New Brunswick Board of Commissioners of Public Utilities

In the Matter of an application by the NBP Distribution & Customer Service Corporation (DISCO) for changes to its Charges, Rates and Tolls - Revenue Requirement

Delta Hotel, Saint John, N.B.
February 15th 2006

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Undertakings

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Delta Hotel, Saint John, N.B.
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BOARD STAFF:	Doug Goss
	John Lawton
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CHAIRMAN: Good morning, ladies and gentlemen. Could I have appearances please for the Applicant?

MR. MORRISON: Good morning, Mr. Chairman, Commissioners. Terry Morrison and David Hashey for the Applicant. And with us at counsel table is Lori Clark.

CHAIRMAN: Thank you, Mr. Morrison. And for Canadian Manufacturers and Exporters?

MR. LAWSON: Good morning, Mr. Chairman, Commissioners. Gary Lawson appearing with Mark Grayson.

CHAIRMAN: Thank you, Mr. Lawson. Mr. Coon is not here today. Enbridge Gas New Brunswick?

MR. MACDOUGALL: Good morning, Mr. Chair, Commissioners. David MacDougall for Enbridge Gas New Brunswick.

CHAIRMAN: Thanks, Mr. MacDougall. The Irving Group of companies? Mr. Booker?

MR. BOOKER: Good morning, Mr. Chair and Commissioners. Andrew Booker for J. D. Irving.

CHAIRMAN: And Mr. Gillis is not here. Rogers Cable? Self-represented individuals? The Municipals?

MR. GORMAN: Good morning, Mr. Chairman and Commissioners. Raymond Gorman appearing on behalf of the Municipal Utilities. Today I have Dana Young and Eric Marr with me.

CHAIRMAN: Thanks, Mr. Gorman. Vibrant Communities? Public Intervenor?

MR. HYSLOP: Good morning, Mr. Chairman. Peter Hyslop with Mr. O'Rourke, Ms. Power and Kurt Strunk.

CHAIRMAN: Thanks, Mr. Hyslop. Now if there are any Informal Intervenors who want to go on the record why speak now or forever hold your peace.

And Mr. MacNutt, who do you have with you today?

MR. MACNUTT: Mr. Chairman, I have with me today Doug Goss, Senior Adviser, John Lawton, Adviser, Jim Easson, John Murphy and Andrew Logan, Consultants.

CHAIRMAN: Thank you, Mr. MacNutt.

Just one preliminary from the Board's perspective is that the Secretary informs me that next Thursday has opened up for this room in the hotel if we need to add another day.

But I just want to go around the room and see if there were any of the parties or their solicitors that are already booked on something else and we will just take it off the table.

MR. MORRISON: We are open, Mr. Chairman.

CHAIRMAN: Okay. Well, Madam Secretary, on the break you can let the hotel know that we will be sitting next Thursday then. And as well the shorthand reporters and the technician and the translators.

Okay. Any preliminary matters?

MR. MORRISON: Yes, Mr. Chairman. Just a couple. In reviewing the transcript from February 13th, Ms. Clark noticed an error in the transcript. And in fairness to the Court Reporter I recall that Ms. Clark was probably away from her microphone at the time. And it appears at page 3871 at lines 13 and 14.

And how it reads in the transcript is -- the question was from Dr. Sollows, "So the OATT change would have been reflected in the 05/06, is that correct?"

And Ms. Clark's response on the transcript is "In fact they were. Because when we followed their evidence we weren't aware of the changes at that time."

What she thinks she said, and what I believe she said, is "In fact they weren't. Because when we filed our evidence we weren't aware of the changes at the time." So I will point that out to the Court Reporter.

And there is one other correction that comes from February 9th. And it is at page 3764 of the transcript. And it is evidence of Ms. MacFarlane. And perhaps it would be best if Ms. MacFarlane corrected that response herself. Ms. MacFarlane?

MS. MACFARLANE: I was asked about the refinancing of the $100 million note that came due in December '05. And I indicated it was refinanced in December '05. In fact it was refinanced in January '06. So I just wanted to correct the record for that.

MR. MORRISON: And we have one additional undertaking response, Mr. Chairman, which is undertaking number 3 from February 8th, requested by Mr. Hyslop.

And it deals with the percentage change and distribution assets over the past five years. And the

Board Secretary has copies of that.

CHAIRMAN: My records indicate that will be A-94.

MR. MORRISON: Thank you, Mr. Chairman. That is all the preliminary matters from the Applicant.

CHAIRMAN: Any other preliminary matters? Mr. Gorman, go ahead, sir.

MR. GORMAN: Thank you, Mr. Chairman.

CROSS EXAMINATION BY MR. GORMAN:

Q.144 - Good morning, Mr. Marois, Ms. MacFarlane and Ms. McShane. When we I guess concluded yesterday we were dealing with exhibit A-55, appendix 1 which is Ms. McShane's report. And we were at page 11. Do you have that evidence?

MS. MCSHANE: I do.

Q.145 - Thank you. You will recall yesterday that we I guess in questioning you in dealing with TransAlta, and this is based on evidence on page 12 of your report, that their current rate is 37 percent equity?

MS. MCSHANE: Well it's no longer TransAlta, but the distribution assets that now belong to Fortis Alberta have an equity ratio of 37 percent.

Q.146 - Thank you. And I asked you what the average of the allowed common equity would be with respect to the peer companies that you had named, and I'm not sure that we actually dealt with that sufficiently, and it struck me that maybe in asking you about average I wasn't specific enough because in going back to I guess some of the statistics that would have taken many, many, many years ago in university I recall that there was a mode, a median and a mean, all are expressions of average, and I certainly didn't specify which I was talking about. If I talked about the mode what would it be if we had 37 percent down for TransAlta?

MS. MCSHANE: It would be 37 percent because that's the only number that's repeated twice. But I would also say that really what you are looking at when you look at the 37 percent is the fact that all electricity distribution utilities in Alberta were given 37 percent. So I could actually have put the two municipal distributors on that list as well. That would have given us another two 37 percents.

On the other hand, if we went and put all of the Ontario municipal electricity distributors within the same size range in there which would have given us a number of other utilities with 40 percent, the mode would probably have been 40 percent.

Q.147 - Sure. But you are the one that picked the peers for your report and based on that table it would be 37?

MS. MCSHANE: Certainly I picked the peers but I didn't have the intention of giving the average, the median or the mode as the most relevant comparator to Disco.

Q.148 - Would you agree then that the median is also 37?

MS. MCSHANE: We are talking about leaving out TransAlta, is that -- or leaving TransAlta in?

Q.149 - We are talking about TransAlta at 37.

MS. MCSHANE: The median would be --

Q.150 - Be the middle number, wouldn't it, in their five numbers?

MS. MCSHANE: Well --

Q.151 - Sorry. Wouldn't the median be the middle number?

MS. MCSHANE: Sorry. You can't count TransAlta at 37 percent in the last block there, because TransAlta Disco at 56 percent is the same company as Fortis Alberta at 37 percent. So you can't count it twice.

Q.152 - So if we took that out then what would the median be?

MS. MCSHANE: It would be the mid point of 37 and 40 --

Q.153 - Okay.

MS. MCSHANE: -- which would be 38-and-a-half.

Q.154 - Thank you. And the -- I guess the measure that we most commonly use is the mean and that would essentially be the total number divided by the number of units, and when I do that I come up with 39. Subject to check, would you accept that as being --

MS. MCSHANE: I would accept that subject to check, with the caveats that I have given you before.

Q.155 - Thank you. Now with respect to the companies that are listed in table 1 on page 11 as peers, are any of them Crown corporations?

MS. MCSHANE: Well all of the municipal electricity distributors are owned by governments. So I would consider them to be virtually equivalent to Crown corporations from that perspective. I don't have on here, as I said to you a couple of minutes ago, the municipally owned distributors in Alberta, but they are also allowed common equity ratios similar to those of the investor owned utilities. In fact they are actually allowed a bit more because in Alberta they don't pay income taxes. The Ontario municipal electricity distributors capital structures also cover Hydro One distribution operations which in fact if they had been put in separately they have an allowed common equity ratio of I believe it's 36 percent, plus they have preferred shares of four percent.

Q.156 - Okay. Then can I take from your answer that other than the Ontario examples in your table the others aren't Crown corporations or equivalent to Crown corporations?

MS. MCSHANE: The other ones in the table are investor owned utilities.

Q.157 - Thank you. Can I now go to page 15 of your evidence. And this is part of the section where you are looking to assess the reasonableness of a 10 percent return on equity, would you agree?

MS. MCSHANE: Yes.

Q.158 - And the 10 percent return on equity that has been chosen, I think I can find where that's derived from in Sharon MacFarlane's evidence which is at A-50, tab 3, subtab 4, at page 10, and I don't think it's necessary to turn that up. I'm just going to quote from her evidence. She says, "Based on the advice of the Province's financial advisors a return on equity of 10 percent was determined to be reasonable for Disco." Is that where the 10 percent return on equity is derived from?

MS. MCSHANE: That's correct.

Q.159 - And I don't know if we have covered this or not, but who are these Province's financial advisors? Are they -- well perhaps I will ask you just to answer that question?

MS. MCSHANE: The firm that was employed to assist the Province with the financial restructuring and the modelling was CIBC World Markets.

Q.160 - Thank you. Now if I can go to table 2 on page 15, you -- Ms. McShane, you have again set forth a table to in a sense benchmark a -- I guess what other utilities are doing with respect to appropriate return on equity?

MS. MCSHANE: Yes.

Q.161 - And would you agree that the examples that you have used or the appropriate benchmark utilities all are below 10 percent?

MS. MCSHANE: Yes.

Q.162 - And if we were to go through the exercise with respect to deriving an average -- and I guess you have actually set forth an average here at 9 percent, but if you use the three different tests of mean, mode or median, they all come in at 9 or perhaps slightly over, maybe as high as 9.1, but very close to 9?

MS. MCSHANE: Correct.

Q.163 - Now the jurisdictions that are dealt with here, some of them are private investor utilities?

MS. MCSHANE: In Alberta the return that's in there applies to the investor owned utilities and the municipal utilities. In British Columbia the Terasen Gas return, which is currently being reviewed, is also applicable to B.C. Hydro. The National Energy Board. I don't think there are any government owned pipelines. Newfoundland Power is investor owned. In Ontario the Enbridge Gas 9 percent. The same number also applies for 2006 to the

Ontario distributors, including Hydro One. And in Quebec the -- I don't know precisely what the 2006 are. We -- for Hydro Quebec Distribution is going to be because they still have an application outstanding with no decision, but essentially the Regie has determined the ROE and capital structure for Hydro Quebec Distribution using the same kind of parameters as I have suggested here, that is, by reference to investor owned utilities.

Q.164 - Now if I continue on at page 15, the conclusion that I come to from your evidence is that a return on equity of approximately 9 percent is accepted as reasonable for a benchmark Canadian utility?

MS. MCSHANE: When I say a benchmark Canadian utility, it's a relatively low risk Canadian utility. There are obviously other utilities in the country that are allowed higher returns because they have higher risk.

For example, I put the benchmark number in here for British Columbia which is Terason Gas, but if you looked at some of the other utilities that the commission regulates in British Columbia, their returns on capital structures are higher -- higher common equity return, thicker common equity allowed than Terason Gas. So Terason Gas has a 33 percent allowed common equity ratio right now versus Fortis B.C. which is an electric utility which has a 40 percent allowed common equity ratio. Terason Gas has the return that I have noted here, Fortis B.C. has a 40 basis point increment to its allowed return.

Q.165 - Now with respect to this benchmark of 9 percent, we talked yesterday when we were talking about the debt equity ratio of there being in a sense ranges, because it may not be an exact science, that there is a certain amount of judgment that has to be applied. And I guess as I read through your evidence, effectively what you are saying is to go one percent higher than the benchmark is not unreasonable. Is that a fair statement?

MS. MCSHANE: What I said was that in my judgment, based on looking at the business risks of Disco relative to these benchmark utilities, that given the capital structure that the advisors had suggested, that a one percentage point increment to the benchmark return would not be unreasonable.

Q.166 - Now the advisors, being I guess CIBC World Markets, and again if there is a range, wouldn't I expect that advisors would bring in as a recommendation a high end of a range, not the low end?

MS. MCSHANE: I certainly have no reason to believe that when the advisers looked at what a reasonable return was that they would be looking at the high end of the range.

They would be looking at the allowed returns for utilities in a similar range of risks. So -- I'm speculating since I wasn't there.

But I would have imagined, given what I know about CIBC's approach to return, because I have seen some of their testimony in cases where they have appeared as financial advisers on the record, that they would have been looking at returns for Canadian utilities as well as U.S. utilities. So this would be fairly well in the middle of the range.

Q.167 - If it is in the middle of the range then that implies to me that something less than 10 percent is still within the reasonable range. Would you agree?

