis, the prior years of service of former members of the Canadian Forces who join the public service will be recognized for the purpose of calculating vacation entitlements.

THE PUBLIC UTILITIES BOARD
OF THE
NORTHWEST TERRITORIES

DECISION 13-2007 **August 29, 2007**

IN THE MATTER OF the Public Utilities Act, being Chapter 110 of the Revised Statutes of the Northwest Territories, 1988(Supp.), as amended.

AND IN THE MATTER OF an application by Northwest Territories Power Corporation for changes in the existing rates, tolls and charges for electrical energy and related services provided to its customers within the Northwest Territories.

6.1.3 At-Risk Compensation

There was no mention of at-risk compensation in the Phase 1 Application. At-risk compensation was first mentioned on the record on page 42 of NTPC's 2005/06 Annual Report, which was submitted as an attachment to HC.NTPC-1. At-risk compensation falls under the responsibilities of the NTPC's Board of Director's Compensation Committee. The following description is from the Annual Report.

> "The compensation committee should be responsible for:
>
> (a) reviewing and approving corporate goals and objectives relevant to CEO compensation, evaluating the CEO's performance in light of those corporate goals and objectives, and determining (or making recommendations to the board with respect to) the CEO's compensation level based on this evaluation;
>
> (b) making recommendations to the board with respect to non-CEO officers and director compensations, incentive-compensation plans and equity-based plans; and
>
> (c) reviewing executive compensation disclosure before the issuer publicly discloses this information."

According to the Annual Report, the Compensation Committee should be composed entirely of independent directors. The members of the committee at that time were:

1. Peter Allen – Committee Chairman and Board Member
2. Richard Nerysoo – Board Chairman
3. Leon Courneya – President and CEO

The at-risk compensation system was described in detail in BR.NTPC-10(b&c).

"NTPC's Senior Management (SM) Salaries and At-Risk (performance based component) are set by the Board of Director's Governance and Compensation Committee (Committee) and approved by the Board of Directors with the assistance of outside consultants. NTPC's SM salaries are set in comparison to a group of utilities selected by the Committee as the organizations which NTPC competes with for staff.

The Committee retains Towers Perrin HR Services to perform a detailed survey every 3 years of a group of utilities to compare NTPC Senior Management compensation to for salary and incentive plans. The last detailed survey was prepared in March 2004. In years between detailed surveys an informal review is done to ensure there have been no material changes to Senior Management compensation in the intervening years.

The Corporation cannot release the details of the study as it is considered proprietary information of Towers Perrin. The Committee adopted the process of setting SM salaries based on being within 10% (plus or minus) of the 50th percentile. The survey compares total target cash compensation (salary, plus incentive plan/at risk). The method for setting the salary component of SM salaries has not changed since it was adopted. The comparability of the different sizes (revenues) of the companies in the survey is increased through the use of regression analysis.

The results of the last detailed survey in 2004 found that the President's & CEO's total compensation (salary and incentive) were within the target range. The survey also found that while the salaries for the Directors' positions were within the target range the incentive component of Director's compensation was, in general, below the target range.

The last informal survey completed in November 2006 indicated that at the President & CEO's annul salary increase were competitive with the market the Director level annual salary increases were typically below the competitive market and that NTPC's short term target incentive opportunities were below the competitive market.

The Corporation's incentive plan is considered at risk compensation. The At-Risk plan covers all management and excluded positions currently includes approximately 40 positions. Effective April 1, 2007 excluded employees will no longer be eligible for At-Risk (they will receive overtime instead) and the number of positions in the plan will be approximately 30.

Currently there are 3 components to the plan. For each position's eligible pool, 50% of the potential amount is based on net income targets, 25% is based on the achievement of individual objectives and 25% is based on the achievement of operational targets.

Employees under the plan are eligible to earn At-Risk compensation up to 15% of their salary (excluded and Managers), up to 20% of their salary (Directors), up to 30% of their salary (Vice Presidents) and up to 40% for the President & CEO. The system supports achievement of results by setting financial and operational targets. Performance measurement targets are set for system availability, debt/equity ratio, efficiencies, operating cost per kwh generated, customer service (based on external survey), staff turnover, safety (accident severity, lost time accidents, lost time days), MWh generated per hours worked, hazardous materials spills, employee satisfaction (based on external survey).

Management and excluded employees compensation packages are based on the same principles/objectives as the Senior Management Compensation with the exception of how the salary ranges are determined. Excluded and middle management employees positions have been evaluated using the Hay Methodology of job evaluation.

