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February 18, 2016

DELIVERED

Island Regulatory and Appeals Commission
134 Kent Street – Suite 501
National Bank Tower
Charlottetown, PE

RECEIVED
FEB 18 2016
The Island Regulatory and Appeals Commission

Hand Del 356pm MLA

Attention: J. Mark Lanigan, CA, CPA,
Director, Corporate and Appeals Division

Dear Mr. Lanigan:

RE: Application of Maritime Electric Company, Limited ("MECL") for an Order Approving Rates, Tolls, and Charges for the Period March 1, 2016 to and including February 28, 2019

As you know we represent the Government of Prince Edward Island which has intervened in the captioned matter.

On February 10, 2016 our client received Interrogatories of Commissioned Staff the responses to which are enclosed herewith.

Additionally, we enclose a copy of a report dated February 3, 2016 prepared by Grant Thornton on behalf of our client's agent The Prince Edward Island Energy Corporation providing observations on capital structure and fair return on common equity for MECL. This is also being submitted as part of our client's submission respecting its intervention in this application.

Yours truly,

CARR STEVENSON & MacKAY

J. GORDON MacKAY, Q.C.
JGM/id
Enc.
c client

1. **Attached find reports issued by Concentric Energy Advisors and Ontario Energy Board ("OEB") staff relating to Cost of Capital and Equity Returns. Please provide commentary rationalizing the agreed upon ROE of 9.35% in the Agreement with the analysis of these reports. Please advise on the Company's estimates of risk premiums which should be paid to MECL as a result of its size, location or other unique factors.**

Maritime Electric proposed a Return on Equity (ROE) of 9.7 percent within a range of 9.5 to 9.9 percent in its' General Rate Application (GRA). This proposal was supported with a report by Concentric Energy Advisors (CEA) dated October 16, 2015.

CEA also produced the May 1, 2015 report that was attached to this interrogatory.

The CEA report of October 2015 utilized much of the same data contained in the May 2015 report but included ROE analyses and conclusions specific to Maritime Electric.

Grant Thornton was initially engaged by the PEI Energy Corporation (Corporation) in December 2015 to review Maritime Electric's GRA. For carrying out this review, both of the above noted CEA reports were available and utilized.

Observations from this initial review by Grant Thornton include:

- Newfoundland Power and Nova Scotia Power are comparable regulated electric utilities in Atlantic Canada. From 2010 to 2015, the allowable ROE for Newfoundland Power and Nova Scotia Power dropped by 0.2 percent and 0.35 percent, respectively.
- Maritime Electric's risk is a combination of business risk and financial risk. Maritime Electric's business risk is rated as excellent (i.e., low), which is the best possible rating, and its financial risk, which is determined by core financial ratios, is rated as aggressive (i.e., relatively high).
- An allowed ROE of less than 9 percent could adversely impact Maritime Electric's "BBB+" Standard & Poor's (S&P) overall debt rating.

The other interrogatory attachment, "OEB Staff Report", indicates that ROE's for regulated Ontario utilities have decreased by 0.55 percent from 2010 to 2015.

In rationalizing the agreed upon ROE, Government recognized that past regulatory decisions allowed for a risk premium, presumably for the purpose of protecting Maritime Electric's S&P debt rating. On this basis and in the interests of continued rate stability, it was deemed prudent to reach agreement on an ROE reduction of 0.4 percent (for an allowed ROE of 9.35 percent). This reduction is in the range of what has been seen in other Canadian jurisdictions over the past five years.

Over the term of the 2016 General Rate Agreement (Agreement), Government intends to gain a better understanding of Maritime Electric's financial risk, specifically looking at historical and forecast financial ratios, and the sensitivity/impact of a lower allowed ROE on core financial ratios and resulting overall debt rating.

2. **Do you have any information indicating the Schedule of Inputs is now inaccurate, or will within the term of the Agreement, be different than the projections therein in any material respect?**

   No, however should there be some unforeseen material change in circumstances that would necessitate a change the Schedule of Inputs, there is a provision in the Agreement that allows either party to apply to the Commission to amend the rates, tolls and charges.

3. **The cost of service study discussed in Section 13 of the Application demonstrates that that Residential Customers have not been paying the full costs of providing service to them, but that General Service customers have been paying more that the cost of their service. Is this correct?**

   a) **The amended application proposes delaying changes to the second block discount rates until a further detailed study is completed. Is this correct?**

   b) **Is it correct (based on page 9 of the original application) to say that maintaining the current second block rate system is estimated by Maritime Electric to be a subsidy of $773,000, over term of the Agreement, to that portion of the residential customer class consuming over 2000 kwh/month?**

   Yes, from a cost of service perspective, there is currently an under collection of costs from Residential customers and an over collection from General Service customers.

   a) Yes, the amended application proposes that any changes to the 2nd Block Residential rate class, and the related changes in other rate structures, will be deferred until March 1, 2019.

   b) Based on the 2nd Block threshold adjustments proposed in Maritime Electric's original application, $773,000 is the estimated amount of additional revenue that would be collected over the term of the Agreement from Residential customers that consume more than 2000 kwh/month.

4. **Why should the Commission delay implementation of the second block rate changes proposed by MECL in the original application? Are you aware of any other jurisdiction in North America which has a discounted pricing structure for higher energy consumption by residential customers?**

The 2016 General Rate Agreement as proposed is a collaborative effort that is intended to minimize and stabilize the costs that Maritime Electric customers incur for access to a secure and reliable electricity supply.