MS. MCSHANE: I personally would not agree that something in the middle, if you look at 10 percent, would be reasonable given the risks and given the fact that -- the 9 percent return that's being allowed to Canadian utilities today is being viewed by the investment community, particularly the debt-rating agencies, as low.

Q.168 - If 10 percent were reasonable for Canadian utilities why are there no examples in your table as high as 10 percent?

MS. MCSHANE: The only answer I have to that is that regulators have to some extent determined returns based on what other regulators are doing.

So that they have been comfortable that they are in the range allowed in other jurisdictions. And, you know, these are the low-risk utilities against which I have determined that the 10 percent is reasonable.

Q.169 - Yesterday when we were talking about the debt equity ratio, you I guess conceded something you referred to as the halo effect.

Would that not also apply to a certain extent here as this is a Crown corporation?

MS. MCSHANE: Well, when I referred to the halo effect yesterday, what I was talking about was whether or not a utility which was owned by a government but was accessing capital on its own would see a somewhat lower debt cost. And I mentioned a number of basis points in the spread on a long-term debt issue.

And I think -- I didn't go back and look at the transcript last night to see what number I had actually said. But I did go and look at undertaking number 2 which was -- Ms. MacFarlane is going to get that for me. But it gave the spreads for indicative 10 and 30-year debt issues.

And I don't know if you have a copy of that and if you wanted to look at it. But it's undertaking from February

9th 2006, undertaking number 2. And it gives the credit spread for example for Enbridge Gas Distribution which is rated A minus by Standard & Poor's, as compared to Hydro One which is rated A by Standard & Poor's.

So if we took the halo effect totally out of the equation, you would expect that Hydro One would have the same -- sorry, would have a somewhat lower spread than Enbridge Gas Distribution because it's a bit higher credit rating. The fact of the matter is that Hydro One has an A rating and only has a five basis point differential with Enbridge Gas Distribution which is an investor-owned utility. So there really is very little halo effect.

And so the answer to your question is no, I don't think that that should make any difference in what the common equity ratio and common equity return should be.

MR. GORMAN: I have no further questions.

CHAIRMAN: Thank you, Mr. Gorman. We are impressed with your recall in reference to your stats course at university.

And next would be -- does Vibrant Communities have any -- they are not here. So they wouldn't have any questions of this panel.

Mr. Public Intervenor?

While the Public Intervenor is getting ready I would just point out to those of you in the back of the room that this is an open public hearing and we need to have the door open at all times so the public can get access. It's open now. It has been closing and opening ever since we started this morning. So --

CROSS EXAMINATION BY MR. HYSLOP:

Q.170 - Good morning, Mr. Chairman and Commissioners and members of the Panel, Ms. McShane. I don't have a lot of questions, but just a few topics to run through and most of my questions are directed I think toward Ms. McShane. First, Ms. McShane, I looked at your report and the cover page indicated that it was an opinion on net income, correct?

MS. MCSHANE: Yes.

Q.171 - Right. And this -- I guess I just wanted to make sure that I understood the nature of the retainer and the purposes for which you were required to provide an opinion. And in that regard the -- it seems to me -- excuse me, I'm losing my voice with a cold -- but it seems to me you came into this on the assumption that the capital structure for the 42.5 percent equity was given to you as an assumption, is that correct?

MS. MCSHANE: Yes. What was given to me was the basis on which NB Power Distribution had estimated their net income and they asked me to evaluate whether their approach was reasonable.

Q.172 - Okay. So not only was the 42.5, 57.5 equity debt capital structure provided to you as an assumption, would I be correct in saying the 10 percent rate might also have been provided to you as an assumption only for your comment, am I correct there?

MS. MCSHANE: Yes. The 10 percent return on equity that was given to NB Power Distribution by the Province's financial advisors was also given to me.

Q.173 - Okay. So you started with these two numbers and also with their calculation of the net income and essentially your opinion is that they did their math right, is that essentially what your report is about, Ms. McShane?

MS. MCSHANE: No.

Q.174 - Thank you.

MS. MCSHANE: My report is about determining whether the underlying assumptions are reasonable and whether the approach is in -- is compatible with all of the objectives of restructuring the Energy Policy and the Electricity Act.

Q.175 - Okay. Now you would agree with me that Disco's actual capital structure is at present 100 percent debt.

MS. MCSHANE: Yes, I understand that.

Q.176 - Thank you. And your recommended income is based on the assumption that Disco should be treated as if it were an independently investor owned utility, correct?

MS. MCSHANE: Yes. Those are certainly objectives that are underlying restructuring and the energy policy.

Q.177 - Thank you. And would you accept, subject to check, that the last NB Power rate case decision did not assume that Disco would be treated as if it were an independent investor owned utility?

MS. MCSHANE: I agree but things have changed. We have a whole new framework that we didn't have in 1991. I also point out that the independent financial witness at the time for the Board recommended even without that framework that a capital structure return be determined that would be equivalent to that of an investor owned utility.

Q.178 - I appreciate that, but I also am asking you to appreciate the decision that was made at the last NB Power rate case and that did not assume that Disco would be treated as an investor owned utility?

MS. MCSHANE: Correct.

Q.179 - Thank you.

MS. MCSHANE: And that was before the new framework was established.

Q.180 - Well that's fine. The Electricity Act establishes the framework. Now would you accept, subject to check, that the Electricity Act states -- and this is the definition of revenue requirements -- revenue requirements mean the annual amount of revenue required to cover the projected operation, maintenance and administrative expenses, amortization expenses, taxes and payment in lieu of taxes, interest and other finance expenses and a reasonable return on equity?

MS. MCSHANE: Yes, I agree with that.

Q.181 - Thank you. And further, subject to check, and I'm referring to Section 101(3), this reads, "the Board shall, when considering an application under this section, base its order, decision respecting their charges, rates and tolls to be charged by the distribution company on all the projected revenue requirements for the provision of services referred to in Section 97."

MS. MCSHANE: Yes, that's what it says.

Q.182 - Thank you. And would you agree that, subject to check, that other than these provisions, the Electricity Act is silent on the question of how a reasonable rate of return for a Crown corporation should be calculated?

MS. MCSHANE: To my knowledge there is nothing specific in the Act that says how the return is to be determined, but if you look at -- excuse me just for a second --

Q.183 - Take your time.

MS. MCSHANE: I have a copy of -- I guess I referred to this yesterday. It's called the Minister's Statement on the Future --

Q.184 - I'm not interested in the Minister's Statement. My question was with respect to the Electricity Act being silent on the question of how a reasonable rate of return for a Crown corporation should be calculated.

MS. MCSHANE: And I agreed with you that there was nothing specific in the Act, but I was going to refer you to what the Minister had said with respect to it being expected to operate as a commercially driven utility, which in my mind means that it's supposed to earn a commercial return.

Q.185 - Sure. And it would have been very easy in this legislation to say that the rate of return shall be that rate commensurate with an investor owned utility, and been very specific about it, and I suggest to you there is no specific legislation in the Act that says that. Correct me if I'm wrong, Ms. McShane.

MS. MCSHANE: No, there is nothing specific in the legislation --

Q.186 - Thank you.

MS. MCSHANE: -- just as there is nothing specific --

Q.187 - Thank you.

MS. MCSHANE: -- in the legislation of other regulators which prescribes how the rate of return is to be set.

Q.188 - That's right. Now finally just following up, that given Section 101(3) and the absence of anything specific in the Act relating to the calculation of rate of return, you would agree with me it's certainly within this Board's discretion to determine what a reasonable rate of return should be?

MS. MCSHANE: I'm not a lawyer, so don't take this as a legal opinion. But yes, regulators have discretion and court cases have definitely found that regulators have discretion. But at the same time there is a whole history of regulatory decisions, court decisions, which establish the principles upon which a fair return should be determined.

We all know about the Hope case, the Bluefield case, Northwestern Utilities case in Canada. And those principles were set forth at page 3 of my testimony, which says that those standards shall provide for a utility the opportunity to earn a return on the value of its property commensurate with that of Competitive Risk Enterprises, maintain its financial integrity and attract capital on reasonable terms. So I think the Board's discretion is within the parameters of those standards.

Q.189 - Now Ms. McShane, you indicated that you received some information at the time you were retained. Did you receive the CIBC World Markets reports and recommendations?

MS. MCSHANE: No.

Q.190 - So you never had an opportunity to review in depth their analysis of the capital market that's being established or the capital structure that was being established for Disco?

MS. MCSHANE: No. But there is no reason that I would have required it. I was doing an independent analysis.

Q.191 - Thank you. Now in your testimony relating to -- in front of my friend, Mr. Gorman, you referred to some other provinces and what companies and with regard to rates of return in those provinces.

And my question is can you tell me with respect to government-owned utilities, in particular which government-owned utilities have been permitted to design their rate of return on a deemed capital structure.

MS. MCSHANE: Certainly the ones in Ontario. Certainly the distribution and transmission utilities in Quebec, of Quebec Hydro.

All of the capital structures that were set in the context of the Alberta generic cost of capital proceeding were deemed capital structures.

Q.192 - And that was regardless of their actual capital structure?

MS. MCSHANE: Yes.

Q.193 - Would you undertake to provide me a listing of these? And also would you indicate if there is any legislative provision in those jurisdictions that specifically provide for a rate of return that is based on direction in the legislation?

MR. MORRISON: Mr. Chairman, and it is just a question of work, those cases are all public record. And Mr. Hyslop is quite capable of locating them on his own. I don't think it is fair for this witness to have to go and do research and pull those out.

MR. HYSLOP: This witness has made in her statement of evidence that this is common in several jurisdictions. And we have cross examined her to give us the specifics of that statement.

CHAIRMAN: Frankly, a listing of the cases to which -- or sorry, the jurisdictions to which she is referring is perfectly in order in my opinion. As far as the statutes in those jurisdictions, I agree with you. And Mr. Hyslop is able to get that over the net no problem.

So witness, basically will you supply Mr. Hyslop in an undertaking with the listing of jurisdictions --

MS. MCSHANE: I certainly will.

CHAIRMAN: -- that you are referring to? Thank you.

Q.194 - And the utilities?

MS. MCSHANE: Sure.

Q.195 - Thank you.

MS. MCSHANE: I will do that.

Q.196 - And I will just follow -- I'm just kind of in between the statutory search. And if possible the date of the decision you are referring to that creates those, Ms. McShane?

MS. MCSHANE: Sorry. I missed the part about the statutory.

Q.197 - The statutory, the Board is making me do my own leg work on that. And I appreciate that. But I'm saying also the date of the decision that created the deemed capital structures in those jurisdictions.

MS. MCSHANE: I will do my best.

Q.198 - Thank you. Are you aware of any government-owned utilities where as a result of hearings a deemed capital structure was not permitted?

MS. MCSHANE: Sorry. Give me a second. I'm mentally running through provinces here.

I cannot think of any off the top of my head, no.
Q.199 - Okay. If you in the course of reflecting can think of one, would you undertake to let me know?
MS. MCSHANE: I will.
Q.200 - Thank you. Page 5 of your evidence which is found in exhibit A-55, appendix 1 --
MS. MCSHANE: Yes, I have that.
Q.201 - -- looking at paragraph 5, the second sentence, "An investment grade debt rating in the A category."
Does the phrase "in the A category" imply the range of A plus rating to an A minus rating?
MS. MCSHANE: Yes.
Q.202 - Thank you.
MR. HYSLOP: Mr. Chair, it might be a little early for the morning break. I would like to -- we have another line of questioning we are not sure we want to go down. And I want to get the best advice possible. So I would ask for a short adjournment.
CHAIRMAN: If it is going to save time I'm all in favor of it, Mr. Hyslop. And it may well. So we will take that chance.
MR. HYSLOP: You have got a 50/50 chance.
CHAIRMAN: That is right. We will take a break.
(Recess)

CHAIRMAN: I didn't mean you to disappear, Mr. Hyslop.

MR. HYSLOP: Mr. Chair, as much as I would enjoy a half-hour of give and take with Ms. MacFarlane this morning, I'm taking the good advice of my advisers and advising the Board I have no further cross examination.

CHAIRMAN: Congratulations to the advisers. Thank you, Mr. Hyslop.

Mr. MacNutt, I believe you are on next, are you not?

MR. MACNUTT: Thank you, Mr. Chairman. I will just move up now.

CHAIRMAN: Yes.

CROSS EXAMINATION BY MR. MACNUTT:

MR. MACNUTT: Yes. Good morning, Commissioners and witnesses, panel.

Q.203 - I would like to ask a few questions about reconciling certain deficit figures. And I would like you to turn to exhibit A-48 which is Deloitte audited financial statement for Disco for fiscal year-end March 31, '05.

And I would like you to go to page 3. And you will see on page 3 --

CHAIRMAN: Just a minute, Mr. MacNutt. We have got to catch up here. Okay. Go ahead, Mr. MacNutt.