In order to ensure the Corporation remains compliant with equal pay for work of equal value legislation under the Public Service Act, salary ranges are based on the formulas used to determine the bargaining unit salary scale. Excluded employees and Managers do not currently receive overtime. At-Risk compensation is provided in part to recognize an employee for the extra time and effort employees put in to achieve Corporate and individual objectives. Effective April 1, 2007 excluded employees' compensation package is being adjusted to be similar to that of bargaining unit employees. Excluded employees will be eligible to receive overtime and other leave entitlements provided to unionized employees to ensure compliance with equal pay for work of equal value legislation. Management employees will continue to receive at-risk compensation and are not entitled to overtime. At-Risk payments are non-pensionable.

The Corporation does not have a long-term incentive plan."

Table BR.NTPC-10(a) provided the following at-risk compensation amounts:

- 2002/03 GRA Forecast $586,000

• 2002/03 Actual	$608,000
• 2004/05 Actual	$547,000
• 2005/06 Actual	$595,000
• 2006/07 GRA Forecast	$540,000
• 2007/08 GRA Forecast	$558,000

The Community of Behchoko suggested in its letter that a clear bonus structure, as well as performance benchmarks tied to levels of service, should form part of the executive compensation model and that the model should be publicly available.

In its argument, NTPC submitted that, given the evidence on the record, its forecast salary and wage expenses in the test years, including at-risk compensation, are reasonable and necessary, and should be approved.

The HC argued that since the Towers Perrin review is considered proprietary and was not filed before the Board, no evidentiary value can be placed on whether or not the total target cash compensation is within 10% of the 50th percentile as adopted by the Governance and Compensation Committee. Nor can any weight be attributed to the informal internal reviews, the last of which was conducted in November 2006, as they are directly linked to the Towers Perrin review.

During HC questioning at the hearing, NTPC confirmed that the 50% of the potential amount that is based on net income targets is based on the rate of return on equity on the regulated business. In argument, the HC took the following position:

> "...Although the Hydro Communities are not opposed to incentive pay, this component is of primary concern because it results in and is motivated

> almost exclusively by benefits to shareholders rather than benefits to customers. This component of the at-risk pay provides perverse incentives to staff, in that cutting service levels may be used to improve the bottom line. For example, deferring maintenance, deferring brushing or charging an engine overhaul or repair to a deferral account may improve the bottom line to the benefit of shareholders and management through at-risk compensation, but customers would be faced with higher costs in the future. Any costs related to improvement of net earnings should be borne by the shareholders who will benefit, not by customers." (HC Argument, p. 21 – 22)

Although it did not cite any decisions, the HC asserted that the Alberta Energy and Utilities Board has consistently disallowed that portion of at-risk or variable pay that is related to or is a function of earnings.

The HC submitted that the achievement of higher earnings will not necessarily translate to improved efficiency to customers and in fact may well have the opposite effect and therefore the 50% of at-risk pay that is a function of net income targets should be excluded from the revenue requirement. Accordingly, the HC submitted that salaries and wages should be reduced by $270,000 and $279,000 respectively in the test years.

For the 25% of at-risk compensation based on individual objectives, the HC seemed to express some concern that these objectives could also relate to financial performance but did not provide any recommendations to the Board.

For the 25% based on operational objectives, the HC consider that for the most part, these objectives would primarily be to the long-term benefit of customers.

NTPC replied that that the Towers Perrin study was not provided because Towers Perrin refused the Corporation's request to file it in this proceeding. In

NTPC's view, however, there is sufficient evidence on the record for the Board and that the HC claim regarding the Towers Perrin study should be disregarded.

Regarding the HC's recommendation that the 50% of at-risk compensation related to net income be disallowed, the NTPC responded as follows.

> "Regarding the Hydro Communities speculation about managements' actions, it is important to recognize that net income objectives are balanced with personal objectives that ensure an on-going benefit to customers by maintaining service levels (through, among other things, efficiency gains, customer satisfaction and employee satisfaction) or avoided costs (such as avoided labour disputes in the event that a collective bargaining agreement is not reached)..." (NTPC Reply, p. 13, *ll.* 1 - 5)

NTPC went on to state the following.

