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October 22, 2021

Board of Commissioners of Public Utilities
Prince Charles Building
120 Torbay Road, P.O. Box 21040
St. John's, NL A1A 5B2

Attention: Ms. Cheryl Blundon
Director of Corporate Services & Board Secretary

Dear Ms. Blundon:

Re: Supply Cost Accounting Application – Hydro's Reply

On July 29, 2021, Newfoundland and Labrador Hydro ("Hydro") filed an application with the Board of Commissioners of Public Utilities ("Board") for approval of deferral account proposals to address material changes in system costs associated with the integration of the Muskrat Falls Project ("Project") assets to the provincial electricity system ("Application").

On October 15, 2021, Newfoundland Power Inc. ("Newfoundland Power"), the Island Industrial Customer Group ("IIC") and the Consumer Advocate filed written submissions on Hydro's Application. No further comments were received from other parties.

1.0 Background

The commissioning of the Project and the subsequent interconnection of the Island Interconnected System with Labrador by way of the Labrador-Island Link ("LIL"), and the North American grid by way of the Maritime Link will result in a major change in the source of supply of electricity to the island of Newfoundland. Upon the commissioning of the Project, Hydro will be required to begin supply cost payments under the Muskrat Falls Power Purchase Agreement ("Muskrat Falls PPA") and the Transmission Funding Agreement ("TFA").

In light of the current Project schedule and the in-service date anticipated for the LIL, Hydro anticipates there will be a delay between when Hydro is required to begin making payments under the Project agreements and when rate mitigation and/or recovery through customer rates will occur. The final financial structure chosen for the Muskrat Falls PPA will dictate the level of rate mitigation required annually. To mitigate the impact of potential financial losses in 2021 and possibly 2022, resulting from what are expected to be imminent Project payments, and to deal with changes in supply cost for the provincial system, Hydro proposed the creation of the Supply Cost Variance Deferral Account, and the related discontinuance of the existing Rate Stabilization Plan ("RSP") and its other existing supply cost deferral accounts.

Hydro's Application also requested approval of deferred recovery of accelerated depreciation costs associated with the Holyrood Thermal Generating Station ("Holyrood TGS"), deferral of the contributions required from Hydro for sustaining capital investments in accordance with the Muskrat

Falls PPA, and deviation from International Financial Reporting Standards ("IFRS") with respect to expense recognition of Project costs.

2.0 Supply Cost Variance Deferral Account

As noted above, the proposed Supply Cost Variance Deferral Account is structured to address the issues related to the timing of Project related payments and the financial ramifications to Hydro that would likely arise as a result. The proposed deferral account would also provide for rate mitigation funding and/or rate changes implemented solely to recover Project costs to be applied to the proposed deferral account to offset Project charges to Hydro. The proposed approach would effectively isolate the net effect of the Project costs and rate mitigation (and/or Project related rate increases) in a deferral account and enable Hydro's next general rate application ("GRA") to proceed in an orderly manner to enable the development of a long-term plan to establish customer rates that will provide recovery of Project costs, net of rate mitigation funding that may be made available.

An additional aspect of this proposed deferral account is Hydro's proposal to replace the RSP and other supply cost deferral accounts with the Supply Cost Variance Deferral Account. As Hydro noted in its revised response to PUB-NLH-021, maintaining a new deferral account that addressed only Project related costs and credits would not account for No.6 fuel savings resulting from the reductions in thermal generation due to purchases from the Project. Those fuel savings would instead accrue to Hydro's net income. Replacing the RSP and other supply cost deferral accounts with the proposed Supply Cost Variance Deferral Account would enable the fuel savings to offset Project costs after commissioning. Additionally, the continued operation of the RSP and the Revised Energy Supply Cost Deferral Account in combination with a new standalone Project cost deferral account would increase complexity in understanding what the balances in each account represent.

Hydro proposes to transfer the RSP and other supply cost deferral account balances to the Supply Cost Variance Deferral Account as of the effective date of the proposed deferral account.[1] Hydro is concerned that allocation of balances in RSP components to the RSP Current Plan, such as that discussed in Hydro's response to PUB-NLH-038, provides potential rate shock for the IIC in 2022; as such, Hydro proposes that the allocation of those balances will be addressed at a later date, subsequent to the review by the Board and parties of Hydro's submissions regarding the long-term approach to the Supply Cost Variance Deferral Account in its next GRA. This proposal also allows Hydro to be better informed on customer rate impacts, taking into consideration any details of rate mitigation, before finalizing a recovery plan for costs currently owed from customers.