Q.204 - And you will see on page 3 of exhibit A-48, the Deloitte audited financial statement, in the column --

CHAIRMAN: Mr. MacNutt, I'm sorry. We can't hear you up here. Pull that mic a little closer, if you would, sir.

MR. MACNUTT: I will just speak louder.

Q.205 - On page 3 in the column marked March 31, 2005, if you go down just before the total at the bottom of the page you will find a line "Deficit". And it is shown as $10.5 million.

Have you got that?

MS. MCSHANE: That's correct.

Q.206 - Okay. Now I would like you to go to exhibit A-54 which is response to Public Intervenor 58. That is March 31, '06. A-54, Response to Public Intervenor IR-58.

And I would like you to go to page 2 which is a table, which is entitled "NB Power Distribution and Customer Service Corporation, Return on Equity Calculation."

And if we will go to column 1 which is 2006/07 estimated, and we go to line 16 which has the statement "Opening Deficit 13.0 million."

Would you reconcile those two deficit figures for me?

MS. MACFARLANE: The opening deficit which is line 16 on IR-58 is the deficit that is projected at the time this was done to be the financial position of Disco at March 31st 2006.

What you are looking at in the document A-48 is the deficit that actually existed at March 31st 2005. So the difference between the two of them is the projection that we had at the time.

Now since that time, as you know, we have updated our forecast. And that opening deficit would be different

Q.207 - Yes. Would you tell us to what extent that you updated and what you covered in doing that update?

MS. MACFARLANE: Could I provide that for you after lunch? It will require, as you have indicated, pulling together the numbers into a table.

Q.208 - Yes. Now in the transcript from yesterday, February 14th 2006, there were several places where you referred to implied requirements. And I will just refer you to them. You can look them up, if you wish.

Page 3969 at line -- no, excuse me. I will start at the top. Page 3958 at line 16 Mr. Lawson asked you if there was any legal requirement to actually have any amount as deemed equity. And you responded at line 22, and I quote "Under the Electricity Act there is an implied requirement to pay dividends." And you went on.

And at page 3969 at line 22 Mr. Lawson asked you if there was any legislative provision that you were aware of that requires there to be net income generated by Disco? And you responded on page 3970 at line 4, quote "It's implied in the Act that taxes and dividends are to be paid."

And finally at page 3993 at line 6 Mr. Gorman mentioned that in your earlier evidence that you talked a lot about what was implied in the legislation. You provided an extensive answer beginning at page 3993 at line 12.

My question is would you please tell me the specific sections of the Electricity Act on which you rely to say that there is an implied obligation on Disco to pay dividends and to have a deemed equity in the first year of existence and for fiscal year 2006/2007?

MS. MACFARLANE: I'm going to break your question into two parts, if I may. The first is --

Q.209 - By all means.

MS. MACFARLANE: -- is the section -- the sections of the Act that I would have relied on to understand that Disco is to have equity and to pay dividends and taxes.

And I would have relied on three things. One is, thanks to Mr. Gorman, the definition of revenue requirement which speaks to a revenue requirement including a return on equity.

The second is Section 33 of the Act which describes Section 33(2) in particular, which describes the purposes of Electric Finance Corporation and the fact that they are to facilitate the conversion of the NB Power debt to appropriate levels of debt in the subsidiaries and then to assume and reduce the remaining portion of the corporation's debt.

And the third section I would have relied on is Section 37 which requires payments in lieu of taxes, and under Section 37(3) and (4) allows for the LGIC to call for payments, which is the area that they are using to call for dividends. Those are the sections of the legislation I would have been relying on.

The second part of your question -- could I ask you to repeat that?

Q.210 - And to have a deemed equity in its first year of existence and then for fiscal year 2006/2007?

MS. MACFARLANE: I don't believe that I said there was a legislative requirement suggesting that the corporation had to have deemed equity.

The basis on which we are proposing that there be a net income, which is determined to be reasonable, in line with what a company with a deemed or a real capital structure would have in a commercial sense is coming from two things.

One, the Minister's Statements deriving from the

Energy Policy and delivered in the House at the time that the Energy Policy or the energy -- pardon me, the Electricity Act was introduced.

And secondly we are basing it on the restructuring plan that the Province put together to allow for this over time facilitation of the conversion of NB Power's debt into appropriate levels of debt in the subsidiary companies. And that restructuring plan called for Disco by year 2 or 3 of its existence to have those commercial levels of earnings so that it could then move toward obtaining a credit rating and approaching the debt capital markets without benefit of a guarantee.

Q.211 - Now I'm going to ask you to turn -- Ms. McShane, I would like you to turn to your report, and it's found at exhibit A-55 in Appendix 1. Now on page 8 of your report in the second paragraph, and I will quote, you state, "With respect to the regulatory framework Disco's risk are largely a function of the restructured operating environment which is characterized by a functional separation of the generation, transmission and distribution retail operations." Is that correct?

MS. MCSHANE: Yes, that's what the statement says.

Q.212 - Thank you. And then you go on to say, "The functional separation of those key activities means that the natural hedges that exist in an integrated utility are not available to each function on a stand-alone basis." In other words, you consider that Disco's business risks have been increased?

MS. MCSHANE: I'm not sure I say that they have increased. What I was trying to say is that if you look at an integrated utility that operates fully as an integrated utility, that it will have a certain risk profile in total where you wouldn't actually look separately at the risks of Disco, Genco and Transmission.

Once you break the pieces apart and start looking at the risks of each component on a stand-alone basis, some of the functions are going to be more or less risky than the others. So what I'm saying is that Distribution as a stand-alone entity has higher risk as a result of its obligation to purchase -- or its obligation to purchase electricity with underlying capacity payments that entail transfer of operating leverage to the distribution utility.

Q.213 - If a natural hedge is removed, that must increase the risk?

MS. MCSHANE: It means that the risk of Disco is higher on a stand-alone basis than the integrated utility is.

Q.214 - Now are you aware that the Board of Directors and top management personnel are identical for each of these operating units?

MS. MCSHANE: Sorry, am I aware that, please?

Q.215 - Are you aware that the Board of Directors and senior management of each of these operating corporations are identical?

MS. MCSHANE: I was aware that some of the senior officials are identical as among the companies.

Q.216 - In other words, the directing mind of each of the corporations is the same? The same group of people?

MS. MCSHANE: Directing mind?

Q.217 - Well I'm just using a phrase. Okay. You have agreed that you were aware when you made the statements we just quoted that the senior executives and Board of Directors was the same for each of the five corporations?

MS. MCSHANE: I'm not sure that I was aware of it but I'm not sure it's relevant.

Q.218 - Now does this organizational structure mitigate the business risks created by the restructure?

MS. MCSHANE: I'm not -- I don't think that has anything to do with how the relative risks are analyzed. I mean it has to do with the fundamental operations of the different parts and the way the parts interact in the framework that has been established rather than whether the executives are the same.

If I could just give you an example. I come back to the Alberta situation as the most analogous. When Alberta was restructured, basically it was a similar situation where you had different functions. And each function's business risk were assessed and a capital structure and return was assigned to them based on the restructured environment. So that at the end of the day the total utility, including Genco, Disco and Transmission, had a capital structure and return that was a function of the utility. Still operating as a single utility for the purposes of going to the capital markets, but each function had separate business risks and separate capital structures.

The situation here is a bit different as I said yesterday, in that that there will be three different companies that actually will be going to the capital markets.

Q.219 - Yes. Now I want you to turn to page 8 of your --

MR. MAROIS: Mr. MacNutt, before you move on, just a little point of clarification. When you mention that there are common executives, I mean I just want to make sure that it's clear on the record that each operating committee has one executive assigned to manage that operating committee. So in the case of Disco, I'm the executive that's assigned to manage that operating committee, and I don't represent any other operating committee -- other operating company.

Q.220 - Okay. You are saying there is a senior executive specific to each of the corporations?

MR. MAROIS: Operating committee, yes.

Q.221 - Okay. Now, Ms. McShane, I would like you to turn to page 8 of your report, third paragraph.

MS. MCSHANE: Yes, I have that.

Q.222 - Utilities generally are characteristic -- and I'm going to quote -- utilities generally are characteristic by a high degree of operating leverage, a high degree of fixed costs, as a result of the capital intensity of the industry the fixed costs -- I'm sorry -- stop there. Would you please describe to the Board the nature of the fixed costs that devolve from a high capital industry?

MS. MCSHANE: What is the nature of the fixed costs?

Q.223 - Yes.

MS. MCSHANE: The nature of the fixed costs are the assets that are used to supply service primarily. But even costs such as labour costs are not variable in the sense that fuel costs are. So they have a certain amount of fixedness as well.

Q.224 - Are interests costs and depreciation included in your concept of costs that devolve?

MS. MCSHANE: Yes, because the recovery of the investment in assets is done through depreciation, interest expense and return on equity.

Q.225 - Now would you please tell the Board why these costs result in a high degree of operating leverage?

MS. MCSHANE: Because they are costs that are unavoidable in contrast to variable costs, which if you don't have any sales you don't incur any costs. The fixed costs have to be covered despite the amount of deliveries or sales that you make.

Q.226 - Now I would like you to turn to page 8 of your report in the fourth paragraph, and where you say, "Further, Disco has a small asset base." Does this mean that you consider Disco not to be capital intensive?

MS. MCSHANE: No. It means that it is capital intensive to start with. A high percentage of its costs are fixed costs. In addition to its own fixed costs it has the fixed capacity payments of the PPAs that it must recover through rates. And those rates are to a great extent consumption based.

Q.227 - So what you are referring to is a small asset base relative to book value?

MS. MCSHANE: No. What I mean is it has a small asset base relative to the total expenses that it must recover.

Q.228 - And finally a question for Ms. MacFarlane. In the transcript on February 14th at page 3962 at line 6, you state and I will quote --

MS. MACFARLANE: 3962?

Q.229 - Correct. Line 6. You stated that, quote "There is a regulatory process to ask for a deemed capital structure. And we haven't done that."

Now would you please explain exactly what it is that Disco is asking for with respect to capital structure and return on equity in this application?

MS. MACFARLANE: Throughout the portion of my testimony that is under the tab called Testimony of Lori Clark, tab 4, we have spoken or I have spoken about a deliberate and controlled approach which is part of the guideline laid out by the Province for restructuring and moving toward a competitive market. Moreover moving toward Disco approaching the debt capital markets.

The restructured plan called first for getting rates to a level that could sustainably represent a commercial operating margin.

Beyond that we have a number of things that we have to do, one of which is to put in place risk mechanisms through applying to the regulator for those to reduce the volatility of our earnings.

That's not something that -- that volatility, that risk that comes from the magnitude of both the operating leverage Ms. McShane referred to and also the types of hydro risks and fuel risks that pass through the PPA, export credit risks that pass through the PPA cause great volatility in Disco's earnings even if the base level of earnings under normal circumstances were to be at a commercial level.

So we need to put in place risk mechanisms through applying to the regulator to allow for those -- for that volatility to be taken out of our earnings through deferral accounts.

We at that time would be able to do the type of -- before the credit rating agencies would be able to have the type of risk assessment done that would allow them to assign a credit rating to us.

And it is at that point that the Province would be considering doing a debt equity swap and that the corporation would come before this Board applying for a capital structure, deemed or actual, as the Board decides.

In the interim, consistent with the first part of the plan, which is to get rates to a level that can sustainably produce those commercial operating margins, what we are asking for at this time is the net income included in the revenue requirement that would set that base, that would start to set that base.

And in determining a reasonable net income to request, we have used two tests of reasonableness. One is what would the net income be if we had a deemed capital structure and a deemed rate of return?

And the second test is what interest coverage would result from that net income? And is that an interest coverage that is consistent with the policy objectives of the government? And is it an interest coverage that would be deemed reasonable relative to other stand-alone distribution utilities by this Board?

So we have not asked for a deemed capital structure at this time, largely because we don't believe we have the risk mechanisms in place to at all assess that.

Ms. McShane has spoken about the fact that the risk to Disco right now is inordinate in any environment.

And I think in UM IR-19 we speak to the volatility that typically Disco is exposed to right now under the PPAs through the hydro adjustment, the credit adjustment and the annual fuel price adjustment. It is not a tenable risk environment in terms of the volatility of earnings.

So there are some steps that we have to take in order to get to the debt capital markets. But one of them -- and the restructuring plan suggested, the first one, is to get our earnings to a commercial level.

Q.230 - Now you have described your approach to the capital structure. But you didn't answer the portion of the question related to what is your -- what are you asking for by way of return on equity?

MS. MACFARLANE: What we are asking for in the revenue requirement is a net income that if -- that can be seen as reasonable by a test of what would be the case if we had a deemed capital structure of 42 1/2 percent equity and 57 1/2 percent debt and a 10 percent return on equity, and if we had an interest coverage as outlined in the evidence.

MR. MACNUTT: No further questions, Mr. Chair.

CHAIRMAN: Thank you, Mr. MacNutt.

