New Brunswick Energy and Utilities Board

IN THE MATTER OF an application by New Brunswick Power Distribution and Customer Service Corporation (DISCO) for approval of changes in its Charges, Rates and Tolls (Includes Interim Rate Proposal)

Delta Hotel, Saint John, N.B., on December 5th 2007.

Henneberry Reporting Service

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IN THE MATTER OF an application by New Brunswick Power Distribution and Customer Service Corporation (DISCO) for approval of changes in its Charges, Rates and Tolls (Includes Interim Rate Proposal)

Delta Hotel, Saint John, N.B., on December 5th 2007.

BEFORE: Raymond Gorman, Esq., Q.C. - Chairman
Cyril Johnston, Esq. - Vice Chairman
Mr. Roger McKenzie - Member
Mr. Don Barnett - Member
Ms. Connie Morrison - Member
Mr. Yvon Normandeau - Member

N.B. Energy and Utilities
Board Counsel - Ms. Ellen Desmond

Board Staff - Mr. Doug Goss
- Mr. John Lawton
- Mr. David Keenan
- Mr. Dave Young
- Mr. Andrew Logan

Secretary to the Board - Ms. Lorraine Légère
Assistant Secretary - Ms. Juliette Savoie

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CHAIRMAN: Well, good morning. The weather is a little bit better today. Can I have the appearances, please, starting with the Applicant?

MR. KEYES: Thank you, Mr. Chairman. Ed Keyes and Terry Morrison on behalf of the Applicant. And joining me at the counsel table today is Sharon MacFarlane and Darren Murphy.

CHAIRMAN: Thank you. CME?

MR. LAWSON: Good morning, Mr. Chairman. Gary Lawson on behalf of CME.

CHAIRMAN: Thank you. Conservation Council of New Brunswick? I think we had an e-mail indicating they wouldn't be hear today. Enbridge Gas New Brunswick, I understoo they weren't coming today either. Irving Oil Limited? J.D. Irving Pulp & Paper Group?

MR. WOLFE: Good morning, Mr. Chairman. Wayne Wolfe.

CHAIRMAN: Thank you, Mr. Wolfe. N.B. Forest Products Association? Dr. Sollows? Not here. Oh, there he is.

DR. SOLLOWS: Present, Mr. Chairman, if not in body, in mind.

CHAIRMAN: You are on a different side of the room this morning. I thought you weren't here. Utilities Municipal?

MR. ZED: Good morning, Mr. Chairman and Members of the Board. Peter Zed. And I am joined by Dana Young and Eric Marr.

CHAIRMAN: Thank you, Mr. Zed. Vibrant Communities?

MR. PEACOCK: Good morning, Mr. Chair. Kurt Peacock here.

CHAIRMAN: Thank you. Public Intervenor?

MR. THERIAULT: Good morning, Mr. Chair. Daniel Theriault. I am joined this morning by Robert O'Rourke and Jayme O'Donnell.

CHAIRMAN: Thank you, Mr. Theriault. N.B. Energey and Utilities Board?

MS. DESMOND: Ellen Desmond, Mr. Chair. And with me is Doug Goss, John Lawton, Dave Young and Board consultant, Andrew Logan.

CHAIRMAN: Thank you, Ms. Desmond. Any preliminary matters this morning, Mr. Keyes?

MR. KEYES: Just one issue, Mr. Chairman. At Monday's, December 3rd proceedings, there were five undertakings given. We now have the answers to those undertakings. Those were undertakings number 9, number 10, number 11, and 12 and 13. So I will file those with the Board.

CHAIRMAN: I guess since the response to these undertakings is all in written form, I am going to mark them as exhibits. the last exhibit number for the applicant that we have is A-43. So undertaking number 9 will become exhibit A-44.

The response to undertaking number 10 will be marked as exhibit A-45.

The response to undertakings 11 and 12 will be marked as exhibit A-46.

The response to undertaking number 13 will be marked as exhibit A-47.

Anything other preliminary matters, Mr. Keyes?

MR. KEYES: No, none.

MR. THERIAULT: Mr. Chairman, just for the record, I believe two of the undertakings state they were requested by myself. I believe it was Board counsel that requested those and not myself.

CHAIRMAN: Which of the undertakings are you referring to?

MR. THERIAULT: I believe it's exhibits 44 and 45.

MR. KEYES: If that's the case, we have no objection to it.

CHAIRMAN: Ms. Desmond, is that correct, 44 and 45 would have been requested by you?

MS. DESMOND: That's correct, Mr. Chair.

CHAIRMAN: We will just write the change on the exhibit.

MR. KEYES: That's fine.

CHAIRMAN: Any other parties have any other preliminary matters? All right. Mr. Keyes, perhaps you could call your --

MR. LAWSON: Sorry, Mr. Chairman. Mr. Lawson. Just I thought I would propose to the Board, the intention was that the motion that we have brought would be heard after the evidence today.

I would like with the Board's indulgence to -- given the comments that were made by Mr. MacDougall to the Board with respect to it, I would like to suggest that we perhaps postpone having the motion being heard until closer to the time of argument.

CHAIRMAN: I think Mr. MacDougall, if I understand what he has written, I think he was suggesting that it be done actually as part of final argument. Is that what you are suggesting?

MR. LAWSON: That would be fine with us immediately prior to argument or as part of argument. That would be fine as well.

CHAIRMAN: Well perhaps we can dispose of this now. Does anybody have any comments to offer with respect to that suggestion?

MR. KEYES: The Applicant is fine with that suggestion.

CHAIRMAN: Does anybody here have a problem with it? Well silence then I guess will be taken as acquiesence. All right. We won't deal with that matter today. We will deal with it in final argument as suggested.

MR. LAWSON: Thank you, Mr. Chairman.

CHAIRMAN: Mr. Keyes?

MR. KEYES: Yes, thank you, Mr. Chairman. At this time we will call Kathleen McShane to the stand.

CHAIRMAN: I would ask Board counsel to come forward and swear the witness.

KATHLEEN MCSHANE, sworn:

DIRECT BY MR. KEYES:

CHAIRMAN: For the record, the witness has been duly sworn.

Q.1 - Good morning, Ms. McShane.

A. Good morning.

Q.2 - I just wanted to make sure you knew how to operate that microphone. You have been here before. I wonder if you could state your name for the record?