Newfoundland Power, in its submissions dated October 15, 2021, noted that in their view ". . . it is important for the parties charged with implementing rate mitigation to understand how Project costs are being treated by Hydro, including the recognition of large balances owing from Newfoundland

[1] The effective date is proposed to be the date upon which Hydro is first required to begin payments under the Muskrat Falls PPA.

Power's customers." In Hydro's view, the proposed deferral account successfully provides this transparency as each cost component is easily identifiable and calculated.

2.1 Intervenor Submissions

Newfoundland Power indicated that they are supportive of Hydro's cost deferral account proposals, with the exception of Hydro's proposal to calculate finance charges on the Supply Cost Variance Deferral Account on a monthly basis using Hydro's approved test year weighted average cost of capital ("WACC"). The IIC, in their October 15, 2021 submissions, also advised that they took no issue with the proposed discontinuance of the RSP and Hydro's other existing supply cost deferral accounts; however, similar to Newfoundland Power they did contest Hydro's use of WACC as the measure of the financing costs for amounts accruing in the proposed Supply Cost Variance Deferral Account. The IIC also provide submissions regarding the permanence of the deferral account definition, and Hydro's proposal to include only those proceeds from the sale of greenhouse gas credits that occurred subsequent to the implementation of the deferral account. The Consumer Advocate, similarly, did not oppose Hydro's Application for the establishment of a deferral account for Project costs, nor did the Consumer Advocate challenge the structure of the deferral account or any of the other proposals made by Hydro. The Consumer Advocate proposed a delay on the decision by the Board regarding the Application, pending receipt of additional information by Hydro which would ". . . impact Hydro's financial position and its proposed method of cost recovery."[2] Hydro's responses to these particular issues are as follows.

2.1.1 Financing Charges

As indicated above, both Newfoundland Power and the IIC took issue with Hydro's proposal to charge financing costs on the monthly balance in the Supply Cost Variance Deferral Account at Hydro's approved test year WACC. Hydro's proposal to charge financing costs based on its approved test year WACC is consistent with the longstanding treatment of the RSP and past practice of the Board through use of the asset rate base method, whereby utility deferral accounts are included in rate base.

The new balances in the deferral account resulting from payments under the Project agreements are expected to be financed using short-term borrowings until Hydro's next GRA. As a result, both Newfoundland Power and the IIC propose instead to compute financing charges at Hydro's short-term interest rate. The submissions of Newfoundland Power and the IIC do not appear to consider that a material balance will transfer into the Supply Cost Variance Deferral Account from the RSP and Revised Energy Supply Cost Deferral Account. Depending on the date of the transfer, this opening balance is projected to be approximately $95 million;[3] a large portion of that balance would relate to the RSP Hydraulic Variation Component, representing a deferral of historical fuel costs. As such, a material portion of the total Supply Cost Variance Deferral Account balance is expected to be recovered over the long-term for which Hydro would normally, pursuant to current RSP Rules, recover its financing costs based on its approved Test Year WACC.

Hydro's belief that the use of WACC for computing financing charges for balances that require ongoing recovery over the long term is appropriate is unchanged. This position is consistent with past practice with respect to financing deferral accounts in this jurisdiction. However, given the unique circumstances

[2] "Newfoundland and Labrador Hydro – Supply Cost Accounting Application," Consumer Advocate, October 15, 2021, p. 2.
[3] NP-NLH-010 indicates $85 million in historic fuel costs. However, there is an additional $10 million estimated for the current plan balances being transferred.

in which Hydro expects rate mitigation payments to materially offset the unrecovered portion of Project payments until the conclusion of Hydro's next GRA, Hydro believes it is not unreasonable to deviate from the use of WACC in this circumstance. Given the blending of the historical balances from Hydro's existing deferral accounts with the payments under the Project agreements in the Supply Cost Variance Deferral Account, Hydro proposes the use of its 2019 Test Year Embedded Cost of Debt which would still grant Hydro a reasonable opportunity to recover the cost of financing the deferral account balances until the conclusion of its next GRA.[4]

2.1.2 Greenhouse Gas Performance Credits

Hydro's Application proposes to credit revenues earned from the sale of greenhouse gas performance credits, for all sales which take place after the approval of the Supply Cost Variance Deferral Account. This proposal was made in order to provide the value of these credits to Hydro's customers on a prospective basis.

The IIC submit that all revenues from greenhouse gas performance credits should be credited to the account on a retroactive basis back to 2019.[5] While the IIC did not specifically address the issue of retroactive ratemaking, they state that because the proposed Supply Cost Variance Deferral Account "…will have rolled into it balance from existing deferral accounts" it cannot be considered to be *tabula rasa*.