It is understood and agreed that 2nd Block pricing, whereby consumption above a certain threshold results in a discount, intuitively sends the wrong message to consumers. However, it should also be noted that the current 2nd Block pricing structure for the Residential rate class has been around for some time and changes to it could have a significant financial impact on some electricity consumers. For this reason, there are several activities that should preclude any change to the status quo, including:

- The development of a new Provincial Energy Strategy is currently underway which could lead to new policy direction on electricity supply and/or usage;
- A more comprehensive Demand Side Management Plan is expected through direction from the Commission and collaboration between Maritime Electric and Government.
- The results of the 2014 Cost Allocation Study and subsequent updates should feed into a Rate Design Study as is proposed in the amendments to the GRA submission.
- Consultation with electricity consumers that will be affected by the results of the Rate Design Study should occur. For the consumers that are materially impacted by the results of the Rate Design Study, there may be opportunities to mitigate the financial burden through programs resulting from the Provincial Energy Strategy and Demand Side Management Plan.

The Corporation is not aware of any other jurisdiction in North America with discounted energy pricing for higher consumption for customers in a Residential rate class.

Grant Thornton
An instinct for growth™

Observations on Capital Structure and Fair Return on Common Equity for

Maritime Electric Company Limited

February 3, 2016

Grant Thornton
An instinct for growth™

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February 3, 2016

Dear Mrs. Horrelt:

OBSERVATIONS ON CAPITAL STRUCTURE AND FAIR RETURN ON COMMON EQUITY

We enclose our independent report as to our observations of Maritime Electric Company Limited's capital structure and fair return on common equity for 2016.

Our report, along with supporting calculations, details the methods, considerations, analyses that underlie our observations. We believe that our report must be considered as a whole. Selecting portions of our report or the factors we considered, without considering all factors and analyses together, could create a misleading view of the process underlying the report. The preparation of a report is a complex process and is not necessarily susceptible to partial analysis or summary description. Any attempt to do so could lead to undue emphasis on any particular factor or analysis.

We thank you for the opportunity to provide our services and will be pleased to discuss the foregoing with you at your convenience.

Yours sincerely,

Troy MacDonald, CPA, CA, CBV
Partner, Advisory Services

Louis-Pierre Francoeur, CPA, CA, CBV
Senior Manager, Advisory Services

LPF/amf

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Observations

Our observations are based on the scope of our review and subject to the assumptions, restrictions, and qualifications noted herein.

- During the period of 2010 to 2015, we observe that the allowed return on equity's ("ROE") approved by Canadian regulators have decreased.

- We note that the allowed ROEs in 2010 (during the Company's last general rate application ("GRA")) are higher than in 2015. Specifically, we note that Maritime Electric Company Limited's ("the Company") allowed ROE premium over Newfoundland Power and Nova Scotia Power was 0.75% and 0.40%, respectively, in 2010 vs. 0.95% and 0.75% in 2015.

- During the period of 2010 – 2015, we observe that the allowed common equity ratios approved by Canadian regulators have been relatively stable.

- Concentric Energy Advisors, in its report, utilized the Capital Asset Pricing Model ("CAPM") and Discounted Cash Flow ("DCF") approaches, and these approaches are the most widely accepted by Canadian regulators.

- Concentric Energy Advisors, in its report, has an ROE conclusion primarily based on a North American Proxy Group. Canadian regulators have accepted the use of comparable US data but have not necessarily placed equal weight on US data.

- We note no major changes in the fair return on equity standard.

- In its March 2015 report, Standard & Poor's ("S&P") noted that the Company had an "Excellent" business risk profile and an "Aggressive" financial risk profile. We recommend further work be performed as to better understand the financial risk, specifically looking at historical and forecast financial ratios, and the sensitivity/impact of having a lower allowed ROE on S&P's core ratios.

- The Company continues to argue that it has higher total/overall risk than other Atlantic Canadian electric utilities and comparable utilities across Canada. The Company's business risk is rated as "Excellent", which is the highest category. The Company's overall credit rating is lowered due to its comparatively weaker financial ratios.

- Current long-term Government of Canada benchmark bond yields are below those used to establish the Company's regulated ROE as part of the 2010 GRA.
- During the period of 2010 – 2015, we note that the key economic indicators have been relatively stable.
- On January 29, 2016 we note that the Company and the Province of Prince Edward Island signed a settlement agreement whereby the allowed ROE effective March 1, 2016 until February 28, 2019 will be 9.35%. The Company's allowed ROE premium over Newfoundland Power and Nova Scotia would be 0.55% and 0.35%, which puts it more in line with the premiums that existed in 2010 (date of last GRA). This assumes the 2016 allowed ROEs in both Newfoundland Power and Nova Scotia would be the same as in 2015.

Scope of work

In completing this assignment, we reviewed and relied upon the following information, documents and data:

a Evidence regarding capital structure and cost of capital filed by the Company on October 28, 2015 with the Island Regulatory & Appeal Commission ("the Commission");

b Commission's Order UE-10-03 concerning capital structure and fair return on equity;

c Allowed return on equity and equity ratios of other Canadian regulators for 2010 - 2015, as available;

d Cost of capital decisions of other Canadian regulators since the Company's 2010 GRA;

e Bank of Canada information;

f S&P credit reports, March 2009 and March 2015;

g S&P criteria information: (1) Utilities: Key Credit Factors For The Regulated Utilities Industry, and (2) Corporates: General: Corporate Methodology;

h PEI Department of Finance - economic indicators as of February 1, 2016;

i Capital IQ;

j Settlement agreement between the Company and the Province of Prince Edward Island dated January 29, 2016;

k Evidence, information requests and related responses filed by any other parties to the proceeding; and

l Various discussions with the PEI Energy Corporation ("PEI Corp.") management.