A. Kathleen C. McShane.

Q.3 - And what is your occupation?

A. I am President and senior consultant with Foster Associates Inc., and economic consulting firm in Washington, D.C. -- actually we are in Bethesda, Maryland, sorry.

Q.4 - Now there has been a report filed in this matter entitled "Capital Structure and Interest Coverage Ratio Targets for NB Power Distribution and Customer Service Corporation", which was dated June 26th 2007, and it's filed as exhibit A-7 under the tab Net Income, Mr. Chairman.

And this report is under your name, Ms. McShane. That was prepared by you or under your direction?

A. Yes, it was.

Q.5 - Now at page 10 of your report is a list of your qualifications. I wonder if you could give the Board a brief overview of your education and professional experience.

A. I have a Masters degree in finance from the University of Florida and I have been a Chartered Financial Analyst since 1980. I have been employed by Foster Associates in the area of utility cost capital since 1981 and I have testified in more than 150 proceedings since 1987 on areas related to utility cost of capital and other related ratemaking matters.

MR. KEYES: That took care of my next question. Mr. Chairman, subject to any questions by any of the intervenors, I would move that Ms. McShane be declared an expert in the area of utility cost of capital for the purposes of this proceeding.

CHAIRMAN: Any questions from any of the intervenors? Mr. Lawson, anything? I guess I'm not hearing anything from anybody and based on that she will be qualified as an expert witness in the area of utility cost of capital.

Q.6 - And just for the record, Ms. McShane, have you had the experience of testifying as an expert before the New Brunswick Public Utilities Board in the past?

A. Yes, I have testified here, I believe, four times.

Q.7 - Can you tell the Board for the record what was the scope of your retainer, what you were asked to do in this matter?

A. I was asked to assist NB Power Distribution with developing a capital structure and interest coverage targets that would be consistent with self-sufficiency and to prepare a report that would discuss the reasonableness of those targets.

Q.8 - And before I turn you over to the other parties for questions, I wanted to address one issue, and you have read the report marked PI-3 which would be Dr. Lawrence Booth's report?

A. Yes, I have.

Q.9 - Do you have any comments with respect to Dr. Booth's opinions that you would like to address at this time?

A. I have one comment that is a concern with his assessment of my report. And I bring it up because I think that it perhaps goes to a misunderstanding which I believe is central to the understanding of the report that I prepared.

On page 2 of Dr. Booth's report, and going over to page 3, he says that he has no objections to the long run targets should DISCO be completely privatized. And then goes on to say that these targets would be low relative to what investor owned utilities are allowed.

But then goes on to say, these financial parameters very much depend on the types of risks that the utilities are exposed to and a straight transfer from the financial parameters of investor owned utilities to crown corporations is not possible, since the risks are significantly different.

And we actually prepared an information request for Dr. Booth and this would be PI DISCO IR-19. And the question was, please explain on what basis Dr. Booth has concluded that the proposed financial parameters are a straight transfer from investor owned utilities. And the response to the IR was schedules 1, 2 and 3 from Ms. McShane's opinion use privately owned utilities as benchmarks for DISCO.

It is true that as part of the report I have referred to investor owned utility benchmarks in the context of saying what would DISCO eventually have to get to if it were to be able to access the capital markets on its own on a totally stand-alone basis without the benefit of a Provincial guarantee.

However, my report focuses on what I believe is appropriate as an interim objective, that is, for DISCO to move to a position of self-sufficiency. And indeed my report at page 5 says that in that context, to develop the recommended parameters of 25 to 30 percent equity and an interest coverage target of 1.75 times, that I am looking specifically at other crown owned utilities and not at investor owned utilities.

Q.10 - Dr. Booth's interpretation of your -- what you were relying on is not correct, in your opinion?

A. I believe that there is a misinterpretation there, yes.

MR. KEYES: Mr. Chairman, those are my questions for Ms. McShane.

CHAIRMAN: Thank you, Mr. Keyes. Cross examination then, Mr. Lawson?

MR. LAWSON: No questions, Mr. Chairman.

CHAIRMAN: Thank you, Mr. Lawson. J.D. Irving Pulp & Paper group, Mr. Wolfe?

<u>CROSS EXAMINATION BY MR. WOLFE</u>:

Q.11 - Good morning, Ms. McShane.

MS. MCSHANE: Good morning.

Q.12 - I would just like to ask you a few questions on your report. I wasn't here in the last hearing, so please excuse me if I'm asking the same questions as come up before.

First of all on page 1, line 28, I'm just curious where you talk about the interest coverage ratio 1.25. Have you done other analyses where you recommended less than 1.25 for other companies?

A. I don't recall ever doing that, no.

Q.13 - Thank you. Page 2, at line 51 to 54, you are comparing to Hydro Quebec and Nortwest Territories Power. Are any of them deregulated like NB Power?

A. Hydro Quebec has been restructured and its generation is not regulated by the Regie D'Energie and it has separate transmission and distribution functions.

Q.14 - And do they access debt on their own?

A. No, they don't.

Q.15 - So they still have a government guarantee then?

A. Yes, they both do. Hydro Quebec pays a guarantee fee for its debt to the Province of Quebec.

Q.16 - And Northwest Territories?

A. No, it does not pay a fee.

Q.17 - It doesn't pay a fee at all?

A. No, but its debt is guaranteed.

Q.18 - Next on page 2, line 6, you talk about schedule 1, and earlier you said that there were no crown corporations in schedule 1?

A. I'm not sure I said that. I said that my analysis for the purpose of establishing the targets was based on crown corporations.

Schedule 1 does have in it a crown corporation Hydro One, but Hydro One's debt is no longer guaranteed by the

Province of Ontario. There are also in schedule 1 a number of utilities that are not crown corporations but are government owned corporations, owned by municipalities.

Q.19 - The vast majority on that page though can access debt through shares equity -- sorry -- excess equity through share ownership?

A. If you are asking do the -- can the vast majority of them go to the equity market on their own, is that your question?

Q.20 - Yes.

A. Yes. More than half of them can go to the equity market on their own. All of the companies on schedule 1 that are government owned do not. And that would be seven of them.

Q.21 - Does it not become very difficult for a company like DISCO that can't access equity to ever get to these bond ratings?

A. Without an equity infusion?

Q.22 - Yes.

A. That's correct. And that's why my report is structured the way it is.

I talk at the beginning about the factors that will have to occur in order for this to happen. One of the factors that I discuss is the need to have an equity infusion to get to this point.