> "Further, if NTPC's managers strive to ensure earnings objectives are met (which by necessity means some combination of lower costs due to efficiencies, or higher revenues), it is in fact customers who will benefit in longer run from lower rates than would otherwise be required, or avoided rate increases and deferred rate cases.
>
> In any event, there is no evidence on the record to suggest that NTPC employees act in the manner described by the Hydro Communities to impair customer service to the benefit of the shareholder. If the Hydro Communities' speculation were true, one would see the performance targets not being met. For example, if management cut costs related to maintenance programs, one would expect problems with safety, reliability, customer service and employee satisfaction. That has not been the case.
>
> There is evidence, however, that the actual amounts paid out by the Corporation as part of the at-risk compensation program have typically been higher than the amounts included in the Corporation's revenue requirement. This means that a portion of the actual costs of the at-risk compensation program is in fact already borne by the shareholder and not by ratepayers. Further, at-risk compensation avoids having to pay overtime – the avoided cost of paying overtime instead of at-risk

> compensation for all positions excluding the Officers of the Corporation is estimated at $425,000.
>
> Lastly, while the Hydro Communities states that the "[t]he Alberta Energy and Utilities Board has consistently disallowed that portion of at risk or variable pay that is related to or is a function of earnings" and lists a number of public utilities, it does not provide any references to regulatory authorities in support of its claim.
>
> NTPC is a regulated entity that must submit its revenue requirement to the review of the PUB and intervenors. The costs included with respect to the at-risk compensation program are typical of such programs for other utilities, are reasonable and should be approved." (NTPC Reply, p. 14, *ll.* 11 - 34)

TGC stated in its reply that it was in agreement with the position taken by the HC in its argument.

Views of the Board

The objective of the Towers Perrin review was to compare NTPC's executive compensation program to other utilities, with NTPC's Governance and Compensation Committee having established a total target cash compensation that is within 10% of the 50th percentile of the other utilities. The Board agrees with the HC that since the Towers Perrin review is not in evidence before the Board, the Board cannot apply any weight to the review when making its decision.

However, the HC has not provided any recommendations or evidence for the Board to use in evaluating the target established by NTPC. The HC does not dispute the 10% of the 50th percentile as being a suitable target for NTPC. Nor did the HC provide any evidence on other utilities' compensation programs. As noted by the HC during questioning, Towers Perrin has provided information in several proceedings in Alberta. It is the Board's view that the HC could have filed this information from other proceedings before the Board.

It is the Board's view that it has no evidence or reason upon which to dispute the NTPC's total target cash compensation range of 10% of the 50^{th} percentile as being acceptable for NTPC.

While the range is not in dispute, what is in dispute is which party should pay for the at-risk compensation: the shareholders or the ratepayers. It is the view of the Board that any at-risk compensation that is included in the revenue requirement should result in clear benefits to customers.

The Board notes that under the Corporation's at-risk compensation program, 50% of the potential compensation amount is based on net income targets, 25% is based on the achievement of individual objectives and 25% is based on the achievement of operational targets.

The 50% of NTPC's at-risk compensation, which is based on net income, is based on the return on equity of the regulated business. The Board agrees with the HC that the potential exists for management to improve net income, and hence increase at-risk compensation, in manner that is detrimental to the ratepayers and exclusively to the benefit of the shareholders.

While NTPC argues that there is no evidence of this occurring, the Board is of the view that no such evidence is necessary for the Board to take action as it is the compensation model that is at question, not any specific actions of management. It is the Board's view that an at-risk compensation model that allows for actions that benefit the shareholders, but not the ratepayers, is not appropriate in NTPC's regulated business.

Ontario Energy Board
Commission de l'Énergie de l'Ontario

2006 ELECTRICITY DISTRIBUTION RATE HANDBOOK

May 11, 2005

Incentive plans

Distributor incentive compensation plans reward employees for meeting specific performance targets. The targets can include performance which benefits ratepayers, or which benefits primarily the shareholder.

Incentive payments related to benefits to shareholders will not be recoverable in the 2006 revenue requirement. An applicant seeking to include expenses related to employee incentive plans should include only the costs of incentives that reward the creation of ratepayer benefits.

An applicant with incentive compensation plans must file the following information in Schedule 6-5:

- details of the incentive compensation plan(s)
    - a list of performance measurement criteria
    - identification of incentives that benefit ratepayers and shareholders, and an explanation for that characterization
- total annual dollar value of incentive compensation
    - breakdown the shareholder-related component and the ratepayer-related component separately

6.2.6 Pensions and Post-retirement Benefits

Pensions: OMERS members

An applicant whose employees are members of the Ontario Municipal Employees Retirement System (OMERS) pension plan must provide OMERS pension premiums and adjustments expense for the years 2002, 2003 and 2004 in Schedule 6-6.

Pensions: Non-OMERS members

A distributor whose employees are not members of OMERS may fund and administer its own pension plans and may recover pension expenses.

Such a distributor must provide the following information in Schedule 6-7.

- cash versus accrual valuation
- any "smoothing" methods employed, and their impact
- eligibility by employee groups
- summary of performance for each plan

Decision 2006-024

ATCO Electric Ltd.