We did not audit or otherwise verify the data and information contained in these documents.

Assumptions

In preparing our report, no major assumptions were made that may affect our observations.

Introduction

Introduction and purpose

PEI Corp. has requested that in connection with the GRA of the Company, we prepare a report ("Report") outlining our observations as to the reasonableness of the Company's capital structure and fair return on common equity.

At a later date, the PEI Corp. may hire Grant Thornton LLP to prepare an independent expert report. As such, this Report does not include any conclusions and is not an expert report under the Practice Standards #310 or Limited Critique Report under Practice Standards #410 of the Canadian Institute of Chartered Business Valuators.

We understand that our Report may be disclosed as part of a public rate hearing process, and we have given PEI Corp. our consent to the use of our Report for this purpose.

You have agreed that you will use our Report only for the purpose stated above. No other use is intended or permitted without the prior written consent of Grant Thornton LLP.

All amounts contained in this Report are expressed in Canadian dollars unless otherwise stated.

Fair return standard

We note no major changes in the fair return on equity standard since the Company's previous GRA. The principles underlying the determination of a fair return continue to be articulated in key legal decisions.

Canadian regulatory overview

We have reviewed the cost of capital decisions of other Canadian regulators since the Company's 2010 GRA.

We acknowledge that looking to cost of capital decisions of other Canadian regulators may have an aspect of circularity. However, we believe that the recent decisions of other Canadian regulators can provide another check as to reasonableness.

We have excluded Canadian jurisdictions that mainly regulate Crown corporations as we believe their figures are not comparable. Investor-owned utilities are more relevant as market information (such as debt ratings) is based on a function of a utility's risk on a stand-alone basis and not of one being directly or indirectly supported by government ownership.

ROE methodology

The most widely used ROE estimation techniques used by Canadian regulators are CAPM and DCF and, to a lesser extent, the Equity Risk Premium ("ERP") and Comparable Earnings ("CE") approaches. As recent examples, we note the following:

- The British Columbia Utilities Commission ("BCUC"), in its 2013 decision, used CAPM and DCF, and placed no weight on the ERP and CE methodologies to determine a fair ROE. Equal weighting was given to both the CAPM and DCF approaches[1].

- The Alberta Utilities Commission ("AUC"), in its 2015 decision, used the CAPM and DCF methodologies and placed little or no weight on other methodologies[2].

- The Board of Commissioners of Public Utilities, Newfoundland and Labrador ("NL PUB"), in its 2013 decision, concluded that given the current financial and economic conditions, a simple application of the CAPM cannot be relied on to produce a fair return. In the circumstances, the NL PUB believed it was necessary to take a broader view and look to other available information in relation to fair return. The NL PUB continued to give primary weighting to the CAPM

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[1] *BCUC Generic Cost of Capital Proceeding, May 2013 Decision, Stage 1, page 56.*

[2] *AUC Generic Cost of Capital Proceeding, March 2015 Decision, page 57.*

approach; however, it considered the DCF approach as well (albeit placed lesser weight than CAPM). The NL PUB placed little weight on the ERP approach.[3]

– We note that Concentric Energy Advisors, in its report, utilized the CAPM and DCF approaches and gave equal weighting to each[4].

Allowed ROEs and common equity ratios

In **Table 1** and **Table 2** below, we have compiled the allowed return on common equity and equity ratios approved by other Canadian regulators in 2010 - 2015.

Table 1 - Allowed return on common equity

Entity	2010	2011	2012	2013	2014	2015
British Columbia Utilities Commission						
Benchmark utility	9.50%	9.50%	9.50%	8.75%	8.75%	8.75%
FortisBC Energy Inc. - *gas distribution*	9.50%	9.50%	9.50%	8.75%	8.75%	8.75%
FortisBC Energy (Vancouver Island) Inc. - *gas distribution*	10.00%	10.00%	10.00%	9.25%	9.25%	N/A
FortisBC Energy (Whistler) Inc. - *gas distribution*	10.00%	10.00%	10.00%	9.50%	9.50%	N/A
FortisBC Inc. - *integrated electric*	9.90%	9.90%	9.90%	9.15%	9.15%	9.15%
PNG - West Division - *gas distribution*	10.15%	10.15%	10.15%	9.50%	9.50%	9.50%
PNG - Fort St. John/Dawson Creek - *gas distribution*	9.90%	9.90%	9.90%	9.25%	9.25%	9.25%
PNG - Tumbler Ridge - *gas distribution*	10.15%	10.15%	10.15%	9.50%	9.50%	9.50%
Alberta Utilities Commission						
Generic cost of equity	9.00%	8.75%	8.75%	8.30%	8.30%	8.30%
Ontario Energy Board						
Generic cost of equity	9.75%, 9.85%	9.85%, 9.58%	9.58%, 9.12%	9.12%, 8.98%	8.98%, 9.36%	9.36%, 9.3%
Quebec Regie de l'Energie						
Gaz Metro - *gas distribution*	9.20%	9.20%	8.90%	8.90%	8.90%	8.90%
Nova Scotia Utility and Review Board						
Nova Scotia Power Inc. - *integrated electric*	9.35%	9.20%	9.20%	9.00%	9.00%	9.00%
Prince Edward Island Regulatory & Appeals Commission						
Maritime Electric - *integrated electric*	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%
National Energy Board *(note 1)*	N/A	N/A	N/A	N/A	N/A	N/A
Board of Commissioners of Public Utilities, NL						
Newfoundland Power Inc. - *integrated electric*	9.00%	8.38%	8.80%	8.80%	8.80%	8.80%