With respect to funds residing in existing deferral accounts, the Newfoundland and Labrador Court of Appeal stated:

> The operation of deferral accounts is permissible under the existing regulatory scheme in this province regardless of whether it might be argued they incidentally have retrospective or retroactive effect. Deferral accounts are utilized in public utility regulation to deal with the effects of uncertain or volatile costs in a manner that ensures that rates are reasonable, not unjustly discriminatory and that the utility earns a just and reasonable return. They permit the recovery or rebate in a subsequent period of any deficiency or excess between forecast and actual costs. Regulatory regimes generally permit the operation of deferral accounts.[6]

Hydro notes that revenues from the sale of greenhouse gas performance credits are not included in any of its existing deferral accounts, nor Hydro's test year forecasts. As such, Hydro submits that they cannot be considered to be encumbered revenues. Were such a broad interpretation of encumbered revenues from deferral accounts to be used, as proposed by the IIC, any cost or revenue variance between test

[4] Should the Board determine financing charges other than WACC are appropriate in the short-term until Hydro's next GRA, Hydro will include in its next GRA a proposal to apply financing charges at a rate consistent with the expected recovery period of the Supply Cost Variance Deferral Account.
[5] "Hydro Supply Cost Accounting Application – Island Industrial Customer Group Submission," Island Industrial Customer Group, p. 7/17–20.
[6] Newfoundland and Labrador Hydro v. Newfoundland and Labrador (Board of Commissioners of Public Utilities), 2012 NLCA 38 (CanLII), para. 63.

years regardless of its prior approval for deferral could theoretically be retroactively encumbered so long as any deferral account existed when the cost variance occurred.

Without any prior approval to defer of these revenues, Hydro submits that the IIC proposal amounts to retrospective ratemaking with respect to greenhouse gas performance credit revenues. As noted by the Court of Appeal:

> More broadly, it also yields a presumption (which is of benefit to the utility as well), flowing from the idea that the Board acts prospectively in setting rates, that the Board cannot or, even if it has jurisdiction, should not as a general rule, make orders that have the retroactive effect of disturbing existing rights already enjoyed by the utility. In practical terms, it leads to the argument that where rates, tolls and charges have been approved by the Board as being permissible for the utility to charge, the Board cannot or should not make a subsequent order that has the direct or indirect effect of reducing or otherwise changing those rates. In other words, changing past transactions or attaching new consequences to past transactions would be prohibited.[7]

Hydro submits that, consistent with the principles of predictability and fairness in ratemaking and the findings of the Court of Appeal, that revenues associated with the sale of greenhouse gas performance credits in 2019 and 2020 should not be retroactively included in the Supply Cost Variance Deferral Account as proposed by the IIC.

With respect to the 2021 sale of greenhouse gas performance credits, as Hydro's Application seeks approval of a deferral account to allow for the recovery of 2021 costs and to give Hydro the opportunity to earn and just and reasonable return in 2021, Hydro would not oppose the inclusion of 2021 Greenhouse Gas Performance Credit revenues in the Supply Cost Variance Deferral Account.

2.1.3 Proposal of Methodology for Recovery

The IIC submitted that Hydro's proposals for the methodology and mechanisms for recovery should be made through its GRA, to allow for sufficient opportunity for a fulsome review. Additionally, the IIC felt that the proposed deferral account definition components should be considered to be interim and preliminary, and be subject to full review and revision in the context of Hydro's proposed recovery methodology in the GRA.

As Hydro noted in its response to PUB-NLH-003, although Hydro has not made this particular Application on an interim basis, the intent is that the proposed deferral account will serve to deal with the transition to incorporating Project costs into customer rates. Hydro advised of its intent to provide evidence in its next GRA regarding its proposed methodology and mechanism of recovery of Project costs, as well as its proposed long-term approach to the Supply Cost Variance Deferral Account. This will permit Hydro to obtain more details regarding the rate mitigation plan and to have more certainty regarding the balances in the deferral account to more properly inform the disposition proposals. Subsequent to that detailed review, Hydro will file an application with the Board to deal with the allocation and recovery of the balance in the deferral account proposed in this Application. The future application will be premised

[7] Section 101 of the Public Utilities Act (Newfoundland) (Re), 1998 CanLII 18064 (NL CA), para. 80.

on the conclusions of the discussion and analysis in the GRA. Hydro submits that what it has proposed addresses the concerns raised by the IIC and the Consumer Advocate in this regard.