So what the crux of my report is is what is essentially an intermediate objective that DISCO can achieve by having a certain interest coverage over time in retaining earnings, and essentially set itself on the path to what would, if pursued, ultimately be a stand-alone company with the ability to access the capital markets on its own.

Q.23 - That leads to my next question then. On page 4, at line 102, you state that DISCO will need an equity infusion, and then at line 10 you -- I believe you are saying when it takes -- line 110, I'm sorry -- I estimate it could take over 30 years. So that's 30 years without an equity infusion then?

A. Yes. The point is that if DISCO starts where it is, with no equity, and we are allowed a 1.25 times coverage, then basically without an equity infusion it would take 30 years to get to a 40 percent common equity ratio.

Q.24 - And what do you mean when you say right after that, with two percent annual rate base growth? What do you mean by that?

A. In other words -- maybe the term "rate base" in this context isn't -- isn't one that has been used in the development of the revenue requirement for DISCO. So tell me if I'm explaining something to you that you already understand and I will stop.

But the rate base in a typical utility situation would be the assets that are devoted to public utility service. Those assets are normally financed by a combination of debt and equity.

So you have got two sides of the balance sheet essentially, the asset side which is the rate base and the capitalization side which is the debt and equity. So if a company is growing over time, then that means that they will need additional capital to finance the growth in the assets.

So a two percent growth in assets or rate base is a relatively conservative estimate of what the growth in the assets might be.

Q.25 - You are not talking about the P&L statement at this point?

A. No. I'm simply talking about the growth in the assets that are required to provide service to customers.

Q.26 - Thank you. My next question is on page 5 then, at line 127, where you state, "The more debt that the Province of New Brunswick either guarantees on behalf of NB Power group of companies or raises on their behalf, the higher could be the cost of debt."

Are you assuming then that the debt is going to grow when you say that?

A. When I say that -- if the debt grows then yes, what I'm saying is that the higher could be the cost of debt to the Province. Whether or not the debt grows depends on essentially what the outcomes are over time in terms of the way the company is capitalized and/or the regulator allows equity to grow through retained earnings.

Q.27 - Have you done any comparison to show what the Province would save if they didn't carry the debt versus what it would cost DISCO or NB Power to go out and access debt as far as the Province is concerned in total?

A. Do you mean in terms of debt cost?

Q.28 - Yes.

A. No. That's very difficult to determine specifically, because although there is likely some incremental cost, it is very difficult to determine what that is.

Q.29 - So you wouldn't know how much the interest rate would be for a stand-alone DISCO versus the guarantee rate?

A. Oh, I do know that. I could tell you that the stand-alone cost of debt for a distribution utility with an A rating today probably would be around 5.75 to 6 percent for long-term debt and the Province can raise debt at probably -- I want to say 4.75 percent, and then they charge a debt guarantee fee -- or a debt portfolio management fee to DISCO of approximately .65 percent.

But that is assuming that DISCO is actually capitalized as a stand-alone utility. For them to actually go out and raise debt today, they couldn't do it.

Q.30 - Are you saying then that you couldn't raise debt until you at least got an A rating?

A. No, I'm not saying that. What I'm saying is that the cost rate that I gave you would be the approximate cost if you had an A rating.

If you were capitalized on the basis of self-sufficiency, you wouldn't be A rated and your cost of debt if you tried to go out and raise it on your own at those ratios would be significantly higher. Today it would be a lot higher.

As an example, TransAlta Corporation, which is an electric operation, it's not a utility anymore, but it is still considered as part of the utilities index and -- among traded equities -- and it is a triple B rated company, investment grade, and if it were to try to go out today and raise 30 year debt, it would pay almost two percentage points higher than an A rated company.

Q.31 - If your numbers are correct that you just stated for

New Brunswick, it looks like there is about .4 percent difference between stand-alone, if you are an A company, versus a guarantee then, plus the guarantee charge -- 3, .4 percent difference?

A. So I gave you --

Q.32 - You said 5.75 to 6 for stand-alone --

A. Yes.

Q.33 - -- and 4.75 plus .65.

A. Yes. That difference is about right and suggests probably that -- at least in my own personal opinion -- that the debt guarantee fee could be significantly higher.

Q.34 - Out of curiosity, when you say 1.25 and then 30 years, what -- have you looked at what it takes for a P&L statement to actually show for that 30 years in order to ever get there?

A. Have I -- sorry -- have I looked at --

Q.35 - Have you looked at what it would take on a P&L statement, in other words, what profits would DISCO have to make over that 30 years to be able to get to a 30 percent, 40 percent equity?

A. Well what I did was I looked at the coverage and I said if DISCO were allowed to -- were allowed rates that included this coverage each and every year and the amount of margin, the assumption being that they actually earned the margin, and the amount of the margin that is included in that coverage ration were retained and the next year coverage were set on the basis of the debt that was outstanding in each and every year, then it would take that many years to bring the retained earnings up to the 40 percent level.

Q.36 - I see. One last question. On page 8 at line 207, you say the big difference between the ones you looked at is that they don't make payments in lieu of taxes, with the exception of BC Hydro.

We are told that those payments go against the debt. If that is correct, have you done any work -- does that change any of your assumptions or your calculations if that is going against the debt as an equity infusion?

A. What I understand is that the payments in lieu of income taxes flow to Electric Finance and are used to -- as a revenue stream to service the debt that is held by Electric Finance. And no, that doesn't change anything in terms of my analysis.

Q.37 - We have been told that it goes to Electric Finance and then it pays strictly against the debt. So I assume that means that if DISCO pays $2,000,000 it takes $2,000,000 off their debt.

A. I believe that the funds are used as a revenue stream to service the debt which would include a payment of interest.

And to the extent that the revenue stream that goes to Electric Finance as an excess of the total amount of interest, then it would also be used to pay down the debt. But there is additional debt in Electric Finance that is not sitting in the operating companies of NB Power.

Q.38 - As I understand it, there is one line which says interest which covers the interest for the long-term and short-term debt for all the companies, and then a second line that says payment in lieu of taxes as it goes against the debt at Electric Finance.

A. When you say one line, a line in --

Q.39 - A line in the P&L statement.

A. There would be a line in the P&L statement for interest and there is a line in the P&L statement for payments in lieu of income taxes.