Note 1: *NEB allows a WACC on the rate base rather than an ROE and a deemed capital structure. NEB has not issued an ROE decision since 2009.*

Sources:
BCUC Order No. G-158-09; Fortis 2011 annual report; BCUC Order No. G-47-12; FortisBC Inc. Application for 2012/2013 Revenue Requirements and Review of 2012 Integrated System Plan; AUC Generic Cost of Capital Decisions 2009 & 2011; OEB Cost of Capital Parameter Updates 2011 and 2012; Regie D-2009-156 & D-2011-182; 2010 NSUARB 6, 2011 NSUARB 184; IRAC Order UE10-03; NEB RH-1-2008 Decision; NL PUB Orders Nos. P.U. 43 (2009), P.U. 32 (2010). P.U. 17 (2012).
NL PUB Order 13 (2013), Newfoundland Power 2016/2017 General Rate Application, Maritime Electric 2016 General Rate Application, AUC Generic Cost of Capital Decision 2013, BCUC Order No. G-47-14, Emera 2014 Annual Report, Emera 2013 Annual Report, OEB cost of capital updates 2012. 2013, 2014 and 2015, Gaz Metro Q3-2015 financial reports

During the period of 2010 to 2015, we observe that the allowed ROEs approved by Canadian regulators have decreased.

We note that the allowed ROEs in 2010 (during the Company's last GRA) are higher than in 2015. For example, since 2010 we note that the allowed ROEs have decreased by 0.65 - 0.75% in British Columbia, decreased 0.70% in Alberta, decreased 0.55% in Ontario, decreased 0.30% in Quebec, decreased 0.35% in Nova Scotia and decreased 0.20% in Newfoundland and Labrador. The reduction in allowed ROEs in British Columbia, Alberta, Quebec, Nova Scotia, and Newfoundland and Labrador are a result of regulatory decisions. The Ontario Energy Board ("OEB") continues to utilize an automatic adjustment formula, and this has resulted in lower allowed ROEs. The OEB is the only

[3] *PUB Order No. PU 13 (2013), pages 11-31.*
[4] *Concentric Energy Advisors, Cost of Capital report, page 3.*

regulator that currently uses an automatic adjustment formula. The BCUC also utilizes an automatic adjustment formula; however, it only comes into effect if the long Canada bond yield is above 3.8%.[5]

We note that the Company's allowed ROE premium over Newfoundland Power and Nova Scotia Power was 0.75% and 0.40%, respectively, in 2010 vs. 0.95% and 0.75% in 2015. The premium has increased since the allowed ROEs have decreased both in Nova Scotia and Newfoundland and Labrador.

Table 2 - Allowed common equity ratios

Entity	2010	2011	2012	2013	2014	2015
British Columbia Utilities Commission						
Benchmark utility	40.00%	40.00%	40.00%	38.50%	38.50%	38.50%
FortisBC Energy Inc. - *gas distribution*	40.00%	40.00%	40.00%	38.50%	38.50%	38.50%
FortisBC Energy (Vancouver Island) Inc. - *gas distribution*	40.00%	40.00%	40.00%	41.50%	41.50%	N/A
FortisBC Energy (Whistler) Inc. - *gas distribution*	40.00%	40.00%	40.00%	41.50%	41.50%	N/A
FortisBC Inc. - *integrated electric*	40.00%	40.00%	40.00%	40.00%	40.00%	40.00%
PNG - West Division - *gas distribution*	45.00%	45.00%	45.00%	46.50%	46.50%	46.50%
PNG - Fort St. John/Dawson Creek - *gas distribution*	40.00%	40.00%	40.00%	41.00%	41.00%	41.00%
PNG - Tumbler Ridge - *gas distribution*	40.00%	40.00%	40.00%	46.50%	46.50%	46.50%
Alberta Utilities Commission						
Electric and gas distribution (except Altas Gas)	39-41.0%	39-41.0%	39-41.0%	38-40.0%	38-40.0%	38-40.0%
AltaGas - *electric and gas distribution*	43.00%	43.00%	43.00%	42.00%	42.00%	42.00%
Electric transmission	36-37.0%	36-37.0%	36-37.0%	36.00%	36.00%	36.00%
ATCO Pipelines - *gas distribution*	45.00%	45.00%	38.00%	37.00%	37.00%	37.00%
Ontario Energy Board						
Enbridge Gas/Union Gas - *gas distribution*	36.00%	36.00%	36.00%	36.00%	36.00%	36.00%
Hydro One/Electric Distribution *(note 1)*	40.00%	40.00%	40.00%	40.00%	40.00%	40.00%
Quebec Regie de l'Energie						
Gaz Metro - *gas distribution*	38.50%	38.50%	38.50%	38.50%	38.50%	38.50%
Nova Scotia Utility and Review Board						
Nova Scotia Power Inc. - *integrated electric*	37.50%	37.50%	37.50%	37.50%	37.50%	37.50%
Prince Edward Island Regulatory & Appeals Commission						
Maritime Electric - *integrated electric*	40.00%	40.00%	40.00%	40.00%	40.00%	40.00%
National Energy Board *(note 2)*	N/A	N/A	N/A	N/A	N/A	N/A
Board of Commissioners of Public Utilities, NL						
Newfoundland Power Inc. - *integrated electric*	45.00%	45.00%	45.00%	45.00%	45.00%	45.00%