Before I call on my fellow Commissioners, Ms. MacFarlane, did I hear you in your response to Mr. MacNutt's second last question bemoaning the fact that the management of NB Power Corporation, as it was in the mid '90's, did away and collapsed those -- what I have referred to as rainy day accounts?

MS. MACFARLANE: I am supposing that there were reasons for that at the time that made that a reasonable decision. In the new environment where we very clearly have a distinct regulated entity and a mandate from the owner to shall we say get off the Provincial guarantee, which means that we have to have sustainable and predictable earnings for purposes of getting a credit rating, they would be very useful.

CHAIRMAN: So in effect you are considering the old export sales stabilization account and the hydro portion of the generation equalization account?

MS. MACFARLANE: Those two variables that pass through the PPA are the ones that create most risk.

CHAIRMAN: Any consideration being given to adding a nuclear after refurbishment?

MS. MACFARLANE: The way the PPA is currently struck there really is no nuclear risk to the Disco business unit. Because there is a price set. And if nuclear is down the risk is entirely to Nuclearco.

And Generation provides the energy that otherwise would have been provided by nuclear at the nuclear price. So there is really very little risk to Disco of nuclear not being able to supply.

CHAIRMAN: Well, if -- with great frankness, and this is simply my personal opinion, if the breakup of the companies had not occurred, it would be my humble opinion, and someday it may be tested, but that the old NB Power Corporation was in contravention of a Board order by collapsing those.

And therefore, if you were still the fully integrated legal utility, why you could go right back initiate those because the Board's order would still stand on them. However you are a new corporation. And that is not the case.

So I will call on my fellow Commissioners.

BY THE BOARD:

MR. NELSON: Just a quick question. On page 11 you listed the Ontario Municipality Electricity Distributors in your chart. Are any of those municipalities covering the -- guaranteeing the bonds for those companies?

MS. MCSHANE: There are still some, yes, that are issuing debt through the municipality. They may not be actually guaranteeing it. They may actually raise it on behalf of the distributors. The smaller ones, that would be the case. The larger ones, for example, the ones that are listed here, no, there is no guarantee anymore. They have gone out and they have issued debt on their own without a municipal guarantee.

MR. NELSON: So to the best of your knowledge there is some of them in there that would be covered by their owners, we will call it, guaranteed?

MS. MCSHANE: The smaller ones, yes, for sure.

MR. NELSON: Thank you.

DR. SOLLOWS: Yes. Ms. MacFarlane, I would like to start with the financial statement, A-48, that we looked at earlier. And I recall -- and it's my recollection that when we discussed the notion of your compliance with Section I think it's 37(1) of the Act, you indicated that there was a note in these financial statements that made it clear that you were not in compliance with the Act. Could you identify and read that note into the record, please?

MS. MACFARLANE: I would have to check the transcript, but what I intended to say was that we disclosed the method that we were using to undertake the calculation in the note to the financial statements. We did not disclose whether or not we were in compliance with the Act. We disclosed how we calculated it.

And I believe if you were to look at page 8 of the notes to the financial statements, this is the accounting policy note. There is a description there of the method that is used.

DR. SOLLOWS: Could you read that, please?

MS. MACFARLANE: Yes. "The corporation is required to make special payments in lieu of income taxes to NBEFC, which is earlier defined as New Brunswick Electric Finance Corporation. Total special payments in lieu of taxes consist of an income tax component based on accounting net income, which is what we reviewed, multiplied by a rate of 35.12 percent, a capital tax component based upon the large corporate tax rules contained in the federal and provincial Income Tax Acts."

And then it goes on to talk about recognition of future tax benefits of current losses when it is more likely than not that sufficient income will be generated in future periods to utilize losses previously incurred, no other provisions are made for future special payments in lieu of taxes as a result of any temporary differences as the tax basis of assets and liabilities and their carrying amounts for accounting purposes are considered to be the same for purposes of this calculation.

DR. SOLLOWS: Thank you. And so when I look at the first sentence, it says the corporation is required to make special payments in lieu of taxes to NB Electric Finance.

MS. MACFARLANE: Yes.

DR. SOLLOWS: And then it goes on to say they consist of. But my understanding of the record so far, and I would like you to correct me if I am wrong, is that what you describe those as consisting of is not what they are required to be.

MS. MACFARLANE: The first line -- well let's start with the second line, a capital cost component based on the large corporate tax rules contained in the federal and provincial Income Tax Acts is compliant with the Electricity Act.

The first bullet, an income tax component based on accounting net income is not strictly compliant with the Income Tax Act. And as I say, in the text following the two bullet points, there is a description of exactly how we manage those requirements.

DR. SOLLOWS: So I guess the bottom line, someone reading these audited financial statements would not really have been able to determine that you were not in compliance with your legislation?

MS. MACFARLANE: Not unless they went back to the legislation, that's correct.

DR. SOLLOWS: Thank you. Ms. MacFarlane, do you think that would be viewed as a risk indicator for someone evaluating debt issued by Disco, that someone was not in compliance with legislation?

MS. MACFARLANE: I'm sorry. I really don't know. I don't know whether the credit rating agencies would take into consideration that the decision was made with the shareholder or not.

DR. SOLLOWS: Okay. Ms. McShane?

MS. MCSHANE: I don't know either. It seems to me that the credit rating agencies would look at what cash flows are being produced from the way taxes are calculated. I mean, when they look at how the company is calculating its income tax really, although -- as Ms. MacFarlane says, it's not strictly compliant, I mean what the differences are are simply timing differences. And if you compared, for example, the way the income tax is calculated per the financial statements as compared to how it is recovered let's say through rates in the U.S., where all of the tax allowance in rates is essentially based on tax computed on accounting income. So that you have got taxes payable, current taxes.

DR. SOLLOWS: You are talking about Canada now or the United States?

MS. MCSHANE: No. I'm talking about the United States.

DR. SOLLOWS: Could we speak about Canada, please?

MS. MCSHANE: Sure. There have certainly been situations in Canada where utilities have been regulated on the basis of normalized taxes. So it would -- I'm not sure that the credit rating agencies would view this as being a terribly important risk factor.

DR. SOLLOWS: Okay. Thank you. I would like to now, Ms. McShane, go to your report. And I note on page 2 you start by saying that to evaluate the reasonableness of Disco's approach I started with a review of Energy Policy in New Brunswick including the Electricity Act. What other documents did you review?

MS. MCSHANE: I reviewed the Act. I reviewed the White Paper. I had reviewed the prior documents that had preceded the White Paper and to be honest I don't remember the name of each of them. There were several papers. There was the 1998 -- actually these are they. It was the Report of the Select Committee on energy's electricity restructuring, that was done in '99. There was a report called Electricity in New Brunswick Beyond 2000 which was published in 1998. And I had also seen the Hay-Savoie report which was dated July 1998. And I have the two statements of the minister that I referred to previously, the Minister's Statement on the Future of NB Power, which was delivered May 30th, 2002, as well as the Minister's Statement introducing the Electricity Act dated January 21st, 2003.

DR. SOLLOWS: Okay. So do you -- you didn't review the financial performance of the utility that led to and sort

of created the context for those policy documents?
MS. MCSHANE: I'm aware of the financial performance of the utility. I did not review in detail the financial -- the historic financial statements.
DR. SOLLOWS: Did you go back and look at the various documents that were prepared, the Premier's Round Table on Energy and the Economy and -- what I'm getting at is generally people doing policy review will consider it very important to put the documents in their correct historical context. And I just want to make sure that you appreciate the history that led to the creation of these documents.
MS. MCSHANE: Well I think I'm aware sufficiently of the background to have an understanding of what the driving forces behind the restructuring were. I mean I'm aware of the historic financial performance of the utility.
DR. SOLLOWS: And you feel that was one of the driving forces for it?
MS. MCSHANE: Yes. It clearly was in the Minister's words -- a driving force was to -- in restructuring NB Power was to mitigate the financial risk to both ratepayers and tax payers, which arose from the fact that the level of debt held by the corporation had risen to a level where the corporation was a hundred percent debt.
DR. SOLLOWS: Right. But yet I hear you saying that Disco

is exposed to a lot of risk because of its requirement to buy capacity from Genco.

And we have heard earlier from Mr. Marois that Disco doesn't prepare any cost benefit analysis in determining the amount of capacity that it nominates under the PPA. So I'm wondering how these -- how in your view this document, and this has -- what we are facing with here really meets the test and the objectives that were established and that led to the White policy and the various statements that you are referring to and basing your evidence on.

MS. MCSHANE: I'm sorry. That was a very long question.

DR. SOLLOWS: I'm sorry. I'm notorious for it.

MS. MCSHANE: So I have lost the thrust of what the question was.

MR. MAROIS: If I may, I know the question was not posed to me, but I feel like putting your question into context. When you say that Disco is exposed to risk because of the capacity payment it's making to Genco, the reason it's making capacity payment to Genco is because Disco under the Act must play the role of standard service provider. So that's the big difference between when some other companies that Ms. McShane is alluding to in her evidence is that some companies only play the role of wire. They only move power. They don't buy it. They don't sell it. Whereas the Act gives us a mandate to provide power. So to provide power we have to buy power and to buy power we have to commit to certain fixed costs and that creates a risk for us. So again to your point about putting these comments in the proper context, the Act clearly states the role that Disco must play.

DR. SOLLOWS: I appreciate that. What I was really getting to is the notion of -- and I know, Ms. McShane, you have mentioned it several times, the risks that Disco bears as it flows through the PPAs. And you said several times that the requirement to purchase capacity shifts the risk from the generator to Disco, as I took it.

MS. MCSHANE: Correct. But what I probably should add to that, that when I evaluate the risks of a utility, I look at the framework but I don't try to determine how much the return or the capital structure should be different because of these specific choices that management might make.

My assumption is whenever I make a recommendation as to capital structure and return, that within the framework that has been established that management's choices have been rational and efficient.

DR. SOLLOWS: All right. On that basis I would like to go later in your report -- I think I have marked them earlier. I will get to it here. Yes. On page 17 you quote from a number of different sources. At the bottom of page 17. You quote from a DBRS Report, which as I understand is Dominion Bond Rating Service.

MS. MCSHANE: Correct.

DR. SOLLOWS: And you say -- you are quoting them as saying that while -- this is in reference to Atco Limited -- "while Atco's diversified operations coupled with the company's prudent management approach, provide a level of earning stability additional challenges carry on." So it would appear from that quote that the bond rating agencies very much consider the prudency of the management when they make a decision, is that correct?

MS. MCSHANE: Yes.

DR. SOLLOWS: As distinct from the approach that you take. You just assume that they are prudent?

MS. MCSHANE: Well it seems to me that it would be inappropriate to base an equity return on the inefficiency of management. So the assumption has to be from the outset that management is operating prudently and efficiently.

DR. SOLLOWS: Then if in the view of this Board on consideration of all of the evidence we felt that management was not operating prudently and efficiently, how would that affect any decision to award a net income?

MS. MCSHANE: In my view, it shouldn't impact the level of net income that's awarded. If the Board believes that management is -- in other areas than capital structure return is making choices that it believes are inappropriate it makes the decisions in those areas. It doesn't penalize the company through a reduction in the return, because that basically becomes to my mind -- contradicts the whole objective of getting the utility to a position where it will be able to go to the capital markets on its own behalf.

DR. SOLLOWS: But I thought the whole foundation of performance based ratemaking was to reward the company for good management performance and good performance and penalize it for poor performance. But you are saying they should not be penalized?

MS. MCSHANE: I don't disagree with the fact that performance based regulation is intended to do that. But most performance based regulation approaches that I'm aware of don't start by setting a level of return that reflects a penalty. They establish sort of a base level of rates and then establish around that different specific standards that a utility has to meet and if -- perhaps if they don't meet those standards then there is a penalty, or if they exceed those standards then there is an incentive payment. But typically you don't start at the point where you award a return in base rates that is less than the cost of equity.

DR. SOLLOWS: So how do we establish that base? What is the process that you are aware of in terms of developing an incentive based regulation. How would we establish that base given that this is the first time in 13 years we have seen the utility coming for a rate case and they are on the record as planning on not coming back if they can avoid it?

MS. MACFARLANE: I'm sorry. I don't think we are on the record as saying we are not coming back if we can avoid it.

DR. SOLLOWS: You said the plan was -- as I understood your words, the plan was to not come back for seven to ten years.

MS. MACFARLANE: What I said was that the guidelines that the financial advisors of the Province were using was to put in place a structure that could allow for a gradual movement towards commercialization of all of the companies within the context of the existing legislation that permits three percent rates without returning to the regulator. That was the plan of the Province of New Brunswick.

I went on to say that there are many things that may cause us to come before the Board for a rate application. We are here today because fuel markets are very much different today than what was anticipated by those financial advisors when they put that long-term model together.

It is not our intent to avoid this Board. We work within a framework of the legislation and if the legislation does not require that we -- because our revenue requirement doesn't require more than three percent, then we do not incur the costs of a rate hearing. There is absolutely no intent on behalf of NB Power to avoid the regulator.