Both of those items would flow to Electric Finance and be used to pay the interest payable by Electric Finance and to pay down the debt that Electric Finance holds.

But Electric Finance holds more debt than is outstanding on the balance sheet of NB Power. So there needs to be more of a revenue stream that flows to Electric Finance than just the interest that's on the P&L

statement of NB Power to meet the interest on the debt held by Electric Finance before any of the debt can be paid down.

MR. WOLFE: Thank you, Ms. McShane. Mr. Chairman, that's all my questions.

CHAIRMAN: Thank you, Mr. Wolfe. Dr. Sollows?

CROSS EXAMINATION BY DR. SOLLOWS:

Q.40 - Just -- really just one point, maybe a couple of facets of it. I heard you say earlier in response to Mr. Wolfe that your evidence is premised on the notion that the regulator would allow the equity to grow through retained earnings.

And when I read through your evidence I see you are recommending a 1.75 times interest coverage ratio in order to get to -- in 11 years in order to get to the 25 percent or the 40 percent equity that you were thinking was reasonable?

A. 25 percent.

Q.41 - 25 percent?

A. Yes.

Q.42 - That is fine. Yes.

How do you account for dividends?

A. There aren't any. In this analysis there were none.

Q.43 - So you assumed that there would be no dividends going forward?

A. Not over this period. Not until the equity ratio was reached.

Q.44 - Okay. And if the government were to declare a dividend and take -- if the equity was built based on an order of this Board and the government were to look at it and declare a special dividend and take the money, that would sort of defeat the purpose of the basis of your analysis, wouldn't it?

A. It would mean that the equity ratio would not be achieved within the period of time that my analysis covered.

Q.45 - Right. You are aware that under the current regulatory arrangement in this province that the government is the sole shareholder and can declare its dividends as it sees fit?

A. I'm aware that the government can call for dividends, yes.

Q.46 - Okay. So is it fair to characterize -- act of faith is too strong -- but really the underlying assumption to your work is very much that government going forward wants to see this as an independent entity and wants to see the equity grow and wants it to go out to the markets as an independent entity.

Is that sort of the underlying basis of the evidence?

A. I don't think that that is necessarily true. The way I see it is that if the government decides ultimately that it prefers not to have DISCO go out and raise money on its own, and that it doesn't ever need to get to 40 or 45 percent common equity, then the interim objective, that is having DISCO be a self-sufficient organization, is a reasonable objective in and of itself.

So that if it gets to 25 percent equity, it has a reasonable ability to cover all of its costs, including dealing with capital expenditures and dealing with paying principal on the debt outstanding.

Q.47 - I understand where you are coming from. And I think I agree with you. I may not be as optimistic as you about the ability of this Board to foresee any dividends that might be declared.

But coming now from a slightly different perspective, part of -- and I read the references in your report, and I think you have repeated them here -- sort of the long-term objective was, even given the fact that short-term reasonable objective doesn't require going to the markets, are there any other impediments that you would see in the structure of DISCO that would impede it going to the market?

And I'm thinking specifically of the government's -- really the shareholders' ability to set the revenue requirement irrespective of any decision of this Board. Is it likely that you could take this company to the market in the current circumstance where the Cabinet, Lieutenant-Governor-in-Council can simply set aside any decision of this Board and impose whatever revenue increase or revenue requirement it desires?

I guess my question is how would you ever take it to the market without a government guarantee in that case?

A. You raise a good point. I'm hesitating because I'm thinking of other companies that are or have faced analogous situations. I think that the debt market certainly would require a premium to account for political risk were the company to go to the market on its own. And we have seen this in Ontario where the government did interfere in the restructured market. And what happened was that the distribution companies were to all essentially be restructured.

They were all to have capital structures that would be consistent with going to the market on their own with a rate of return on equity, similar to other investor-owned companies -- I shouldn't say other investor-owned companies, but investor-owned companies. And what the government did was required that the capital structures and returns be phased in over a period of time.

And so when you look at the debt-rating reports of these distribution companies that were accessing debt on their own, the ratings were lower than they would have otherwise been. And one of the challenges that was noted on all of their debt-rating reports was political risk.

And most recently, because the government has not interfered in the electrical utility market in Ontario for a period of years, what you have seen is those ratings have come up.

Q.48 - Thank you. So that pretty much covers all of my questions. I just want to make sure that it is clear in my own mind for later use in argument, if I intend to go in that direction.

Is it fair for me to characterize your -- the basis of your evidence as setting DISCO on the right course so that it could go to the capital markets to float its own debt without government guarantee, but it would -- that would be necessary but not sufficient?

There would be other things beyond the purview of your evidence with respect to maybe legislative changes or things to reduce the political risk that would also be necessary?

A. Yes. I do think there are other things that would be necessary. And I have discussed a couple of those in my report.

DR. SOLLOWS: Thank you. That is all.

CHAIRMAN: Thank you, Dr. Sollows. Mr. Zed?

MR. ZED: We don't have any questions for this witness.

CHAIRMAN: Thank you. Mr. Peacock?

MR. PEACOCK: Thank you, Mr. Chair. Really a very few brief questions.

CROSS EXAMINATION BY MR. PEACOCK:

Q.49 - You had mentioned -- or the expert witness had mentioned that in her opinion the debt guarantee fee -- and pardon me if I'm paraphrasing your comments. The debt guarantee fee that the NB Power group of companies pays could in fact be significantly higher, is that correct?

A. I said that, yes.

Q.50 - Obviously such an action would be beneficial to the shareholder in the sense that it would assist Electric Finance. But would it also be fair to state that a higher debt guarantee fee could have a negative impact on the ratepayer?

A. Do you mean would the rates be higher?

Q.51 - Yes.

A. Yes. The rates would be higher if the costs are higher. That doesn't mean they are not fair. It just means they are higher.

Q.52 - Okay.

A. When I look at the debt guarantee fee, I tend to think about it in terms of that the person or the entity that is doing the guarantee, providing the guarantee should be compensated fairly for the risk that the guarantor is taking.

And one way of measuring what the appropriate magnitude of the guarantee fee is is to look at what the difference is between the cost at which the government can raise the debt and the cost at which the utility could raise the debt on its own.

And if you recall a discussion that I was having about TransAlta, that differential today is very, very large. So DISCO is getting if you will a bargain.