Note 1: *Hydro One was a Crown Corporation until 2015.*
Note 2: *NEB allows a WACC on the rate base rather than an ROE and a deemed capital structure. NEB has not issued an ROE decision since 2009.*

Sources:
BCUC Order No. G-158-09; AUC Generic Cost of Capital Decisions 2009 & 2011; OEB EB-2005-0520, OEB EB-2006-0034; OEB EB-2009-0084, OEB EB-2010-002; Regie D-2009-156, Regie D-2011-182; 2010 NSUARB 6, 2011 NSUARB 184; IRAC Order UE10-03; NEB RH-1-2008 Decision; NL PUB Orders Nos. P.U. 43 (2009), P.U. 32 (2010), P.U. 17 (2012).
NL PUB Order 13 (2013), Newfoundland Power 2016/2017 General Rate Application, Maritime Electric 2016 General Rate Application, AUC Generic Cost of Capital Decision 2013, BCUC Order No. G-47-14, Emera 2014 Annual Report, Emera 2013 Annual Report, OEB cost of capital updates 2012, 2013, 2014 and 2015, Gaz Metro Q3-2015 financial reports

During the period of 2010 – 2015, we observe that the allowed common equity ratios approved by Canadian regulators have been relatively stable.

We also note that the allowed equity ratios in 2010 (during the Company's last GRA) are largely the same as in 2015.

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[5] *BCUC Generic Cost of Capital Proceeding, May 2013 Decision, Stage 1, page 91.*

Utilization of US data

The BCUC, in its 2013 decision, stated that while they accepted that there are similarities between the two jurisdictions (US and Canada), they did not accept that US data should be considered to be the same or necessarily be given equal weight as the data for Canadian utilities. The BCUC noted that Canadian investors considering US utility investments are subject to currency exchange risk that would not be the case with Canadian utility investments. Additionally, the US regulatory environment, while similar, is not identical to that of Canada. The BCUC determined that the use of US data must be considered on a case by case basis and weighed with consideration to the sample being relied upon, and any jurisdictional differences which may exist[6].

The National Energy Board ("NEB"), OEB and Quebec Regie de l'Energie ("Regie") have also accepted the use of US data and proxy groups for purposes of establishing the allowed ROE[7].

We also note that the DCF approach is largely based on identifying comparable US utilities (due to lack of Canadian available data), and the DCF approach is widely accepted by regulators in Canada.

We note that Concentric Energy Advisors, in its report, utilized three proxy groups: (1) Canadian Utility Proxy Group, (2) US Electric Proxy Group, and (3) North American Electric Proxy Group. Its ROE conclusion is primarily based on the North American Electric Proxy Group, which consists of seven US electric utilities (determined comparable based on business and financial risk using select criteria) and two Canadian investor-owned utilities that are primarily engaged in the provision of electricity (Canadian Utilities and Emera)[8].

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[6] *BCUC Generic Cost of Capital Proceeding, May 2013 Decision, Stage 1, pages 19-20.*

[7] *NEB 2008 decision, OEB 2009 decision, Regie 2009.*

[8] *Concentric Energy Advisors, Cost of Capital report, page 3, page 18.*

Risk profile and capital structure

Credit ratings

S&P continues to be the only third party agency providing a credit rating on the Company and its debt.

S&P's overall credit rating viewed on a stand-alone basis was BBB+, stable per its March 2009 report (used in the 2010 GRA). Its overall rating (including Fortis support) was also BBB+, stable. The Company's senior secured debt had a rating of A, stable[9].

S&P's overall credit rating viewed on a stand-alone basis was BBB, stable per its March 2015 report. Its overall rating was also BBB+, stable. The Company's senior secured debt had a rating of A, stable[10].

Business risks[11]

S&P defines business risk as including the following elements:

- Industry risk
    - i) Cyclicality
    - ii) Competitive risk and growth
        - a) Effectiveness of industry barriers to entry;
        - b) Level and trend of industry profit margins;
        - c) Risk of secular change and substitution by products, services, and technologies; and
        - d) Risk in growth trends.
- Country risk

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[9] *S&P rating report, Maritime Electric Co. Ltd. dated March 23, 2009.*

[10] *S&P rating report, Maritime Electric Co. Ltd. dated March 31, 2015.*

[11] *S&P Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Criteria | Corporates | General: Corporate Methodology.*

- Competitive position
    i) Competitive advantage;
    ii) Scale, scope, and diversity;
    iii) Operating efficiency; and
    iv) Profitability.

In its March 2009 report, S&P noted that the Company had a strong business risk profile[12].

In its March 2015 report, S&P noted that the Company had an excellent business risk profile[13].

Based on our initial review, the Company appears to face the same business risks as in 2010 and to have the same level of business risk as it did in 2010.

Financial risks

In its March 2009 report, S&P noted that the Company's somewhat weak financial risk profile offsets its credit strengths. The rating agency went on to mention that the Company suffered from somewhat weak free cash generation[14].