DR. SOLLOWS: Do you mind -- somewhere in the evidence -- I know we had it in the CARD hearing -- you had the business plan. Could you find that and refer to it for me? I can't quite recall the number on it. It would probably be in the A-50s or A-40s.

MS. MACFARLANE: The 2005/2006 to 2007/2008 Business Plan was filed as exhibit A-7.

DR. SOLLOWS: A-7. I don't seem to have it. Here we are.

We are all set. This is A-7 and I refer you to page 9, the rate strategy. And as I understand it -- yes, this is 2005/6 to 2007/8. The first paragraph of that rate strategy says the planned average annual increase is 7.5 percent subject to Board approval. The forecast for the next two years of the Disco plan 2005 is 3 percent in 2006/7 and 3 percent in 2007/8. Now if I understand the legislative constraints, that would mean that you were not planning on appearing before this Board in 2006/2007 or 2007/2008.

And I guess my concern is that as I understand the need very much as Ms. McShane has said to establish a reasonable basis on a go forward basis for managing a company like yours, I'm finding it difficult to understand how we can possibly do that if you only come infrequently.

MS. MACFARLANE: Let me start by saying that what I was taking objection to is your statement that NB Power is actively trying to avoid the Board. When rates are determined for budgeting purposes or revenue requirements are determined for budgeting purposes, it starts with costs. And we do our level best to not only forecast our costs with some degree of accuracy, which is difficult to do given the circumstances in our cost structure, but also with efficient management to keep the costs as low as possible.

If the costs do not drive the revenue requirement over 3 percent, the legislation says there is no need to subject that to the regulator. We don't start with the premise let's set rates below 3 percent so we don't have to go to the regulator. That is not the starting point. The starting point is to forecast our costs and to manage those forecasted costs as effectively as we can and then determine what our revenue requirement is.

Once we determine that if it calls for rate increases of greater than 3 percent, yes, we go to the Board. In Disco plan 2005, this reflected the forecasts of the day and it suggested that with one application to the Board in 05/06 that our rates would get to a level that with two further 3 percent rate increases we would be where the restructuring plan called for us to be.

Since that time a number of things have come into play and our costs as forecasted then are very different than they are forecasted to be now because of the fuel markets. So it has changed the revenue requirement and because that change is calling for something greater than 3 percent, we are here before the Board.

It may well happen in the future. I have no confidence in fuel markets coming down. But we do not plan to not come before the Board. We follow the legislation.

DR. SOLLOWS: Thank you. I guess the -- buried in the middle of that was the, with good management, and I guess in terms of the record of this company as an integrated company, was we heard earlier, there is not much indication of that. You took the 3 percent per year or so all through the '90s and early part of this decade and lost -- I think the number was close to $300,000,000. So I'm not sure where good management fits into that and why a well managed utility would not have availed itself of the right under the legislation to come to the Board to increase its return.

MR. MAROIS: Mr. Sollows, we can't unfortunately change the past. We can only influence the future. And I think we mustn't lose track that we are here for one fiscal year. We are asking for a raise for 06/07. So I think if we keep that in our focus, it might make this rate case a bit more simpler.

DR. SOLLOWS: That is true, but I can't help but comment at this point and I will leave it after that. Those who --

MR. MAROIS: Me neither I guess.

DR. SOLLOWS: Those who forget their history are deemed to repeat it. But I will move on.

A point that was raised again on page 18 in reference to a Standard & Poor's report referencing tariffs on gas, it starts with a statement saying, quote "The regulation however is considered weak in comparison with international peers."

The context is not here. But I'm wondering if you can provide us with the context of what do they mean by the regulation is considered weak?

MS. MCSHANE: I will. I have to go look that up. It doesn't look right when I read the quote. Because as a matter of fact, the regulation in B.C. is considered to be quite good in comparison to other jurisdictions in the country. So I think there may be a misquote here.

DR. SOLLOWS: Could you clarify that please?

MS. MCSHANE: Yes.

DR. SOLLOWS: Thank you. Now further on on page 19 you quote someone called Maureen Howe working for RBC Capital Markets and something she published called "It's the Grid, Silly."

And it says towards the end "To encourage new transmission investments FERC has proposed additional incentives that would boost allowed return on equities for transmission investments."

Can you explain how that is relevant to this proceeding?

MS. MCSHANE: The point was simply that I was trying to, with these various quotes, when I was looking at the 10 percent return that had been proposed, I started with the proposition that one of the ways of looking at it was to benchmark it against low-risk utilities in Canada and what they were allowed.

The second step was then to say well, how does investment -- how does the investment community view that level of allowed return, the 9 percents that we were talking about? So I looked at what participants in the debt market were saying by virtue of debt rating reports. And the tariffs on gas was one of those. And then I was looking at what participants in the equity markets were saying relative to allowed returns in Canada in general.

So this specific comment on the FERC incentives has nothing specific to do with this case. It was offered up more as a general commentary on the relative level of returns allowed in the electricity market or in the electricity industry in this country relative to the United States.

DR. SOLLOWS: Thank you. That is fine.

MR. NELSON: While Dr. Sollows is collecting his thoughts, Ms. McShane, did you at any point in time review and make any recommendations as to the PPAs between Disco and Genco?

MS. MCSHANE: I did not.

MR. NELSON: So you don't know what liabilities lie in there?

MS. MCSHANE: I'm not familiar with the PPAs.

MR. NELSON: At all?

MS. MCSHANE: no.

MR. NELSON: So therefore you do not know any liabilities pertaining to Disco and Genco that would lie with Disco?

MS. MCSHANE: I'm sorry. I'm aware of what Disco is obligated to pay. I did not review the PPAs in the context of determining reasonableness of any part of them.

MR. NELSON: So there is no in-depth or any recommendations or anything from yourself to --

MS. MCSHANE: On the PPAs?

MR. NELSON: Yes.

MS. MCSHANE: No.

MR. NELSON: Okay. Thank you.

MR. MORRISON: I would point out, Mr. Chairman and Deputy Chairman, that Ms. McShane is not an expert in that field, quite frankly, nor was she qualified in that area.

MR. NELSON: So that therefore you wouldn't look at the PPAs at all as to the risk factor for Disco? I guess that is what I'm going to.

MS. MCSHANE: Well, to the extent that --

MR. NELSON: That if you went out into the open market there would be these risks between the contracts between Disco and Genco. And investors would look at that?

MS. MCSHANE: Yes, they would.

MR. NELSON: So investors would look at those risks?

MS. MCSHANE: Yes. And they would look at how those risks were reflected in the regulatory framework of the distribution utility.

So when I say they would look at the risk, what I mean by that generally is if -- let's say at the most extreme distribution has no obligation at all to purchase electricity. So that would be the least risk situation. That would put them on a similar basis to a pure wires company.

In the current situation they have obligations which have certain risks that they will pay more or less than what's in the base rates. That, from the debt markets perspective, will be what they will view as the biggest risk. Because it will determine whether or not Disco will be able to cover its interest obligations as a stand-alone utility.

What Ms. MacFarlane was saying earlier was that because of those risks of earnings volatility flowing from the PPAs, then one of the steps that the utility -- that Disco must take is to determine what type of risk mitigation accounts that they want to or they believe are appropriate to establish, as Mr. Nicholson and Ms. MacFarlane were discussing.

DR. SOLLOWS: Thank you, Commissioner Nelson.

I think two more areas that I want to touch on. And one for you, Ms. McShane. In your review of the Act and the legislation, did you find any provision for the Lieutenant Governor in Council to rewrite the power purchase agreements?

MS. MCSHANE: It's not something that I recall seeing.

DR. SOLLOWS: Perhaps anyone else know if there is a provision in the Act that would allow the Lieutenant Governor in Council or essentially the shareholder to, for a limited period, modify the power purchase agreements or other matters arising to this?

MS. MACFARLANE: The contracts themselves provide for Electric Finance Corporation to modify the PPAs.

DR. SOLLOWS: Okay. And there is no provision in the Act? Or there is? I'm asking. I seem to recall seeing something there. But I can't put my finger on it at this point.

MS. MACFARLANE: I don't recall anything in the Act.

DR. SOLLOWS: But we can check?

MS. MACFARLANE: Yes.

DR. SOLLOWS: Okay. But in any case, the PPAs allow the Electric Finance Corporation to modify them. So presumably since the shareholder controls Electric Finance we could adjust these contracts to mitigate the risk to Disco if we found it appropriate?

MS. MACFARLANE: EFC could change the PPAs, yes.

DR. SOLLOWS: Okay. Thank you. The other point that I want to deal with here is -- I think, Ms. MacFarlane, you said yesterday and you referred us to exhibits -- the words you used were "The export margins were extraordinarily high in this year."

And that is part of why you have gone from a deficit forecast to a slight surplus forecast, if I understand?

MS. MACFARLANE: That's correct.

DR. SOLLOWS: Now can you explain to us exactly what you mean by an export margin?

MS. MACFARLANE: It is the sales price, the market price that we take out of New England. And as Mr. Marois said earlier, we are price-takers, it is an active market, less the cost of providing the energy, being fuel. There are some incremental operating costs and transmission.

DR. SOLLOWS: Okay. So have you calculated how much this export margin has been increased by the designation of natural gas-fueled power plants as must run facilities in this province and thus freeing up lower cost production for export?

MS. MACFARLANE: I have not done that calculation myself.

DR. SOLLOWS: Could you please?

MR. MAROIS: I think that has been done as part of a response to an IR. I can dig it up.

DR. SOLLOWS: Oh, it if you could dig it out that would be fine. Just so that we know.

Vice-Chair Nelson informs me that this might be already subject to an interrogatory that you have -- it is an outstanding undertaking, is that --

MR. MAROIS: The one I was referring to was a previous question that we answered awhile ago.

DR. SOLLOWS: Okay. I just want to be sure that on the record -- you know, you have attributed to high water flows. But historically when I read your Annual Reports, high or low water flows -- almost all of the hydro energy was dispatched into the province.

And now it seems to be available because natural gas-fired utilities have been designated must run within the province, and --

MR. MAROIS: We haven't -- I don't think we have attributed the exceptional results on the export market to high water levels. I mean --

MS. MACFARLANE: We have. But we have left out those interim words. The fact that there is high hydro is saying that thermal energy that would otherwise have to be dispatched in-province is available in the export markets. So the high hydro is not being exported. It's in-province use. But the fact that it's in-province means that we can export off Belledune and Dalhousie which are lower cost units than what we normally sell off of which is Coleson Cove.

DR. SOLLOWS: But the difficulty I'm having with that is when I review the documents provided by the National Energy Board, it very clearly shows that hydro is being exported from this province.

MS. MACFARLANE: There is a small amount of hydro being exported.

DR. SOLLOWS: Right. And significantly more actually than historically, as I have read it. And I'm quite familiar with the historical data in this regard.

And so that is why I'm somewhat concerned about this notion of designating high-cost fossil fuel plants as must run within the province and then freeing up lower cost production plants to participate in the export markets, and essentially thus subsidize Genco at the expense of Disco's customers.

That is I guess my concern. And that is why I'm looking for that information on the record.

MR. MAROIS: I guess, Mr. Sollows, we might be getting into the next panel. But when you talk about designate natural gas generators as must run, third party or NUGS, nonutility generators are quite different than utility generators. Because as you know, the utility generators, the fixed costs get recovered through different means. And it's only the fuel costs that ends up being in the dispatching.

While we have a NUG -- I mean, the price we pay to a NUG includes both fuel and their operating costs. So that will impact how you dispatch these third party contracts. So they have to recover their cost, I mean. And we will see more and more of that as we go.

I mean, the more we go to third party generators, these will have to be considered must run. Because that's the only way these projects will get financed.

So it's a reality. It's not -- the way you portray it it almost seems like it's discretionary. It's a fact of life that when you have a third party generator you must pay them. If they run you must pay them. Otherwise they will never get financing, so --

DR. SOLLOWS: I guess that is what I'm finding confusing. Because my understanding of the New England market is that there are -- the dispatch is done in economic order. There are system constraints. There are a whole variety of constraints.

But again it seems -- and we are going to deal with this, as you suggest, at a later date. It is somewhat perplexing to me that in an environment where we are trying to create a market, we have put all the generation in one company. And then that subject to a vesting agreement through Disco, so that Disco picks up all of the costs.

But as you say, if we are going to deal with this at a later date then that will be fine.

MR. MAROIS: Well, I must again comment on your comment. First of all the third party NUGs were assigned to Genco as part of restructuring. So we didn't have anything to do with it. And again we play by the rules.

Second is you have got a lot of merchant plants which is different than the NUGs we have here. And a lot of merchant plants had the key in the door because they weren't able to sell. So we just have to be careful to compare apples with apples.

DR. SOLLOWS: I agree. I think that is it. Thank you, Chairman. Thank you, panel.