Q.53 - In your examination of other government-owned utilities, are there any debt guarantee fees that are in fact lower in percentage terms than the debt guarantee fee applied to the NB Power group of companies?

A. To my knowledge there are four crown corporations, provincially-owned crown corporations that pay guarantee fees. The only one of the four that is lower is the guarantee fee that is paid by Hydro Quebec.

MR. PEACOCK: Okay. Thank you. That is all, Mr. Chair.

CHAIRMAN: Thank you. Mr. Theriault?

CROSS EXAMINATION BY MR. THERIAULT:

Q.54 - Good morning, Ms. McShane.

A. Good morning.

Q.55 - With whom did you consult in the preparation of your opinion?

A. I consulted with Ms. MacFarlane and several other members of the NB Power DISCO organization. Do you want all of their names?

Q.56 - Yes, if you can recall them offhand.

A. The two that I remember are Ms. Nicole Poirier and Mr. John Dobson.

Q.57 - Thank you. Now according to your report you were asked, and I will quote, "to provide an expert opinion on the reasonableness of New Brunswick Power Distribution Customer Service Corporation's proposed target level of retained earnings, range of 25 to 30 percent, a pretax interest coverage ratio target of 1.75 times and the proposed interest coverage ratio of 1.25 times for the test year." Is that accurate?

A. Yes.

Q.58 - So can I infer from this statement that DISCO proposed these target levels and that you wrote an opinion on the reasonableness of these levels?

A. No. They were developed together. And then I wrote a report on the reasonableness of them.

Q.59 - Were you ever shown a copy of the board of directors' resolution approving these targets?

A. No, I wasn't.

Q.60 - Were you ever shown anything from Electric Finance approving these targets?

A. No, I wasn't.

Q.61 - Now Ms. McShane, could you show us where in the test year the revenue requirement -- or in the test year revenue requirement of DISCO where the pretax coverage of 1.75 times is sought by the utility?

A. It's not.

Q.62 - It is not in the revenue requirement?

A. The revenue requirement includes an interest coverage target of 1.25 times.

Q.63 - Okay. And could you show us where that is?

A. I can show you how to calculate it.

Q.64 - Okay. Is it in -- do you know if it is in the evidence?

CHAIRMAN: Can you point us to the evidence, can you?

MR. KEYES: A-2, section 8, page 1.

Q.65 - So could you point out to myself and to the Board where the 1.25 times after tax coverage ratio was contained in Table 8 (a)?
A. It's a pre-tax coverage ratio.
Q.66 - Okay.
A. And it's -- excuse me. I will take off my glasses. It's small print. It is on Table 8 (a), line 6, column 1.
Q.67 - Thank you. Just so we are clear, Ms. McShane, that is a 1.25 pre-tax?
A. That's my understanding.
Q.68 - Now would it be fair to say, Ms. McShane, that you developed your opinion on the basis of the following statements, that DISCO was one of the operating subsidiaries of NB Power Group, that it is a separate legal entity governed by the Business Corporations Act, that the financial plan of the shareholder in the province of New Brunswick includes capitalizing the New Brunswick Power group of companies, including DISCO, and that DISCO was interested in striving for self-sufficiency, that is that it would like to eventually access debt markets on its own? Would those statements be accurate?
A. No.
Q.69 - Okay.
A. Can we go through them one by one?

Q.70 - Sure. The first one is that DISCO is one of the operating subsidiaries of the NB Power Group?

A. Yes.

Q.71 - That it is a separate legal entity governed by the Business Corporations Act?

A. Yes.

Q.72 - That the financial plan of the shareholder, the Province of New Brunswick, includes capitalizing the New Brunswick Power group of companies, including DISCO?

A. That has been the plan. But the interim objective is not dependent on that plan.

Q.73 - But you would agree that that is the financial plan of the shareholder?

A. It has been. But again achieving the interim objective of self-sufficiency is important whether or not the government eventually has the individual companies set up as stand-alone companies accessing the capital markets on their own.

Q.74 - Now Ms. McShane, I will refer you to page 2 of your report, line 41.

Now you do state there -- and I will read this -- and I will read this. And you tell me if I'm accurate.

It is my understanding that the financial plan of the shareholder, the Province of New Brunswick, includes

capitalizing the New Brunswick Power group of companies, including DISCO, so that a minimum the companies are self-sufficiency, and that potentially they would be able to access the public debt markets without the benefit of a provincial guarantee?
A. Yes. I did say that.
Q.75 - So then my statement would be accurate?
A. Maybe I misunderstood what you were getting at. What I understood you to be saying is that my recommendations in this report are contingent upon the shareholder capitalizing the NB Power group of companies so that they would be able to access the public debt markets without the benefit of a guarantee.
Q.76 - No. My question was that you developed your opinion on the basis of the following statements?
A. Well, in that narrow context, yes. But my conclusions are not contingent upon the government capitalizing DISCO so as to be able to access the capital markets on their own. My conclusions are still valid even if the government decides not to do so.
Q.77 - But the point being is that was the basis on -- one of the bases on which you formed your opinion, that statement? At least that is what it says at page 2 of 14 of your report.

A. Well, what I see at page 2 is what the government says. I mean, it's a statement of fact. It's not supposed to be a -- it's not supposed to be, as I said, a factor that is required to occur for my conclusions to be valid.

Q.78 - Yes. And I understand that. Now the final statement that DISCO was interested in striving for self-sufficiency, that is it would like to eventually access the debt markets on its own, again would that, that you developed -- it would be fair to say that that is one of the factors on which you developed your opinion?

A. Could you read me that sentence again?

Q.79 - Sure.

A. Because I think you have --

Q.80 - That DISCO was interested in striving for self-sufficiency, that is it would like to eventually access debt markets on its own?

A. No. It says or. It says the establishment of financial parameters for DISCO that are compatible with self-sufficiency or ultimately that would permit it to access the debt markets on its own.

Q.81 - Okay.

A. So those are two different -- two different levels of capital structures.

Q.82 - Now, Ms. McShane, would it be fair to say that the sum of all these statements suggests that the original intent of government was to ultimately create, in the case of DISCO, a distribution utility with an equity position that could stand on its own in securing debt financing in the capital markets?

A. The plan of the government was to capitalize the companies to stand on their own. Again I don't mean to be repetitive. But the validity of my recommendations is not contingent upon that happening.