In its March 2015 report, S&P noted that the Company's aggressive financial risk profile reflects their expectation of low-but-stable cash flows and a legislated minimum equity base of 40%[15]. We recommend further investigating the reason for the historical and forecasted low-but-stable cash flows.

We also note that the Company has not disclosed in its GRA application historical and forecast key ratios used by S&P (only EBIT interest coverage ratios), which they use to assess financial risk. The core ratios used by S&P to determine financial risk are[16]:

- FFO to debt
- Debt to EBITDA

We would recommend that PEI Corp. request from the Company that historical and forecast core ratios noted above be calculated using allowed ROEs between 9% - 9.75% for sensitivity purposes. A lower allowed ROE could result in a deterioration of both core ratios which could impact the Company's debt rating.

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[12] *Ibid.*

[13] *Ibid.*

[14] *Ibid.*

[15] *Ibid.*

[16] *S&P Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Criteria | Corporates | General: Corporate Methodology.*

Based on our initial review, the Company appears to face the same financial risks as in 2010 and to have the same level of financial risk as it did in 2010.

2010 GRA findings re: risk

The Company had argued that it faced higher business risk than other Atlantic Canada investor-owned electric utilities as it operates on a small island with an undiversified economy.[17] In its latest GRA filing, the Company maintains that it has higher overall risk than other Atlantic Canadian electric utilities and comparable utilities across Canada[18]. As noted above, the Company's business risk is rated as "Excellent", which is the highest category. The Company's overall credit rating is lowered due to its comparatively weaker financial ratios. The Company's overall business risk rating is the same as Nova Scotia Power, with a slightly worse rating regarding financial risk. Therefore, Maritime Electric would have higher total risk when compared to Nova Scotia Power according to S&P. We also note that the Company's overall credit rating remains below the average A-[19] rating assigned by S&P to the universe of Canadian utilities, suggesting the Company has higher total risk.

The Commission accepted that Maritime Electric, with its responsibilities for electricity supply, is different than Ontario electric distribution utilities. The Commission viewed the differences as significant[20].

The Commission viewed Maritime Electric as a higher risk than the benchmark BC utility and Fortis BC due to a variety of factors such as utility size, nature of operations, economic climate and regulatory risk factors. As noted above, the spread between the Company's allowed ROE in 2010 vs. 2015, when compared to the benchmark BC and FortisBC allowed ROEs, has increased.

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[17] *The Island Regulatory and Appears Commission, Order UE10-03, page 21.*

[18] *Maritime Electric's 2016 GRA, page 66.*

[19] *S&P rating report, Maritime Electric Co. Ltd. dated March 31, 2015.*

[20] *The Island Regulatory and Appears Commission, Order UE10-03, page 22.*

Economic and capital market conditions

Government of Canada bond yields

Current long-term Government of Canada benchmark bond yields are below those used to establish the Company's regulated ROE as part of the 2010 GRA. **Figure 1**[21] below shows the weekly Government of Canada benchmark long-term and 10-year bond yields from January 2010 to January 2016. Between January 2010 and January 2016, both the long-term and 10-year bond yields have decreased 2.11% and 2.40%, respectively.

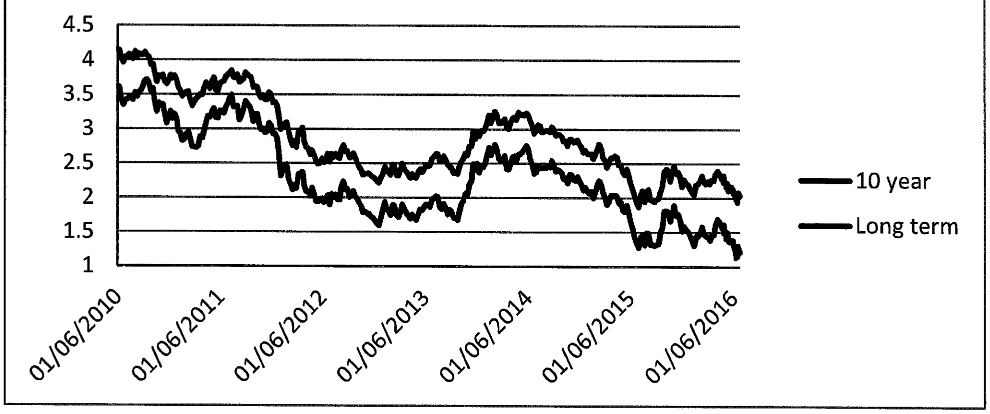


Figure 1: Government of Canada Benchmark bond yields

Real gross domestic product growth, inflation, unemployment and population growth

In **Table 3,** we have compiled key economic indicators for PEI and Canada for the period of 2010 to 2015 and also looked at available forecasts for 2015 and 2016.