2005-2006 General Tariff Application

March 17, 2006

Alberta Energy and Utilities Board

recovery mechanism may be available in some circumstances to successful participants in the appellate process.[55]

The Board has considered the position advanced by AE in this proceeding, however, the Board is not persuaded by AE's views. Rather, the Board shares the views that were expressed in the ATCO Gas Decision referred to above. Accordingly, the Board denies AE's request for inclusion of forecast costs for legal costs in excess of the Board's Scale of Costs in connection with proceedings before the Board, including Review and Variance applications. The Board notes that any provision for consulting fees in excess of the Board's scale of costs similarly would be denied. The Board directs AE, in its refiling, to reduce the revenue requirement amounts by $325,000 in each of 2005 and 2006 to reflect fees in excess of the Board's Scale of Costs. The Board notes that AE may apply for recovery of these costs in its application for recovery of costs associated with this proceeding. Further, the Board directs AE to ensure that these additional costs are not charged to AE through any additional budgeting or cost allocation process within AE or from its affiliates or parent company.

5.4.4 Variable Pay Program

AE included a forecast amount of $350,000 in 2005 related to a new variable pay program for approximately 15 senior employees. The forecast amount for 2006 was based on the 2005 amount with an adjustment for inflation. AE contended that the variable pay program was designed to:

- retain key employees in the organization;
- be competitive in the marketplace with respect to the hiring of new employees;
- provide incentives for these employees to achieve operational excellence (50%) and attain earnings targets (50%);
- provide incentives for other employees to aspire to be selected for the program.

IPCAA submitted that AE did not substantiate how the goals outlined in its variable pay program would lead to benefits to customers. IPCAA noted that in a recent Decision the Board denied a portion of an incentive pay program related to financial targets and operating expenses that would be to the benefit of shareholders.[56] IPCAA submitted that the 50% of the variable pay program tied to shareholder goals should be disallowed.

FIRM submitted that AE did not provide any evidence supporting the need for a variable pay program and noted that there was no indicated turnover within the group targeted by the program. Also, FIRM submitted that AE failed to meet the burden of proof to demonstrate the extra payment is necessary to bring the total compensation for these employees to a competitive market level. FIRM considered that the plan's goals relating to operational excellence through cost reductions and achieving higher earnings by a rate of return greater than the approved rate would benefit shareholders and not customers. FIRM recommended that the costs of the plan for 2005 and 2006 should not be allowed and should instead be funded fully by shareholders from the cost savings and increased returns flowing to their benefit from the plan.

[55] Decision 2006-004, p. 102
[56] Refer to Decision 2005-127, AltaGas Utilities Inc., 2005/2006 General Rate application, Phase I, November 29, 2005.

AE stated the employees subject to the variable pay plan would not receive the 50% of the variable pay associated with financial goals until the service goals had been achieved, making operational excellence a pre-requisite for qualifying for the portion of the program associated with its financial goals. AE submitted that the program should be viewed as a balance of the public's right to reliable, effective and efficient service, and AE's right to receive a fair return on its investment. AE asserted that customers benefit from its being a strong and financially healthy distribution company that has access to capital markets and an incentive to operate in a more effective and efficient manner. AE also submitted that variable pay programs are the norm in the market place and to deny the program would cause it to be disadvantaged in its attempts to attract and retain employees. However, AE acknowledged that, in the short-term, efficiency gains may be for the benefit of the shareholder, but argued that customers benefit from these gains forever.

AE submitted that the full amount of the requested costs for its variable pay program should be included in revenue requirement. AE further submitted that failure to allow the costs would prejudice its right to earn a fair return on capital and would be inconsistent with the principle that a utility should be entitled to recover prudently incurred costs of doing business if such costs are not excessive or wasteful. To address a short coming inherent in the incentive plans of other utilities, AE requested that a deferral account be used for the program to ensure that amounts collected in revenue requirement would not exceed amounts that would be paid out.

Board Findings

While AE stated that customers would benefit in the long run, the Board is not persuaded by AE's evidence that this result would arise from the variable pay program. Accordingly, the Board agrees with IPCAA that the 50% portion of the variable pay program that addresses shareholder goals should not be recovered through customer's rates.

The Board considers that where the benefits will add to AE's efficiency and provide tangible benefits to customers, there may be merit to the applicable portion of the variable pay program being included in revenue requirement. However, where the benefit primarily provides an increased return to AE, the Board considers that it is not appropriate to fund the portion of the variable pay program through rates.

Therefore, the Board denies inclusion of the 50% of the variable pay program that focuses on financial returns. Accordingly, the Board directs AE, in its refiling, to reflect the Board's approval of 50% of the costs that will be awarded for operational targets. However, the Board finds AE's proposal to use a deferral account to reconcile the variable pay program for the operational component to be appropriate and accordingly, the Board approves AE's request for a variable pay program deferral account.