If the government decides ultimately that this is not the route that it wishes to pursue, the company should still strive to be self-sufficient.

And the recommendations in my report are consistent with that interim objective, not with the ultimate potential objective of having these companies access the capital markets on their own without the benefit of a debt guarantee.

Q.83 - And wouldn't it be fair to say that the original intent of government was to allow DISCO through its rates earn and keep a certain portion of net income that would be used to build up a retained earnings position?

A. I'm not sure of the specifics on that. But that would make sense that that was what was intended.

Q.84 - Now Ms. McShane, have you ever seen a written document from the Lieutenant-Governor-in-Council for New Brunswick pledging never to modify or reverse a decision of this regulatory Board?
A. No.
Q.85 - Okay. And have you ever seen written assurances from NB Electric Finance pledging never to take any amounts from the net income of DISCO other than those amounts associated with payments in lieu of income taxes?
A. Do you mean has it ever signed anything that said it won't call for dividends?
Q.86 - That is correct.
A. No.
Q.87 - Have you ever seen written assurances from DISCO that they would pursue a rate case whenever forecast net income is below an amount necessary to ensure pre-tax interest coverage of 1.75 times or after-tax interest coverage of 1.25 times?
A. Can we just stop and correct something?
Q.88 - Sure.
A. The 1.25 times coverage is pre-tax. It is the coverage ratio that is being requested for the test year. The 1.75 times coverage is also pre-tax. And it is intended to be a coverage that we would -- or NB Power

would get to eventually. But they are both on a pre-tax basis.

Q.89 - But the question is have you ever seen written assurances from DISCO that they would pursue a rate case whenever the forecast net income is below an amount necessary to reach those objectives?

A. No. But I wouldn't have expected to.

Q.90 - Are you aware that the president of DISCO has assured the public that if the Board approves the current application by DISCO, DISCO will not be back before the regulator until 2010?

A. No. I wasn't specifically aware of that, no.

Q.91 - Are you aware that if this scenario unfolds as described, as I have suggested it was described, that the utility will be restricted to a rate increase of 3 percent or the change in CPI, whichever is greater, for the intervening years?

A. Yes. I'm aware of that.

Q.92 - And have you seen any analysis form DISCO that supports a conclusion that these above-mentioned increases would be sufficient to generate the coverage ratios that you support in your opinion?

A. No. I have not specifically looked at those, no.

MR. THERIAULT: Okay. Thank you very much, Dr. McShane.

And I hope you have a much easier trip back home than you had coming in.

MS. MCSHANE: Thank you so much.

CHAIRMAN: Thank you. Ms. Desmond?

MS. DESMOND: Could I suggest a short recess, Mr. Chair?

CHAIRMAN: Well, I will suggest a 20-minute one. How is that?

MS. DESMOND: Good.

(Recess - 10:20 a.m. - 10:40 a.m.)

CHAIRMAN: Ms. Desmond?

MR. MORRISON: Mr. Chairman, perhaps before Ms. Desmond begins I would just like to say a couple of things to the Board with respect to schedule.

Yesterday I had a brief discussion with Board Staff with a view to maximizing the efficiency of the time that we have in the schedule. I think with a view to perhaps concluding -- making sure that we conclude the hearing on December 20th as originally proposed. I have spoken with most of the Intervenors, but not all, and I think we are coming to a position where we can slot in which witnesses are going to be where and when. And I would ask if all the Intervenors could stay for a few minutes at the conclusion of today's proceedings to see whether we can finalize that and we would then circulate a new revised schedule to all the parties and the Board.

CHAIRMAN: Well that would make sense. And really what you are talking about is eliminating December 21st from the schedule.

MR. MORRISON: I think that would be a noble goal.

CHAIRMAN: I don't think anybody would hate you for that. Ms. Desmond?

CROSS EXAMINATION BY MS. DESMOND:

MS. DESMOND: Thank you, Mr. Chair.

Q.93 - Perhaps I will start by asking, Ms. McShane, just turn to schedule 1 of your evidence. And Ms. McShane could you identify on schedule 1 which of these utilities are crown owned utilities and confirm for Board Staff what the debt portfolio management fee is with respect to each crown owned utility?

A. On the schedule 1, the only one that I would call a crown utility would be Hydro One and it pays a debt guarantee fee.

Q.94 - And the amount of that fee?

A. They do not pay a fee. They do not have a guarantee.

Q.95 - Nww just by the way of clarification I had understood that earlier in your testimony you had indicated that the utility for the Northwest Territories did not pay a debt portfolio management fee. And then I think with respect to our response, a question asked by Mr. Peacock, you had indicated that DISCO paid a fee that was less than two other utilties. And I am just wondering if you could reconcile those two statements?

A. Sorry, could you ask the question again?

Q.96 - I understood that you had suggested that the utility for the Northwest Territories did not pay a debt portfolio management fee?

A. Correct.

Q.97 - And then later in response to a question from Mr. Peacock, I had understood that you had said that DISCO's fee was less than two other utilities?

A. Correct.

Q.98 - So are there utilities then that do not have that provincially owned -- sorry, the debt portfolio management fee?

A. Yes.

Q.99 - Are you aware of any success or failure by DISCO's sister company, Transco, which was capitalized and earnings of Board approved rate of return through its tariff to access debt markets on its own?

A. No. To my knowledge they have not gone to the market on their own.

Q.100 - During Dr. Sollows' questioning, you indicated that the debt market charged a premium for enhanced political risk?
A. Yes.
Q.101 - And I think you gave Ontario as an example of that. Can you quantify or give a range as to the magnitude of this premium?
A. It's going to depend very much on what the risk is. In the case of Ontario, the ratings of the utilities were A low. And they are currently A, which would have meant improvement in their debt cost of maybe 15 basis points. But when you read the debt rating reports, they still refer to political risk. So there is some there still, although it is less.
So it's very much dependent on how high the risk is that there will be political intervention and at least as importantly what that might result in in terms of the financial parameters of the utility affected. So it's almost impossible to give a generic answer to that.
Q.102 - As you may be aware, DISCO no longer has individual financial statements audited by external accountants. Are you aware of that?
A. I was not aware of that.
Q.103 - In your experience is it common for a stand alone

self-sufficient utilities to have their financial statements audited?