[21] *Bank of Canada.*

Table 3 - Key economic indicators Canada/PEI - 2010 - 2016

	PEI Department of Finance - actual						Conference Board of Canada	
PEI	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2015F**	**2016F**
Real GDP growth %	2.2%	2.0%	1.2%	2.0%	1.5%	N/A	2.4%	1.9%
CPI - all items %	1.9%	2.9%	2.0%	2.0%	1.6%	-0.6%	0.1%	2.3%
Unemployment %	11.4%	11.0%	11.2%	11.6%	10.6%	10.4%	10.5%	10.0%
Population growth %	1.3%	1.7%	0.8%	0.1%	0.5%	0.2%	0.3%	0.5%
Canada	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2015F**	**2016F**
Real GDP growth %	3.1%	3.1%	1.7%	2.2%	2.5%	N/A	1.5%	2.1%
CPI - all items %	1.8%	2.9%	1.5%	0.9%	2.0%	1.1%	1.5%	2.3%
Unemployment %	8.1%	7.5%	7.3%	7.1%	6.9%	6.9%	6.9%	6.9%
Population growth %	1.1%	1.0%	1.2%	1.2%	1.1%	0.9%	1.0%	1.1%

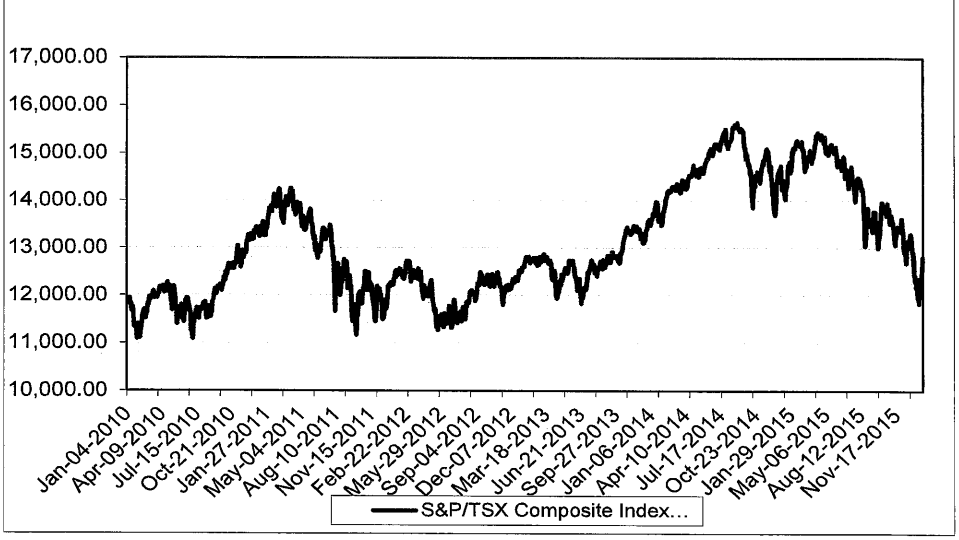
Sources:
Prince Edward Island Statistics Bureau - summary of selected economic indicators - February 1, 2016; Conference Board of Canada Provincial Outlook Summer 2015.

During the observed period, we note that the key economic indicators have been relatively stable.

S&P/TSX Composite Index

The S&P/TSX Composite Index has risen by 8% between January 2010 and January 31, 2016, reflecting the continued economic recovery; however, the increase has been far from linear as shown in **Figure 2**[22].

Figure 2: S&P/TSX Composite Index - Index Value



[22] *Capital IQ.*

Restrictions, qualifications and independence

Restrictions

This Report is not intended for general circulation or publication nor is it to be reproduced or used for any purpose other than that outlined herein without our prior written permission in each specific instance. Notwithstanding the above, we understand that our Report may be disclosed as part of a public rate hearing process, and we have given the PEI Corp. our consent to the use of our Report for this purpose. We will not assume any responsibility or liability for losses occasioned to the intended users or any third party as a result of the circulation, publication, reproduction or use of this Report contrary to the provisions of this paragraph.

The liability of Grant Thornton LLP and any of our employees or other personnel for any claim in tort or contract related to the professional services provided pursuant to our agreement is limited to the amount of professional fees actually paid for those services.

We reserve the right, but are under no obligation, to review all comments and observations included in or referred to in this Report and, if we consider it necessary, to revise our observations in light of any information that subsequently becomes known to us following the date of our Report.

Qualifications and independence

In preparing this Report, we have relied upon the documents and information listed herein.

We are not guarantors of the information upon which we have relied in preparing our Report and, except as stated, we have not audited or otherwise attempted to verify any of the underlying information or data contained in this Report.

The Report has been prepared by qualified Chartered Professional Accountants and Chartered Business Valuators. The professional work to prepare this Report and the attached analyses was performed by Troy MacDonald, CPA, CA, CBV with the assistance of qualified professional staff. Mr. MacDonald's curriculum vitae is attached as **Appendix A**.

We confirm that Mr. MacDonald and other professional staff assisting in this engagement prepared this Report acting independently and objectively.

To the best of our knowledge, we have no conflicts of interest. Our fees were not contingent on an action or event resulting from the use of our Report.

Appendix A: Troy MacDonald's curriculum vitae

CURRICULUM VITAE
Troy MacDonald, CPA, CA, CBV
Partner, Grant Thornton LLP - Toronto

Education and Professional Affiliations:

- Bachelor of Commerce from Saint Mary's University (1994), major in accounting
- Qualified as a Chartered Accountant in 1996
- Qualified as a Charted Professional Accountant in 1996
- Qualified as a Chartered Business Valuator and admitted to the Canadian Institute of Chartered Business Valuators in 2002

Professional History:

- Grant Thornton LLP
  - *National Corporate Finance Leader (January 2010 to date)*
  - *Partner, Corporate Finance & Infrastructure, Toronto, Ontario (January 2008 to date)*
  - *Senior Manager, Capital Markets, London, England (September 2006 to December 2007)*
  - *Senior Manager, Corporate Finance, Halifax, Nova Scotia (March 2003 to September 2006)*
- Emera Inc.(TSX:EMA)
  - *Corporate Development (December 2000 to March 2003)*
  - *Financial Planning (December 1999 to December 2000)*
- WBLI LLP Chartered Accountants
  - *Various positions, including Manager, Corporate Finance (March 1994 to December 1999)*

Infrastructure and Power Experience:

- Over 19 years of experience in corporate finance, with a focus on power sector and infrastructure.
- Power sector experience in regulated utilities, merchant or regulated power transmission and power generation (hydro, biomass, wind, natural gas and coal).
- Valuation engagements for assets or companies operating in infrastructure, wastewater and power.
- Financial advisory engagements for public and private sector clients in relation to infrastructure / public private partnerships and power assets.

