**Pre-filed Testimony of Philip Hughes
for 1998 General Rate Proceeding**

NEWFOUNDLAND POWER INC.

DIRECT TESTIMONY OF PHILIP G. HUGHES

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1. INTRODUCTION

My evidence will underline the seriousness of the decisions facing the Board and the difficulties facing the management of Newfoundland Power.

2. WHAT NEWFOUNDLAND POWER IS REQUIRED TO DO

Newfoundland Power is required to provide reliable service at the least reasonable cost.

During the past 3 or 4 months, the Company has been preparing evidence, responding to questions, dealing with the Board's consultants and participating in public hearings. All of this is aimed at determining whether Newfoundland Power is providing reliable service at the least reasonable cost.

Well, we are improving service; we are controlling costs; we are investing in improving reliability; we are focused on the right things. This Board's financial and engineering consultants' reports confirm this.

And Newfoundland Power will continue to focus on these imperatives.

Our future success will depend in large part on two things. Firstly, will this Public Utilities Board allow management to manage the Company? The second factor is our capability to manage the Company.

3. MANAGING THE COMPANY

In June 1998, the Court of Appeal made it clear that it is management's job to manage Newfoundland Power, not the Board's.

In July 1998, the Board, in Order P.U. 16 (1998 - 99), (the "Cost of Capital Order"), set a minimum threshold of 2.4 times interest coverage and reduced rates to reflect a return on equity of 9.25% in 1998.

With revenues set at a 9.25% return on common equity, the Company cannot do any better in 1999 than meet the minimum interest coverage target of 2.4 times. This is the practical effect of the Cost of Capital Order on management's ability to manage the Company's financial integrity.

The effects of the Cost of Capital Order have been readily recognized by the national financial community. The market reaction to the Cost of Capital Order has included a downgrade in the Company's credit rating and widespread criticism of the Order itself.

Newfoundland Power is expected to manage its affairs in the best interests of both its customers and its shareholders. If one thing is clear as we look forward, it is that the Company has not been given much room.

The constraints of the Cost of Capital Order practically mean that a single adverse event, such as a minor economic downturn in 1999, could have severe financial consequences for the Company and, in turn, its customers and shareholders.

4. LATITUDE TO MANAGE INTO THE FUTURE

A serious issue in this proceeding which threatens to impair management's ability to manage into the future is the so called excess earnings in 1992 and 1993.

The reality is there are no excess earnings. The Company's profit was regulated in 1992 and 1993. It is little more than a technicality that the earnings were required to have been stated as a range of return on rate base as opposed to a range of return on common equity.

The difference between the forecast and actual returns on rate base were caused by reductions in capital spending which were made with the approval of the Public Utilities Board at that time due to the downturn in the economy.

For the Company to have made unnecessary capital expenditures and then recover the costs over the next thirty years would have been irresponsible and much more expensive for our customers. Had the Company taken such an irresponsible decision, it would have led to the return on rate base being within the approved range in these years. But that would have been the wrong thing to do.

The decision to cut capital spending was the right decision in 1992 and 1993. The passage of time has not changed this one iota. The right course of action now is for this Board to affirm the 1992 and 1993 decisions of the Public Utilities Board.

The amounts involved here are not excess earnings, they are the equity of the Company which has been invested in the province's electrical system.

The earnings of 1992 and 1993 were, and still are, the rightful equity of Newfoundland Power. For Newfoundland Power to rebate these earnings would cause 1999 return on equity to fall below 9.25% and forecast interest coverage for 1999 to fall below the 2.4 times level. Practically, this means in 1999 the Company will not be able to meet the minimum financial requirements of the Cost of Capital Order and provide reliable service as it is required to do.

If this were to occur, it would amount to nothing more than the arbitrary reduction of the financial strength of a utility which is legally obliged to maintain a strong financial position so that it can continue to provide reliable service.

To punish a company for making a decision that benefited its customers and was previously approved by the Board would be reprehensible.

5. SENIOR MANAGEMENT COMPENSATION

Senior management capability is critical to Newfoundland Power's ongoing ability to improve service while continuing to control costs.

A considerable part of this proceeding has focused on the compensation paid to the Company's senior management. Much has been made of individual salaries, and relatively little of the fact that the cost of the Company's senior management team has been reduced, not increased, since 1996. This was not a small reduction either, but a 15% reduction when 1999 costs are compared to 1996. But this is not the only critical point on this issue.

An equally critical point is that the Company's independent board of directors has, in good faith, determined levels of compensation which they believe are necessary to attract and retain the management personnel required to improve service while controlling costs. The evidence proves management has done this.

The Company's directors have received the advice of the leading international compensation firm and made judgments in these matters. Their judgments were made on the basis of independently prepared data.

11 of these 12 directors reside in Newfoundland.

The judgments made by the Company's directors were rational judgments that they are required to make. In the review of this matter, this point should not be overlooked.

6. CONCLUSION

Currently, electric rates in this province are competitive. For the average Newfoundland Power electric heat customer, they are the lowest in Atlantic Canada.

Newfoundland Power has achieved this through cost containment while improving reliability and customer service at the same time. In short, Newfoundland Power has been, and is, doing a good job.

To continue on this path, Newfoundland Power requires a small rate increase in 1999 of 1.31%. The absolute minimum is for rates to be set at a return on common equity of 9.25%.

Presumably, a range of 50 basis points around the 9.25% return on equity would be allowed in keeping with the past practice of the Board. However, that range below 9.25% will not give us the minimum interest coverage to maintain the Company's credit worthiness below a 9.20% return on equity. Our interest coverage is below that ordered by the Board in the Cost of Capital Order. In other words, management does not have the management flexibility as outlined by the Court of Appeal in its opinion.

The Cost of Capital Order has ensured that Newfoundland Power's earnings and financial position will not materially improve in 1999.

This province will not benefit from having a second class electricity system. To attract and retain the industries which will enable the economy of Newfoundland to prosper will require better than that.

The province is trying extremely hard to attract hi-tech industries to relocate here or invest further. One of the basic requirements for such industries is a very reliable power system with excellent power quality.

The Company's rate request in this proceeding is about ensuring that the electrical system continues to provide what this province's economy needs.

In 1999, current rates will not enable Newfoundland Power to meet the minimum financial requirements established by this Board just over 4 months ago. It is not in the public interest for this Board to set minimum financial requirements and then proceed to set rates which will not enable the Company to meet those requirements.

In concluding, it is my sincere belief and conviction that any further erosion of Newfoundland Power's financial position would not meet the financial integrity requirements of the *Electrical Power Control Act, 1994*, and would benefit neither the province nor the Company's customers.