CHAIRMAN: Thanks, Commissioner.

Just a couple of questions and pretty general. Ms. McShane, I will not get into a discussion with you or counsel concerning what is government policy and what is not. So I will phrase my question in this fashion.

The documents that you have indicated to us that you have read, do they in fact show that this whole move that has occurred since let's say 2000 in reference to NB Power Corporation was two-pronged, the first of which was to, if I might say so, transform NB Power Corporation into a look-alike to a commercially viable utility with a return and actually having equity and making a profit. And the second part would be to establish a competitive marketplace in New Brunswick.

MS. MCSHANE: I would agree with that.

CHAIRMAN: Okay. The first one need not -- the restructuring need not have occurred in order to put NB Power's house in order financially, as I guess I will just term it. In other words, as a fully integrated utility, the same financial returns could be achieved.

And by the way the last time I looked when it was a fully integrated utility, the debt ratio was about 113 percent or thereabouts. And I think it was still losing at that time too. But we will not go there.

But my point is the restructuring did not have to occur in order to put its financial house in order and to build equity and therefore make a profit.

MS. MCSHANE: If you mean by the restructuring did it have to be split into --

CHAIRMAN: Yes.

MS. MCSHANE: -- the different parts? No.

CHAIRMAN: No? Okay. Now just for the whole panel, and particularly I guess Mr. Marois and Ms. MacFarlane, Commissioner Sollows referred to the Disco A-7, Disco's five-year plan starting in 2005.

And I have been hearing testimony from you on this panel in other times about how the government financial advisers indicated that you could gradually build returns for the companies and then start declaring dividends and do all of these good things.

On a go-forward basis -- I mean, you have just indicated in A-7 Disco's plan, as is the case with the best laid plans of mice and men, went awry. And therefore you have to adapt as you go forth.

But is there an overall plan now for the NB Power group of companies as to how long it will take to pay off the existing debt? I know there is -- somebody called it the heritage debt is around 300,000,000.

But there is also the existing bond issues that have been transferred to the various companies, and when for instance and how much Genco's rates to Disco are going to be increased. So that the regulator, that is this Board and the people of New Brunswick, would get some idea of exactly what the plan is going forward for the next five or six years.

Is there such a thing in existence?

MS. MACFARLANE: Every year NB Power updates its business plan for the coming three-year period. So what you see there is plan '05. And as I have indicated, circumstances changed significantly as we were developing plan '06.

The utility has put together a plan as a requirement under the shareholders' agreement for each of the companies.

And it very much raises that challenge, is because of increasing fuel prices the plan as cast is difficult to implement.

And there are options that are being pursued that may include continuing on the same plan and recognizing that this is a world phenomenon. And New Brunswick is part of the world.

There are other options that beg the question should there be a different long-term plan. And that is why we have not been able to submit to this Board our plan 2006 as was called for once it was approved by government, because it hasn't been. Those discussions are very much under way. I think I had mentioned earlier that one of the burning platforms in our long-term plan is the financial position of Nuclearco during the outage. It only gets paid when it's running. It's not running for 18 months. And what is the plan to deal with that from a financial positioning?

The cash reality will happen one way or another. The impact to the ratepayer will happen one way or another. But from a balance sheet perspective it's a very real issue. There are a number of real issues about the financial plan that are very much in discussion.

CHAIRMAN: If you were a betting person, when would you bet that that plan would be available to the group of companies and I would hope to the regulator?

MS. MACFARLANE: I'm -- the plan contained the 2006/2007 budget. And that piece has been approved. And we are moving forward under that budget.

I am guessing, based on the type of discussion that is required and the type of development that is required between the NB Power group of companies, its board and its shareholders, that what we will see is that those developments will be reflected in plan 2007.

And that plan 2006 will likely not represent a finalized plan, rather more of a position paper, that because it represents advice to Ministers, will not be a public document.

CHAIRMAN: Thank you. Mr. Morrison, any redirect?

MR. MORRISON: No redirect, Mr. Chairman.

CHAIRMAN: Okay. Thank you. Well, this panel will be excused. But of course two of the three will be back sort of on a semi-permanent basis, I think.

But Ms. McShane, thank you for your testimony and your frankness.

MS. MCSHANE: Thank you very much.

CHAIRMAN: And have a safe trip home.

MS. MCSHANE: Thank you.

CHAIRMAN: We will break for lunch and be back at quarter after 1:00.

(Recess - 12:00 p.m. - 1:15 p.m.)

CHAIRMAN: I thought we were going to have some preliminary matters this afternoon. I don't know where I got that idea.

MR. MORRISON: I believe we are, Mr. Chairman. I'm afraid that we might lose Mr. Marois. He has got about an inch clearance before tumbling over those steps, so --

CHAIRMAN: I will say nothing more. Absolutely nothing. Any preliminary matters, Mr. Morrison?

MR. MORRISON: Yes, Mr. Chairman. And while we are speaking of the risk of physical harm, there is an issue that I'm going to bring out -- maybe I should duck but I'm going to bring it up in any event.

It's my understanding with some discussions with Mr. Hyslop that as we get through this panel, and it will likely not be this afternoon but probably tomorrow morning, he will be putting questions to the panel from passages from Mr. Strunk's report which are the same passages that we have submitted objections to.

And I guess the issue becomes whether the Board ought to allow those questions from those what I'm going to call questionable passages to be put to the witnesses.

CHAIRMAN: Could I suggest something, and that is Mr. Hyslop and yourself share with us the passages that he wishes to put to the witnesses and we will then take a look at the report and those passages so that we are able -- I hate making rulings in the dark, if you pardon the pun, but --

MR. MORRISON: That seems like a sensible approach, Mr. Chairman. Actually I thought you were going to suggest that Mr. Hyslop and I step outside and settle the matter, but --

CHAIRMAN: No, I won't go there either. No. If you could do that, gentlemen, that would be very helpful.

MR. MORRISON: That sounds sensible to me, Mr. Chairman.

CHAIRMAN: Okay. Do you want to swear --

MR. HYSLOP: Excuse me, Mr. Chair --

CHAIRMAN: Yes, Mr. Hyslop.

MR. HYSLOP: I --

CHAIRMAN: You want to step outside, is that it?

MR. HYSLOP: I'm not sure whether it's with you or Mr. Morrison.

CHAIRMAN: Well it will be Morrison, not me. Go ahead, sir.

MR. HYSLOP: Thank you, Mr. Chair. If I understand what was just decided, I would provide the various sections that I'm going to put to the witness and then we would get a ruling as to whether those questions could be put.

In fairness to me, you know, I don't want to give him the questions too far ahead of time. I would rather see how the Board -- the panel responds to my cross examination at the time that it's presented to them. And with respect to your ruling, if I have to make these passages available, it does allow a certain amount of time for the panel to consider and deliberate and frame their answer, which may or may not be entirely fair to my cross examination.

CHAIRMAN: I want to be fair to your cross examination, Mr. Hyslop. I guess that --

MR. MORRISON: Mr. Chairman, it's an implied undertaking in an event, but I would certainly go on the record with an undertaking that anything that Mr. Hyslop discusses with me I would not discuss with the witnesses.

CHAIRMAN: Okay. That's good enough for me, Mr. Hyslop. Is it good enough for you?

MR. HYSLOP: Nor make any of the passages that I provide to the Board and to Mr. Morrison available to the witness?

MR. MORRISON: I would undertake that they will stay in my possession only. And actually I may not even keep them. I just would like to have an idea where the issues are and see whether we may be able to come to some agreement on it.

CHAIRMAN: Well that's part of it, and the other part of it is then you can be thinking about what you are going to say about which one. Okay. If you could provide those to us, Mr. Hyslop, let's say at the break or after we rise this afternoon, just so that we can -- the Board can take a look at it.

MR. HYSLOP: Very well. I do have one other preliminary matter, Mr. Chairman, which I have spoken to all counsel I believe and there is agreement. Mr. Strunk, when we moved him out from tomorrow to next Monday, that created a problem in as much as he is in Buenos Aires on Monday, and we have all agreed that he would come back on March 13th, along with Mr. Makholm, subject of course to the Board's agreement.

CHAIRMAN: When is the public day? The 3rd. Why am I thinking about the 13th? Is there something --

MR. MORRISON: The 13th is the day that we scheduled Mr. Makholm to come back.

CHAIRMAN: No, that's not it. Well that sounds fine to me.

MR. HYSLOP: Thank you, Mr. Chair.

CHAIRMAN: All right. Anything further from any of the intervenors? Go ahead, Mr. Morrison.

MR. MORRISON: Thank you, Mr. Chairman.

CHAIRMAN: Madam Secretary, would you swear the two new additions to the revolving Panel.

MR. MORRISON: And they are Mr. Peaco and Mr. Kennedy.

<u>MESSRS. MAROIS, KENNEDY, PEACO and MS. MACFARLANE</u>:

<u>DIRECT EXAMINATION BY MR. MORRISON</u>:

Q.1 - Starting with you first, Mr. Kennedy, could you just state your name and position for the record?

MR. KENNEDY: Yes. My name is Blair Kennedy. I'm the Director of Energy Supply and Contract Management for Distribution and Customer Service.

Q.2 - And you filed some pre-filed evidence in this matter?

MR. KENNEDY: Yes, I have.

Q.3 - And that evidence appears in exhibit A-50, section 3 under tab 1, Direct Evidence of Mr. Blair Kennedy?

MR. KENNEDY: Yes, it does.

Q.4 - And was that evidence prepared by you or under your direction?

MR. KENNEDY: Yes, it was.

Q.5 - And do you adopt that as your evidence for purposes of this hearing?

MR. KENNEDY: Yes, I do.

Q.6 - Thank you, Mr. Kennedy.

Mr. Peaco, you filed evidence, pre-filed evidence in this matter as well?

MR. PEACO: Yes.

Q.7 - And just for the record, could you state your full name and your position?

MR. PEACO: Sure. Daniel Peaco. I'm President of LaCapra Associates.

Q.8 - Thank you, Mr. Peaco. And I believe what are being referred to commonly throughout this hearing is the LaCapra Reports. And there are three of them in total. They are found in exhibits A-5, A-9 and A-49, is that correct?

MR. PEACO: That's correct.

Q.9 - And were those reports prepared by you or under your direction?

MR. PEACO: They were.

Q.10 - And do you adopt those reports as your evidence for purposes of this hearing?

MR. PEACO: Yes, I do.

MR. MORRISON: Mr. Chairman, Mr. Peaco's c.v. is also contained in exhibit A-50. I believe I have spoken to most of the other intervenors.

But I would move, subject to the Board's approval of course, that Mr. Peaco be qualified as an expert in power contracts and production modeling.

CHAIRMAN: Any objection? The Board will accept Mr. Peaco on that basis.

MR. MORRISON: Thank you, Mr. Chairman.

At this point Mr. Peaco does have a presentation that he would like to put before the Board dealing with the processes and methodology that he used in preparing his evidence.

CHAIRMAN: Are there copies of these, I presume to be --

MR. MORRISON: Yes, sir. There are.

CHAIRMAN: There are? Okay. And you are going to put those in evidence now?

MR. MORRISON: Yes, Mr. Chairman.

CHAIRMAN: Have you shared it with the other parties?

MR. MORRISON: I believe they are being circulated as we speak.

CHAIRMAN: Are we going to run into that difficulty of new evidence?

MR. MORRISON: It is my understanding, Mr. Chairman, that a great deal of rigor was applied to ensuring that that was not the case.

CHAIRMAN: If any of the intervenors want some time to look at these we will give you time to look at them.
Mr. Hyslop?

MR. HYSLOP: Yes. We would like to have a few minutes to look at the documentation.

CHAIRMAN: All right. Will you let us know when you have completed your review?

MR. HYSLOP: We will.

CHAIRMAN: We will take a break now and wait for the word.
(Recess)

MR. MORRISON: I have been outdrawn. The panel -- the balance of the panel should be here in about 10 seconds.

CHAIRMAN: This is Mr. MacNutt's fault, you know. He told us that we were ready to roll here.

MR. MORRISON: I believe it was my fault. I understand, Mr. Chairman, that Mr. Hyslop has a couple of questions just for clarification before -- and I don't know whether he has an objection to the presentation or not. But I believe he has a couple of questions.

CHAIRMAN: Okay. Mr. Hyslop?

CROSS EXAMINATION BY MR. HYSLOP:

Q.11 - Yes, Mr. Peaco. I have looked at -- I guess it is some paper product of a Power Point presentation you are about to give us.

Is there anything in this report that represents new evidence that was not originally put into the three reports which you earlier prepared for this Board?

MR. PEACO: To the best of my knowledge, this is just an explanation of the contents of the three reports.

Q.12 - Okay. I'm going to refer you to page 14. Can you refer me in your report where we would find that evidence, Mr. Peaco?

MR. PEACO: No. That would not be in the report per se.

