Q. **2018 Cost Deferral and Interim Rates Evidence - Revision 2, November 14, 2018**

Further to PUB-NLH-180 - Hydro is not seeking approval to establish a deferral account for the 2018 revenue deficiency, (other than for the 2018 depreciation expense differential between the current methodology and that accepted in the settlement agreement), while in previous proceedings it has requested approval for deferral accounts for deficiencies. Please explain why Hydro is not asking approval for a deferral account for the 2018 deficiency and what the accounting treatment will be for this deficiency. In the response explain whether the same rationale exists for the 2018 expenses associated with the Business Systems Transformation Project.

A. In Order No. P.U. 48 (2018), the Board approved the 2018 Cost Deferral which is estimated to be approximately $15.0 million. This deferral amount represents the impact of Hydro's proposed new depreciation methodology agreed upon as per the July 2018 Supplemental Settlement Agreement. Based on approval of this cost deferral, Hydro is projecting to earn a return at the lower end of the approved rate of return on rate base for 2018. As a result, Hydro is not seeking a separate deferral of its 2018 deficiency or deferral of 2018 expenses associated with the Business Systems Transformation Project.[1] For further information, please refer to Hydro's response to PUB-NLH-011 of the 2018 Cost Deferral and Interim Rates Application, which is provided as Attachment 1 to this response.

[1] Hydro intends to seek recovery of its 2018 revenue deficiency through conclusion of the 2017 GRA in 2019. While the Parties agreed to defer costs associated with the Business Systems Transformation Project in the April 11, 2018 Settlement Agreement, Hydro is not permitted to defer these costs for financial reporting purposes without an order of the Board approving the settlement agreement.

In addition to recording the 2018 Cost Deferral of approximately $15 million, for financial reporting purposes, Hydro will record revenues which are less than those reflected in the 2018 Test Year (the 2018 Deficiency) and recognize expenses (which are deferred in the 2018 Test Year) associated with the Business Systems Transformation Project in its 2018 financial results. Doing so will result in Hydro reporting a 2018 return near the bottom of the range of return on rate base when compared to the 2018 Test Year forecast. Upon the conclusion of the GRA, Hydro will record any required adjustments in accordance with the 2017 GRA Order (and the 2017 GRA settlement agreements, if approved) in its 2019 results for financial reporting purposes.

In contrast, for regulatory accounting purposes, Hydro will re-state its 2018 Annual Return to ensure that any 2018 revenues or expenses arising from a 2019 GRA Order of the Board are reflected in the correct period.

Q. In the 2013 Amended General Rate Application, the Board issued Order Nos. P.U. 58(2014), P.U. 36(2015) and P.U. 56(2016), approving cost deferral accounts for the revenue deficiency that Hydro forecast for each year as a result of the delay of rate implementation. Hydro stated that the deferral accounts were required to address the financial impacts of the delayed conclusion of the general rate application beyond the end of each year.

On page 70 of 78 of Schedule 1, in paragraph 20, Hydro proposes to recover its 2018 revenue deficiency or revenue excesses over a 20 month period commencing on the dates 2017 GRA final rates are implemented.

Please advise how Hydro intends to address the 2018 revenue deficiency included in Table 4 on page 13 of 78 of Schedule 1, and if approval is required prior to year-end of 2018.

A. <u>2018 Revenue Deficiency</u>

With respect to Hydro's 2018 revenue deficiency / excess as noted in Table 4 of the 2018 Cost Deferral and Interim Rates Application ("Application"), Hydro will seek to refund or recover these amounts, over a 20-month period, consistent with the July 2018 Settlement Agreement.[1] Hydro will recalculate Table 4 in its General Rate Application ("GRA") Compliance Application based upon the 2017 GRA Final Order and propose rates to recover any revenue deficiency or excess at that time.

[1] As per the July 16, 2018 Settlement Agreement, item numbers 20 and 21.

The Application does not propose any additional approvals with respect to its 2018 revenue deficiency prior to its 2018 year-end.

2018 Cost Deferral

Hydro's proposed change in depreciation methodology presents a different situation for the proposed 2018 Cost Deferral when compared to prior cost deferral applications.

Generally, Hydro's 2014, 2015, and 2016 cost deferral applications were due to shortfalls in revenue from rates when compared to test year revenue requirements. In this circumstance, the proposed cost deferrals were required to address material revenue shortfalls relative to forecast test year costs and permit Hydro the opportunity to earn a just and reasonable return in those fiscal years.

As shown in Table 4 of the Application, Hydro's overall 2018 revenue deficiency is forecast to be $7.3 million.[2] However, this revenue deficiency is calculated relative to Hydro's 2018 Test Year costs, which reflect the decreased depreciation expense[3] as per the July 2018 Settlement Agreement. In the absence of an order of the Board, Hydro will be required to record depreciation expense under the current methodology. The 2018 depreciation expense is forecast to be $15.0 million greater than that reflected in Hydro's 2018 Test Year revenue requirement in Table 4 of the Application. In this circumstance, Hydro's revenue deficiency will effectively be $22.3 million,[4] as revenue from rates will under collect 2018 depreciation expense.

[2] Sum of column C.
[3] Depreciation expense includes depreciation expense, loss on disposal, removal costs and disposal proceeds relating to the proposed changed in methodology.
[4] $7.3 million + $15.0 million.

Hydro is required to record an additional $15.0 million expense in 2018 due to the requirement to follow the existing depreciation methodology until a final order has been received. As a result, Hydro has proposed to record a 2018 Cost Deferral for the differential between the existing methodology and the depreciation methodology in the Settlement Agreement. If the Board were to approve the 2017 GRA Supplemental Settlement Agreement (including the change in depreciation methodology) in 2019 and does not approve the 2018 Cost Deferral, Hydro would be required to reverse the additional 2018 expense related to the depreciation methodology in fiscal 2019. This will result in Hydro earning materially less than the lower end of its allowed rate of return in 2018 due to the use of existing depreciation methodology. Subsequently in 2019, Hydro's forecast earnings would materially increase above the mid-point of the allowed range of return on rate base due to the recovery of the $15.0 million in depreciation expense which would have been already recognized in 2018.

If the 2018 Cost Deferral is approved, Hydro will be permitted to prepare its financial results for 2018 in a manner which reflects the reduction in Hydro's costs consistent with the cost reduction provided by approval of the depreciation methodology agreed to in the July 2018 Supplemental Settlement Agreement. Approval of the Application will have no impact on Hydro's customers or customer rates.[5]

[5] Upon conclusion of the GRA and approval of the 2017 GRA settlement agreements in 2019, Hydro would complete a restatement of property, plant and equipment based upon the new depreciation methodology effective January 1, 2018. The restatement would result in an elimination of the 2018 cost deferral and a corresponding increase to property, plant and equipment.