A. When you say stand alone, do you mean specifically utilities that go to the market on their own? Or -- I mean most utilities are treated as stand alone, even though they might only be a divsion of a company and not have truly financial statements, but if you mean specifically companies that go to the market on the basis of their own financial parameters, then yes, they would have audited financial statements.

Q.104 - And that leads to my next question in that would DISCO be able to access the debt capital markets on its own without having the financial statements subject to audit?

A. Probably not.

Q.105 - Hypothetically assuming DISCO is still in a crown owned fully integrated utility, in your expert opinion what would be an appropriate earnings amount to include in the revenue requirement? And I would suggest that you use the interest coverage ratio as the indicator?

A. Are you talking about for an integrated utility?

Q.106 - Yes. A fully integrated utility?

A. So we are talking about a crown -- still talking about a Crown corporation?

Q.107 - That's correct.

A. And debt guaranteed?

Q.108 - That's correct.

A. Probably about the same. 1.75 times.

Q.109 - You wouldn't see any difference whether or not it was fully integrated or what would be the reasoning why it would be the same?

A. Because the ratios that have been developed have been developed on the basis of the spectrum of companies which include integrated companies.

Q.110 - I think you had indicated earlier that DISCO would require a lower common equity ratio if it had deferral accounts to mitigate business, is that correct?

A. Well were you talking in the context of a stand alone company that yes.

Q.111 - Could you provide your opinion as to the prudency of not having deferral accounts for the items mentioned in your report?

A. I don't think it's a question of prudency. Deferral accounts happen to be fairly typical of Canadian companies. But U.S. companies have significantly less -- lesser number of deferral accounts and that's not considered to be a question of prudency. It's a choice of where the risk is placed, whether it's more shared between ratepayers and the shareholder or whether the shareholder

takes more of the risk. Q.112 - If the deferral accounts were to be established what impact, and if you could quantify that impact, would they have on DISCO's borrowing rate, assuming that it was a stand alone entity?
A. Well it's sort of a package. I guess the problem I am having with the question is I can tell you my view of what the borrowing rate would be with deferral accounts and a common equity ratio say in the range of 40 to 45 percent. What I struggle with is being able to put a number on what the borrowing rate would be at the same kind of capital structure without any deferral accounts.
So if the equity ratio is 40 to 45 percent with deferral accounts on the major expense categories, I would think that DISCO would be able on a stand alone basis to achieve a rating in the A category, which would mean today it would probably be able to raise debt at let's say longer -- the longer term debt, 30-year debt at maybe 130 to 40 basis points over 30-year Canada bonds.
Q.113 - We spoke earlier about self-sufficiency and how that was a reasonable interim objective irregardless of the long-term plan?
A. Yes.
Q.114 - And you indicated that a ratio of 1.25 was a reasonable target to reach that interim objective?

A. For the test year.

Q.115 - For the test year. Is there more than one way to accomplish self-sufficiency other than through your proposed method?

A. I'm not really sure I fully understand your question. If you look at the definition of self-sufficiency which from my perspective is the definition that I provided at page 5 of my report, where I say in this context self-sufficiency means that DISCO can service all of its obligations including interest expense and repayment of debt as well as fund its capital expenditures while building and maintaining a reasonable equity cushion through the retention of net income, it seems to me there are only two ways to do that. One is to deem the capital structure and a return and the other is to have a certain level of interest coverage which would permit the achievement of a level of retained earnings.

Q.116 - Would the establishing of deferral accounts help create or reset goal of self-sufficiency without necessarily the proposed ratio that you have suggested?

A. I would say deferral accounts would help, but a utility still needs to have a basic level of retained earnings, and I don't see that being any lower than 25 percent.

MS. DESMOND: Those are all my questions, Mr. Chair.

CHAIRMAN: Thank you, Ms. Desmond. Any questions from the Board? Mr. Barnett?

BY MR. BARNETT:

Q.117 - Good morning, Ms. McShane.

A. Good morning.

Q.118 - You are aware -- I think you have in your evidence and I think questions from the Public Intervenor -- you are aware that the new Electricity Act came into effect on October 1st 2004, and the objectives of that were to set up these four separate companies of NB Power into a holding corporation?

A. Yes.

Q.119 - And their objectives are that they would achieve this self-sufficiency and could go to the capital markets at some point in time.

A. Yes.

Q.120 - Under what circumstances then, if there was an infusion of capital -- of equity into one of these companies -- let's say DISCO or -- I have another one in mind -- and in fact there was a regulatory approved ROE, under what circumstances would that -- or could you envisage any circumstance whereby that company would not go to the capital markets, and they are not a crown

corporation either -- would not go to the capital markets for borrowing?
A. I think I missed a little bit in there. And you said they are not a crown corporation?
Q.121 - They are not a crown corporation as was deemed -- I think it was spelled out in the Electricity Act. Simply put, would there be any circumstances whereby they would not go to the private capital market for funding for a particular project shall we say?
A. If it was cheaper not to.
Q.122 - I'm sorry?
A. If it was cheaper not to.
Q.123 - So notwithstanding the objectives of the Electricity Act there would be circumstances whereby you may still not go to the capital markets to achieve that objective that was spelled out in the legislation?
A. I would say yes, because there is always the risk that if you go to the capital market you would be surprised at what they will charge you to access the debt market. And in the case here I meant it's possible that there is a level of political risk that would make the cost higher than it is by continuing to pay the debt guarantee fee.
Q.124 - So it's the political risk is --
A. It may well be.

Q.125 - -- the significant factor in your mind?
A. It could be.
Q.126 - Thank you. I just have one other question. You have referred to I believe in answer to questions about an interim plan. Are those your words or is there such an animal, and if so, is it one that has been developed by DISCO in regards to achieving this self-sufficiency?
A. I guess the term interim is my terminology, and I look at it as a step on the way to being fully stand-alone, but as I indicated in response to questions earlier, even if that second step doesn't come to pass then reaching the objective of self-sufficiency is a laudable goal in and of itself.
Q.127 - Did you have discussions with the applicant DISCO in this case in regards to that, and in your view were they on the same wavelength in regards to this process?
A. Yes. They were in agreement with that approach.

MR. BARNETT: Thank you, Mr. Chairman.

CHAIRMAN: Anything further from the Board? Thank you, Ms. McShane. I guess at this point in time I will turn it back to Mr. Keyes for redirect.

MR. KEYES: Just one point raised by Mr. Barnett's question.