Q.13 - Thank you. And if you would, would you refer to page 24? And I'm referring to the second major bullet, "Forecasting Method Did Not Change With Restructuring."

Would that be found anywhere in your three reports?

MR. PEACO: Yes, it would.

Q.14 - Could you point me to the reference?

MR. PEACO: Sure. Just give me a moment.

Q.15 - Thank you. Well, if you tell me it is, you can verify that at a later date rather than hold up proceedings. So that would be fine.

MR. PEACO: Just for clarification, it would be in the Phase II report where we looked at the 04/05 comparison.

MR. HYSLOP: Thank you. That is all my questions, Mr. Chair. I'm not objecting. I just wanted to clarify two points where we didn't know where they were.

CHAIRMAN: Good. Thanks, Mr. Hyslop.

My records indicate this would be <u>A-95</u>.

MR. MORRISON: With that, Mr. Chairman, I would ask Mr. Peaco to proceed, with the Board's permission.

CHAIRMAN: Continue.

MR. PEACO: Good afternoon. As we said earlier my name is Dan Peaco. I am president of La Capra Associates and primary author of the three PPA audit reports that you have received in the record as has been identified today. I have prepared this presentation at the request -- to basically walk through the work that we have done --

described the three phases of the audits that we have done, the approach that we took and the results we found. If we go to -- what I plan to do today is describe a little bit about our role in this process, give a little background on Disco's purchase power costs and how they relate to our work, and then walk through the first phase which we looked at last year's budget, purchase power budget, in total, and then the two variance analyses we did for the two subsequent years and talk about how that relates to the budget requests on the table in this proceeding.

First our role, we did three distinct reports in sequence. The first one last spring called -- now known the Phase I report, was what we call PPA Pricing Implementation Audit where we looked at the 2005/06 fiscal year purchase power budget in total, which was 907.9 million dollar budget and did a review of Disco and Genco's analysis of that estimate.

In Phase II about a month or so later we were asked to conduct a follow-on analysis, which is a variance analysis, comparing that budget to the prior year budget and verify the 65.1 million dollar fuel variance that Disco had calculated. And we prepared that report in July.

The third phase was an additional request to do a review of the next year's budget analysis and replicate the fuel cost variance analysis that we did in Phase II and the variance amount that Disco had estimated at that point was 89.6 million year-over-year.
In retaining us to do these audits, Disco's objective was first obtain an outside review of their calculation of the purchase power budget, and because of the nature of the processes required to calculate the cost of the PPA for the forward year, it obviously required some experience with reading and interpreting power contracts and utilizing power system modelling, particularly the model used by Genco and Disco, the PROMOD model.
And lastly their objective was to ask us to prepare reports on that review with the intention that it would be provided to the Board for their review in hopes that it would help them understand their process and have some information on the calculation process of those budgets.
And obviously including bringing this presentation and appearing at these hearings.
As I'm sure you know from reviewing the record evidence to date, the purchase power expense is nearly 80 percent of Disco's revenue requirement. Of that virtually all of it is in the form of purchase power from various

contracts. The operative contracts here -- and I will be referring to these as I go through the process and you are probably familiar with these, but just for clarification. First the Genco vesting PPA which encompasses output from the so-called Genco heritage assets, the assets that were formerly NB Power assets that are now operating -- being operated by Genco, the Coleson Cove asset being the tolling agreement and the so-called Genco NUGs or in the PPA it's referred to as the heritage PPAs. In addition there is the Point Lepreau contract and there is a small what we call Disco NUGs, or small PPAs that Disco has directly with renewable producers.

Moving to the next slide. This is the year-over-year total budget for Disco including the fuel and purchase power. As you can see on the left side of this -- it works -- over on the left side, the 907.9 column is the fuel and purchase power expense that was the subject of our Phase 1 review. The purchase power expense obviously in the current budget on the right bar -- on the middle bar -- is a billion 28.1. And the variance between those is predominantly from the PPA from the purchase power budget of 120.2 million. And so that that would be part of the focus of our Phase III review.

In doing our review we obviously broke this down into component pieces and looked at how each component of that total amount was estimated. And so what I want to do is to walk you through a little bit of the breakdown on how the billion dollars of purchase power expense breaks down into component parts, particularly in terms of how they would be estimated in the cost elements that we reviewed. This chart here simply breaks down the amounts from the 907.9 and the billion 28 into the contributions by PPA. So you can see at the bottom the Point Lepreau or the Nuclearco contract amounts, slightly over $200,000,000 each year, the Genco vesting agreement and all of the assets embedded in that, 679.7 in the 05/06 year increasing to 805 in the current year.

The variance there obviously is largely within the Genco vesting agreement. Stepping into the contracts or unbundling the contracts into components a step further, what I have done here is to break apart some of the major components of the vesting agreement. And as you will see -- let me just go through -- this one has a slightly different total. You will notice at the top on the left bar the total is 987.6, and shows a little math there to explain how it gets there. But this breaks out the credit -- there is a credit at the bottom and most of that credit is the export margin credit. There is a couple of other smaller credits in there but almost all of that is the export margin credit. So that in the prior numbers was integrated into the total.

Here I have broken that out to show the pieces of it, the export margin credit of 79.7 offsets the expenses of 987.6 on the other side. And as you can see there is a substantial capacity component to the vesting agreement. The -- I just point to it here. This bar here is the capacity component of the vesting agreement and that's basically a fixed fee or fixed charge that has a certain schedule with it. And so as we reviewed the budget we broke it down into these pieces and looked at each estimate and it's important to see these components. So the energy piece which remains the largest component -- the energy piece of the vesting agreement, which are these darker green bars, were the focus of our variance analyses.

Going to the description of what we actually did in the Phase I technical audit which was produced last spring, the terms of reference which are in the report required us to first basically read the PPAs and understand the pricing terms, then review the models that were used by Disco and Genco to derive the budget estimate to understand whether those models accurately reflected the pricing terms in the PPAs, and in particular to verify that the outputs of those models, particularly the PROMOD model, were consistent with the inputs provided to them, and then to verify the reasonableness of the key inputs that were produced by Genco and Disco in estimating the number, with the overall objective to verify the reasonableness of the budget relative to the PPAs.

What we did in that was we broke it into two pieces and we found that approximately 60 percent of the total cost in the 907 amount that we were reviewing were basically spreadsheet derived calculations. The Point Lepreau contract, the capacity component of the vesting energy contract -- or the vesting contract and a few other components are fairly simple, megawatts times a number from a contract to get an amount. And there were some fairly simple spreadsheet representations that were necessary to do that and that actually encompasses the majority of the costs in that 907.9.

The PROMOD model -- and maybe I should stop for a minute here and explain PROMOD. I'm sure it's been talked about before. PROMOD -- the word PROMOD is the name for a commercial software product that is used to simulate power systems for their operation so that you can provide to it characteristics of units in a system, heat rates, capacities, availabilities, forced outage rates, those kinds of things, fuel prices, and load. And it will economically simulate -- or simulate the economic dispatch of the system to meet load. So it's basically a tool to simulate the operation of the system and Disco and Genco are using that model to simulate the 06/07 -- or each budget year. They simulate their forecasted operations for their system using that model, and using the outputs of that to set the budget. That's a very common tool used amongst those of us that are in the business of doing power supply planning and system planning, but it's a lot of data and it's fairly data intensive. So it's not auditable the same way a spreadsheet would be.

Our audit process was to first verify the spreadsheet components of this for consistency and accuracy and we were able to basically replicate all the spreadsheet computations that had been used to generate the estimate. We also verified -- we looked at the PROMOD outputs and inputs and verified that they were consistent with one another. We looked to see what kinds of fuel prices were used as inputs and looked at the outputs to see that those kinds of prices were in the outputs and there were several tests of that type that we did to verify the consistency inputs to outputs.

We then did some work to verify the reasonableness of the key inputs such as the fuel price inputs and the heat rates and the characteristics of the units. And from that we put that together to make an assessment of the overall reasonableness of the 907.1 million dollar budget that was produced.

Going back to my sort of component analysis here, the 907.9 on the left is the total budgeted purchase power expense from the 05/06 budget year. And this again just shows the breakdown by PPA in components.

And moving to the next thing I take the -- picking up the energy component, which is the 460.3 million which is the energy component of the Genco -- the vesting energy contract or the vesting contract -- break that down to show what components of that are actually being produced or estimated through the use of PROMOD.

There are two components at the bottom of the middle bar down here which are again, although they are embedded in the energy component of the vesting agreement, are essentially fixed costs.

There is a contribution to fixed cost amount which is the first item on the bottom which is part of -- which is a fixed dollars per megawatt-hour component of the vesting agreement.

And that again is a simple spreadsheet calculation to determine that number. And there is a capacity component to the cost of the NUGs which is included in there which again is a direct number from the contracts themselves.

So the balance of this, there is $359.5 million that was what Disco identified as the fuel component of their budget which was the amounts that we looked at for our variance analyses in phases 2 and 3.

And this chart also shows that that breaks into three broad categories. By the way, this data in this table was included -- this is actually data from what's called the Table 1 which was included in our terms of reference as the analysis that Disco had asked us to review in the Phase II and III reports.

But the components here are grouped a little bit. But starting from the top, the heavy fuel oil component, which is a Coleson Cove fuel, 119.6 million. The natural gas from the two natural gas-fired NUGs, 95.3 million.

And then the balance of that, coal, pet coke, Orimulsion included together with a couple of other miscellaneous items included, including there was some misallocation of the capacity cost of NUGs into that amount in Disco's analysis.

And so I just note there there was a notation in our reports that technically that should have been included with the other capacity cost of the NUGs. But it was inadvertently put in the wrong bucket when we did the variance analyses. So that in fact is included in the 359.5 that we reviewed in the variance analyses.

In reviewing the PROMOD piece -- and again now looking at how is the 359.5 derived and is it a reasonable number, we did a few things. Basically we did a series of diagnostic tests.

We wanted to see -- we looked at the sets of input assumptions that had been generated to run the PROMOD analyses they did, compared that to the output files they had to make sure that there was consistency there.

We looked at consistency of the output of that analysis to the recent history. Were the units operating in some similar pattern to what they had seen in the past? And if there is a variance can we explain why the variance was there?

We obviously looked at the output to see whether the dispatch order was rational. Were the units that you were expecting to see as peaking doing peaking? Were the units that we expected to see as base load doing base load? That kind of an analysis.

And then we just reviewed the results for reasonableness in terms of were the as-operated heat rates of the given units coming out in a range that you would expect to see given the inputs? And were the cost outputs coming in in a reasonable range given the inputs. So we did that kind of a review of what goes in and what comes out to make sure that that was making good sense.

And the criteria that we were applying here was consistency, inputs to outputs, consistency of outputs to history, consistency of outputs to the data that they had, and overall reasonableness of the result.

One of the things that allows us to do this kind of review for this system in particular is the New Brunswick power system, its peak load of a little over 3,000 megawatts. That's a relatively small system to model in the scale of some of the things that these kinds of models are used for.

Just as an example we routinely in our office routinely do models for market price forecast for the New England market which is now I think maybe a 27,000 megawatt system, or the New York market which is a 40,000 megawatt system. The size of this, to model this system relative to some of those other modeling exercises is relatively small.

A few other characteristics that make it relatively straightforward for someone who does this kind of modeling all the time to inspect the results for reasonableness, many of the units in this system are must run or base load. And so that the outputs of the units are fairly predictable just given by the inputs that you give it. Point Lepreau is going to produce at the capacity factor assumed. And you can do that calculation without, you know, having to run PROMOD to see what the answer is, the Genco NUGs or by the vesting PPA treated as must run. And so that's a predetermined input there as well.

So there are very few units that are actually being -- the production and costs are being determined very directly by the operation of the model. It's also a single area model.

Modeling the New Brunswick system by itself with essentially the economy sale to New England as the only point of economic interchange with other systems that's being represented is a relatively simple -- doesn't include a lot of transmission interface constraints that would complicate the dispatch and review of the results.

As I think I have mentioned earlier, there is also a fairly clear dispatch hierarchy in this system. The coal units are very inexpensive. The heavy oil units -- heavy oil is in a different category. The gas, although it's must run in this case, is a different price point. And then the peakers are much more expensive.

So it's very easy to understand. There is not a lot of interplay between dispatch of various units that would complicate the review of the analysis.

And lastly, given the large amount of peaking hydro in proportion to the size of the system in New Brunswick simplifies the operating reserves requirements and simplifies the analysis of it and basically does a lot of load-shaving and simplifies the result that way too.

So in many ways it's nevertheless a complex model. But in the scheme of the kinds of exercises that these kind of models are applied to, this is a relatively simple system to sort of inspect and review.

And this is just sort of a pictorial that shows how this breaks down in terms of scale. And what I have done here simply is taking the megawatt ratings of the units that I think are listed in the back of the vesting PPA and have built them up in the order of their -- roughly in the order of their dispatch priority in the production costing model, starting with the base hydro of Point Lepreau, the Genco NUGs which are must run and the coal, coke and Orimulsion which are run essentially at base load, although they can be dispatched for economics.