- Financial Model review engagements in relation to power and infrastructure assets (gas fired power plants, solar power generation, transmission lines and social infrastructure assets).
- Capital Markets engagements in relation to power assets (biodiesel power generation, hydro power generation, alternative energy).

Relevant Project Experience:

- In 2015, acted as financial advisor and testified as an expert witness in regards to the regulated revenue requirement support for 2015 rate hearing associated with one of Algonquin Power's transmission assets. In addition to the cost of capital work, Grant Thornton provided financial advisory services regarding overall review of the financial case supporting the rate application.
- In 2015, acting as engagement partner for the merger of three municipally owned utilities.
- In 2015, acting as engagement partner for a strategic review of a municipally owned utility and its affiliated companies on behalf of its shareholder.
- In 2015, acted as engagement partner for a buy-side transaction for a municipally owned utility.
- In 2015, acted as engagement partner for a strategic review of a municipally owned utility on behalf of its shareholder.
- In 2015, acting as engagement partner in regards to Value for Money analysis for Metrolinx.
- In 2014, acted as engagement partner in securing over $10M of bank financing for a municipally owned utility.
- In 2014, acted as engagement partner in preparing and presenting a Proof of Concept report to three municipally owned utilities (and their board of directors) who are contemplating a possible merger. The report analysed the impact a merger would have on the viability, rate structure, operations and economic developments of each utility as a combined utility.
- In 2013/2014, acted as engagement partner in regards to a buy-side mandate for a municipally owned power utility in regards to the acquisition of another municipally owned power utility, including bid development, project management, valuation, financial modelling, arranging debt financing, due diligence and stakeholder presentations to the Board of Directors and City Council.
- In 2013, acted as engagement partner in advising on the strategy development for a municipally owned power utility in regards to evaluating options for acquisition, merger or divestiture. This included presentation to the Board of Directors.
- In 2013, acted as engagement partner in advising a municipally owned power utility in the development of financial modelling and transaction structure for power generation projects.
- In 2013, acted as cost of capital expert to the Newfoundland Public Utilities Commission in regards to the 2013/2014 Newfoundland Power general rate hearing. Newfoundland Power is a subsidiary of Fortis Inc. (TSX:FTS). This included testifying during the rate hearing.
- In a series of engagements from 2010 to 2015, acted as engagement partner for value for money and infrastructure procurement review for Metrolinx in regards to the PRESTO farecard. These engagements included regular presentations to the Metrolinx Board of Directors.
- From 2010 through 2016, acted as engagement partner to Rank Incorporated in regards to the infrastructure project for the World Trade Centre in Halifax, Nova Scotia.

- In 2012, acted as engagement partner for a biomass power development project with a regional manufacturer. This engagement included financial modelling of the project and sourcing debt and equity capital.
- In 2012, acted as co-engagement partner to the City of Edmonton on a regulatory rate review and hearing in regards to the Epcor water rate hearing.
- In 2012, acted as co-engagement partner for the refinancing of a fleet of renewable power generation projects totalling 23MW.
- From 2010 through to 2014, acted as engagement partner in regards to the valuation of power generation and infrastructure projects for Connor Clark & Lunn, an asset manager with $49 billion in assets under management.
- From 2010 through to 2014, acted as engagement partner in regards to financial modelling engagements for infrastructure projects for Brookfield Financial.
- From 2009 through to 2014, acted as engagement partner in regards to financial modelling engagements for infrastructure projects for Forum Equity.
- In 2009 and 2010, acted as financial advisor to the Columbia Power Corporation, a provincial crown corporation in British Columbia, in regards to the development and financing of the 335MW Waneta Expansion, a $900M project. This engagement included multiple presentations to the Board of Directors.
- In 2011, acted as co-engagement partner in regards to a financial modelling and tax engagement in support of a transmission development between Quebec and New York State.
- In 2009, acted as engagement partner in regards to the development of a tolling financial model for a LNG facility in Eastern Canada.
- In 2009, acted as engagement partner in regards to a financial modelling engagement for an 800MW gas fired power plant in Mississauga, Ontario.
- In 2009, acted as engagement partner in regards to a financial modelling engagement for an 800MW gas fired power plant in Northern Toronto, Ontario.
- In 2009, acted as engagement partner for the valuation of wastewater facility in support of a transaction between the City of Edmonton and Epcor. This engagement included presentation at City Council.
- As a member of the Grant Thornton UK capital markets team from 2006 through 2007, provided financial advisory services acting as nominated advisor on public listings. Power industry highlights from this experience include advising on the public flotation of a 400MW hydro power plant in India, a clean coal power technology company and a North American a biodiesel power generation company.

Grant Thornton