<u>REDIRECT EXAMINATION BY MR. KEYES</u>:

Q.128 - Ms. McShane, are you aware of a distinction between what is a crowN corporation and what is an agent of the crown?

A. Yes. Do you want me to tell you what it is.

Q.129 - I am waiting to hear your answer.

A. I guess I have used the term crown corporation rather loosely. An agent of the crown really is not subject to like the Business Corporations Act in various provinces and a true crown corporation would be.

MR. KEYES: Thank you.

CHAIRMAN: Thank you for your attendance. I know you had a difficult time travelling here, so I hope that your journey back is much smoother.

MS. MCSHANE: Well I appreciate you waiting for me, and it was worth the trip.

CHAIRMAN: I don't know that we had much choice. We certainly weren't going to where you were to hold the hearing. Thank you. There are a couple of other matters to clear up. I think the first one deals with exhibit A-43, the report on the Belledune tube sample analysis which was filed at the request of Mr. Barnett, and he has an issue with respect to that which he would like to raise with the applicant.

MR. BARNETT: Yes. Thank you, Mr. Chairman. Having reviewed exhibit A-43 it has given rise to a number of other questions, Mr. Morrison, and I just would like to know how we can proceed in regards to that.

MR. MORRISON: I suppose there is two ways to proceed. The Board could submit questions and which we could take as an undertaking, and if the responses aren't satisfactory then we could -- I guess I'm trying to avoid recalling the Panel unless it's necessary, and if the responses that we provide are not sufficient and you require further clarification then we could recall the Panel to answer those questions.

MR. BARNETT: The only question with regards to the Panel -- and I will leave it up to the Chairman in terms of process, but I'm not so sure that the questions we have could necessarily be responded to directly by the Panel that was up, and I'm thinking specifically that one gentleman was I believe the financial side of Generation corporation and he may not be in a position to answer the questions, Mr. Morrison.

MR. MORRISON: Perhaps in that regard, if you could submit the questions in writing perhaps I would suggest, then we could task the appropriate people with the appropriate expertise to create a response. If the response of course is not satisfactory then we would have to bring forward the appropriate person to answer those questions.

CHAIRMAN: I think that process would work well. So, Mr. Barnett, you will get that question together or questions --

MR. BARNETT: I think there might be more than one question, Mr. Chairman, but Mr. McKenzie and I will get together. Thank you.

CHAIRMAN: Thank you. The only other issue that I wanted to deal with this morning, and I'm going to go back to Mr. Lawson's motion, and my issue is one of the timing of what is requested in your motion, because we have now put this off until final argument, and as I read your letter of November 23rd, Mr. Lawson, you had asked that immediately following this hearing that the Board review the issue of allocation of cost among customer classes. And I guess first of all I wanted to clarify as to whether or not you saw that as part of this rate application?

MR. LAWSON: Mr. Chairman, I think because of jurisdictional issues that it will have to be considered as part and parcel of this rate application. I do have some ideas about how that can be achieved without defeating the Board's objective of wanting to make a decision on this application itself. I don't know if you want me to go into that any further at the moment, but I do think it has to because I am concerned about the jurisdictional issue once the decision has been made on this application.

CHAIRMAN: Well I would have expected some discussion with respect to jurisdictional issues, that's why I raised it, and I really don't want to have the Board put in a position of having to consider a motion on the very last day of our hearing which perhaps part of the implication of it may well be that we would potentially be hearing more evidence before rendering a decision. I don't think that we want to be put into a situation where a real extensive delay might occur. And that's the difficulty. So I'm not really sure where you are going. I don't know -- I mean you said you wanted to put -- you are prepared to put the argument on this motion off until final argument, but you can see the position that perhaps everybody then may be gets put into if there is a jurisdictional issue. Once the Board renders its decision, for example, I mean argument may be made one way or other as to whether or not we could then go forward and deal with the issue you have raised.

MR. LAWSON: I understand, Mr. Chairman. The proposal I was going to put forth and will sort of advance now for consideration I guess, not obviously for determination, is the concept that in order to retain jurisdiction the Board would entertain making what would amount to another interim decision resulting from all of the evidence that is heard in this case, effectively then saying that it will be subject to what might be the outcome of a further cost allocation study that would take place hopefully early in the new year. When we say immediately after these hearings we don't expect Christmas Day.

CHAIRMAN: Well I don't know if any of the other parties want to respond to this at this point in time. I quite frankly just wanted to put on the record that I would have anticipated the Board's jurisdiction to be something that would be raised in final argument in the event that parties weren't aware of it. Somebody may have looked for some delay to respond to the jurisdictional issue. So I did want to make sure that everybody was prepared to make that argument when we do deal with this presumably now on the 20th of December.

MR. MORRISON: Mr. Chairman, I'm just going to throw something out to try to maybe bridge the gap between the Board's concerns and obviously Mr. Lawson's legitimate concerns. I think one of the issues that we have and perhaps why we ought not to be dealing with it today is that I do know from comments made by Mr. MacDougall that he does have an interest in this motion. He will be here I understand on Monday for the rate design portion of the hearing, and perhaps we can deal with this sooner as opposed to later, perhaps we can deal with it on Monday, rather than putting it off until final argument. At least that way it will be dealt with a little bit sooner than final argument. And I just put that out as a possibility. I know that -- and I won't argue it now, but - anyway, I will leave that until Monday or whenever the Board decides to rule on it.

CHAIRMAN: Well at least if the parties are aware of the fact that this matter may well be dealt with before the 20th, that it will be dealt with at some point in time, and obviously I wanted to make sure again that everybody was aware of the fact that we would want to hear arguments with respect to the jurisdictional aspect of it. So we won't hear -- we are not going to hear it today but we may hear it certainly before the 20th of December. Is that satisfactory, Mr. Lawson?

MR. LAWSON: That's fine, Mr. Chairman. It's just if we are looking at doing it next week I might, given Mr. MacDougall's concern at least as expressed in his e-mail, perhaps it might be entertained a couple of days after Mr. Larlee and a couple of the other witnesses dealing with cost allocation are going to be dealt with.

CHAIRMAN: So I think that is everything for today, unless anybody has any other issues to be raised. Then I guess we will adjourn until Monday morning at 9:30 and I believe we are back at the Delta.

(Adjourned)

Certified to be a true transcript of the proceedings of this hearing, as recorded by me, to the best of my ability.

Reporter