That group, which is roughly about half the megawatts in the system and perhaps about two-thirds of the peak load of Disco, is either base load or must run. And it's fairly obvious how those will be dispatched.

The Coleson Cove units clearly are the swing units in the system. And they will be -- you will be obviously wanting to look at those. Those will be moving a lot from hour to hour and case to case. And so I think that that's clearly where the predominant load following, thermal load following that happens in the system occurs.

And then of course there is a substantial chunk of hydro peaking that helps levelize the load. And then to the extent it's necessary, there is -- I call fossil peaking there, which is either the combustion turbines or economy emergency purchases that are made in the model.

So that's essentially what the model is doing and determining how the cycling and peaking units are operating and verifying those, which is basically a handful of units, was what we were doing when we were doing our checking.

When we went through this, we found that the key input assumptions for this case were reasonable. We verified their use of prices for heavy oil and gas and consistent with the market reports.

We checked the markets for the indices of the day, that they checked the markets for the indices and verified that the numbers were consistent. We verified the unit ratings that they had with the PPA and the prior reports that NB Power had produced on the units.

We checked the heat rate inputs consistence with historical performance in every case except Coleson Cove, where Coleson Cove had been refurbished. And the refurbishment led to a modest rerating and a modest change in the heat rates.

And so they weren't -- the history wasn't exactly representative of the future. So we took that into account. But the engineering estimates that were provided to us were reasonably consistent with the history subject to that explanation.

And we looked at the history of outages and unit availabilities and verified that the numbers -- the assumptions they used were consistent with that record.

And also we did look at the export levels in the recent history compared to what was -- which is effectively as set in the contract but verified that that was consistent with the representation in the model.

The Phase I findings, we were able to confirm the accuracy of the spreadsheet model components of the estimate being consistent with both the PPAs and the computationally accurate we were able to produced those results. In going through the diagnostic tests or the PROMOD run that was used to do the budget we found that the outputs were consistent with the inputs, and that the inputs that we tested were reasonable relative to the origins of the basis for them deriving those inputs.

And overall we found that the analysis was done consistently and reasonably and consistent with the PPAs and reasonably good estimate of the budget for the coming year, the 05/06 year.

Moving to the variance analyses that we did, and we did two of those, the scope is virtually the same, just the year changed in Phase II. Shortly after we finished our Phase I audit, Disco prepared a variance analysis of the budget that they I guess at the time had before you for approval, and looked back one year at the last year of the budget for NB Power, and found that the increase year-over-year was 65.1 million, and asked us to verify that and review the analysis.

So basically what we did is we reviewed the PROMOD run done for that year, verified -- and went through the variance analysis and compared the year-over-year runs and looked at each of the components of the PROMOD outputs of the two years and looked through all the variances to understand that the variances were tied to the input assumptions and not to computational errors, and then prepared a report on the major causes of the variance.

The same process for Phase III. We did this in September once they completed the 06/07 budget, and the variance there at that time they had estimated was 89.6. And again this is operating on the fuel component of the total budget that we talked about.

So looking at this this is the Phase II dollars year-over-year. The fuel component for -- as you may remember the 359.5 which is the centre bar on this chart was the fuel component that was being estimated by PROMOD a few slides ago. That was for the budget year that we reviewed, 05/06.

The previous year, 04/05, the year that we reviewed in Phase II, the fuel component was 294.4 and the variance 65.1. And as you can see from the bar on the right, the variance was split pretty evenly between the three categories of fuel, oil, gas and the coal components.

The Phase III variance analysis, here the 359.5 now is in the left bar because that's the prior year being compared. Step forward a year, fiscal year 06/07 which is the budget currently in this proceeding, the 449.1, here you can see the variance is much more heavily weighted for the heavy oil and gas components in the mix -- in explaining the variances between these things.

Going back a little bit to how we did the Phase II technical audit. In this Phase II process we basically took the PROMOD review aspects of Phase I and replicated that here and then did a comparison. We had to pick up the 04/05 PROMOD analysis that was done by NB Power to set the budget. Basically this is the period the last year before the restructuring of the companies. And conduct a variance analysis and make sure that we had inputs and outputs correctly in that run, and then we had an apples to apples comparison so we could do the analysis.

The Phase III technical audit, same thing. We took the new PROMOD analyses for the 06/07 budget and they happen to have to be two PROMOD runs in that case because of the -- an issue with Point Lepreau I will explain in a minute. But we looked at those analyses for the same thing, verified that the runs -- outputs consistent with inputs, inputs are reasonable, and then doing a variance analysis comparing year-over-year between the two.

The Point Lepreau issue was simply the way that contract is structured that -- let me back up. Point Lepreau was assumed in the prior year budget to be an annual capacity factor of 83 percent and in this year it's assumed I believe at 76 percent capacity factor. Contractually there is a threshold at 80 percent capacity factor where certain things happen.

Genco's vesting agreement back stops Point Lepreau up to the 80 percent capacity factory. So there were two runs had to be done. First a run assuming Point Lepreau ran at 80 percent, to get a vesting pricing number, and then a second run with Point Lepreau at 76 percent to get an actual dispatch for the year and get a budget. So we looked at both of those runs, but the second run which is the actual budget was the one we did the comparison year-over-year on. But we did look at both cases and verified that.

To be clear, I just put this together to make sure we are clear on what is actually in the fuel component of this analysis. It's the fuel of the heritage assets, the fuel of Coleson Cove, the gas component of the Genco NUGs, the emergency purchases, auxiliary costs, miscellaneous costs, and the fuel and currency hedge settlements which we will talk on in a minute. All the other costs -- and again those cost elements only as they pertain to serving Disco's firm load to the extent that it doesn't go to serving the interruptible load or the export sales.

That's a separate component of the analysis.

So the review that we did here was only looking at those costs that went to serve the Disco firm load in the budget.

The non-fuel components that are excluded from this analysis, all the Point Lepreau costs, all the fixed costs of Coleson Cove, the fixed costs -- actually I didn't list here but the capacity costs of the Genco vesting agreement and all the other fixed costs and the export gross margins were excluded from this variance analysis.

The PROMOD 04/05 analysis verification, we were able to verify that. And by virtue of the fact that the Genco PPA essentially codifies past practice in terms of how their budgets were done, there was a fairly -- there was almost a direct comparison between the PROMOD analyses done for 04/05 as 05/06 -- I mean -- yes, as 05/06. And so they were very comparable and we were able to do that analysis without much adjustment at all.

The key determinants of the variance 04/05 to 05/06 were fuel price increases, some volume and dispatch variance changes, and here I'm just talking about there could be things like load growth, new units, units being out on maintenance or other things that could change the dispatch and actually cause the costs to change. And so I have grouped these into fuel price changes and volume and dispatch changes, and then the financial effects of the fuel and currency hedge settlements as a third component. And in that analysis nearly 50,000,000 of the 65.1 million were our estimate of directly attributable to fuel price increases year-over-year. And interestingly enough it was led by the coal category and the -- that was the year when the coal markets really took a run up and everybody experienced that coal had been boring for years and it took a hit and that's what that number reflects. Heavy fuel oil and natural gas went up about ten percent in that period of time and they also contributed to the variance, but coal was the leading driver in that.

Moving ahead to the 06/07 PROMOD analysis we were able to verify -- again going through the process I have described -- verify the validity of that -- the reasonableness of that run and its inputs, and building off the foundation we had set in reviewing the other PROMOD runs made sure that they were consistent not only with the history and the market but also with the prior runs that had been reviewed. So there were several benchmarks that we were able to use to test that.

Moving to the variance analysis, 89.6 million, the Phase III variance analysis. Here in this year, the story is oil and gas. And the oil prices increased 56 percent and the gas prices increased 34 percent. And the other big factor here is -- and the Point Lepreau capacity factor was down 7 percent from 83 to 76 in the 06/07 budget year. So that loss of that production and the replacement was a factor in this analysis as well. And there also were credits for fuel and currency hedging settlements which we will talk about.

Here we did the fuel only analysis and estimated that roughly 85 million of the 89 million could be explained solely by changes in fuel prices. If that were the only factor involved, that would explain a lion's share of that variance.

The major components of that obviously led by heavy oil and natural gas, very little change -- relatively little change in the coal -- the coal category of the analysis. There were substantial credits from the hedging agreements. And maybe I should stop here for just a minute and explain this. Genco conducts hedging contracts for oil and gas and currency, such that by the time the vesting price settlement day occurs, both of those fuels are largely hedged -- fully hedged forward through the coming budget year.

So there is two things going on here. When we use the -- what they will do at the time that they set the budget, is they will check the then current forward price at the day that they set the transaction and that sets the current market value for the fuel for the coming year. And that allows them to do two things. They can say current -- put a current value on the physical value of the fuel that's going to be consumed in the coming year. And they can also put a value -- a monetary value on the hedge positions they have taken.

So to the extent the fuel prices is up, if they have laid in hedges coming up to that day, they would get credits. So these numbers are the credits or the differential on the credits that they would have year over year. And so that they are -- the reason it's separated in the PROMOD analysis is that the PROMOD runs among other things, solve for exports. And the export -- the inputs for the export market are based on forward prices at that time. And so to have a fair estimate of the export component of that, you need to have then current market prices of fuel being used in the Genco assets to compare to what's happening in the other markets. And so they separate-- the currency hedges from the then current fuel price. So that opportunity cost-based dispatch is the proper way to do the export modelling, but I mean (inaudible mike off) -- the bundle -- the hedging credits from the prices.

The volume dispatch variance was nearly 30 million. And a lot of this was driven by the reduction of Point Lepreau capacity and the resulting dispatch of other units. We don't have a breakdown. We would have to do some PROMOD runs to break that down into particular components. But the net effect of that is about a $30 million variance.

So that you see that we have the -- the fuel component itself being about 85 million. There is about $25 million credit from the hedging and about a $30 million increase due to dispatch costs, due to the lower production at Point Lepreau.

The hedging contracts obviously mitigate -- wait a minute. I went backwards instead of forwards. So in summary, taking the three audits together, we have verified the consistency of the models being used by Genco and Disco to the PPAs. We are satisfied that they have a reasonable representation both in their spreadsheets and in the approach then for the terms and conditions of the PPAs that are being implemented.

We are able to verify the consistency in each of the cases with PROMOD inputs and outputs. We have benchmarked the budget results to prior year budgets to prior year operating history and have verified the reasonableness of the key inputs, and particularly the fuel price inputs, which are the primary drivers of the variance in the analysis. And obviously through this process develop a set of diagnostic tools to help us review what they are doing.

So the conclusions we would have on the current budget estimate, the 449.1 million fuel component based on this review to us is a reasonable estimate of the cost that could be expected in the budget year. And the key factors causing the variance from last year is the heavy oil and natural gas price increases and the reduced Point Lepreau production. And the balance of the billion, 28 budget, as we have talked about before is all derived from more readily verifiable components of the contracts.

And at the time we did Phase I, the contracts had not been disclosed, but now they are in the record here and I think that they are reasonably transparent. So we haven't done a complete review. But the variance in those numbers are very small from last year. And those are all relatively verifiable from a read of the contracts.

So that was -- there is a -- overall that number looks reasonable with -- consistent with the past year.

And I am happy to answer any questions you have.

MR. MORRISON: Thank you, Mr. Peaco. Mr. Chairman, at this point, I know it's late in the day -- I don't know if my mike is working -- we have circulated a summary sheet that was prepared by Mr. Kennedy. It basically identifies certain costs and it links them to articles or sections in the PPAs. So that would be a good summary document for everyone to have.

I was going to have Mr. Kennedy address that, but it would take about 10 minutes. And I thought maybe we would use -- probably start that -- I am not sure that we would get finished before 3:00 o'clock. It might take 10 or 15 minutes to step people through it. I would like to have that document marked and perhaps address it in the morning if that's okay?

CHAIRMAN: Sounds like a good idea.

MR. MORRISON: The other thing I would like to say, Mr. Chairman, and I know that the Panel will be open for cross-examination tomorrow by all the parties, and I would just like to remind -- or have the Board remind the Intervenors that as they ask their questions if it looks like they are straying into areas that would be questioning with respect to information that's been put on the record in confidence that they indicate that to the

Board so that if an in-camera session we can move into that.
Just that I would like the Intervenors to exercise care in their questioning. That's all.

CHAIRMAN: This document will be A-96. Now just before we break k, the Strunk report, does anybody know the exhibit number of that?

MR. HYSLOP: I think they were PI-14 and PI-15, Mr. Chair.

MR. MACNUTT: PI-14, Mr. Chairman.

CHAIRMAN: We will break and reconvene in the morning at 9:15. And Mr. Hyslop I look forward to receiving your information.

(Adjourned)

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me, the best of my ability.

Reporter