The Consumer Advocate, as noted above, suggested the Board's decision on this Application should be delayed to allow Hydro time to obtain information which could impact its proposed method of cost recovery. As Hydro noted in the introduction to this reply submission, Hydro's proposals are intended to mitigate the financial impact of anticipated Project payments expected in the near term. A delay with respect to the implementation of a deferral account to capture these costs would introduce additional financial risk to Hydro.

Finally, Newfoundland Power suggested that Hydro should include reporting on its Supply Cost Variance Deferral Account balances in its quarterly update regarding the timing of its next GRA. Hydro agrees to provide an update with any available information; however, Hydro suggests that it would be more appropriate to provide those updates in its Quarterly Regulatory Reports.

3.0 Holyrood TGS Accelerated Depreciation Deferral Account

At present, there is uncertainty as to whether an extension of the Holyrood TGS facility as a generation facility will be required beyond March 31, 2023. As a result of this uncertainty, there is the potential for material depreciation cost volatility. To address this uncertainty and volatility, Hydro proposed the creation of the Holyrood TGS Accelerated Depreciation Deferral Account to defer the difference between the actual accelerated depreciation at the Holyrood TGS in 2022 and the approved 2019 Test Year Costs. This is intended to avoid negative impacts on Hydro's 2022 earnings as a result of investments in the Holyrood TGS prudently incurred to provide reliable service to customers, as Hydro's next GRA is not likely to conclude before 2023.

3.1 Intervenor Submissions

The IIC take issue with Hydro's proposed Holyrood TGS depreciation deferral account, submitting that it is unnecessary, and inconsistent with fair prospective ratemaking. Hydro does not agree with this assertion and submits that the evidence provided supports a different conclusion.

The commissioning date for the Project has changed several times since Project sanctioning. These changing dates have created material uncertainty with respect to the concluding date for the Holyrood TGS as a generating facility. Even with the most recent end of generation date of March 31, 2023, the IIC submit this is "at best, implausible".[8] The decommissioning date of the Holyrood TGS plant is being impacted by several factors beyond Hydro's control, such as the commissioning of the LIL. Hydro submits that this uncertainty only serves to support Hydro's proposal, as deferral accounts are commonly used by regulators to address uncertain or volatile costs.

Hydro has made, and will continue to make, significant investments in the Holyrood TGS plan to ensure it meets its statutory obligation to provide customers with reliable service consistent with least cost under the *Electrical Power Control Act, 1994* ("*Act*").[9] The additional capital investments that Hydro has made since the 2019 Test Year were necessary and prudent to ensure the Holyrood TGS can continue to

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[8] "Hydro Supply Cost Accounting Application – Island Industrial Customer Group Submission," Island Industrial Customer Group, p. 8/12–14.
[9] *Electrical Power Control Act*, 1994, SNL 1994, c E-5.1, s. 3(b)(iii).

reliably operate as a generator; the evidence in this proceeding shows that depreciation costs resulting from these additional investments have materially offset reductions in depreciation due to the extension of the generation life of the Holyrood TGS.[10] It would not be reasonable to only consider the depreciation savings from the change in asset life assumptions without recognizing the increase in depreciation expense for new assets that have resulted from having to make capital investments to enable the extension of the assets' service life.

Pursuant to Section 80(2) of the *Public Utilities Act* ("*Act*"), Hydro is entitled to recovery of costs that the Board may allow as reasonable and prudent. Hydro submits that the opportunity to recover prudently incurred capital costs need not strictly take place in a GRA, as noted by the IIC.[11] Hydro's Application seeks approval to defer these costs on a prospective basis, consistent with fair and prospective ratemaking.

Hydro's position is supported by the Newfoundland and Labrador Court of Appeal which states that:

> Deferral accounts are utilized in public utility regulation to deal with the effects of uncertain or volatile costs in a manner that ensures that rates are reasonable, not unjustly discriminatory and that the utility earns a just and reasonable return. They permit the recovery or rebate in a subsequent period of any deficiency or excess between forecast and actual costs. Regulatory regimes generally permit the operation of deferral accounts.[12]

Table 1 summarizes the data from Hydro's response to IIC-NLH-020, showing Hydro's actual Holyrood TGS Accelerated Depreciation expense versus the revenue requirement included in the 2019 Test Year.[13]

Table 1: Holyrood TGS Accelerated Depreciation Summary
($ Millions)

Holyrood TGS Accelerated Depreciation	**2019 Actual**	**2020 Actual**	**2021 Forecast**	**2022 Forecast**	**2023 Forecast**
2019 Tear Year	19.0	19.0	19.0	19.0	19.0
Actual / Forecast	21.6	16.3	16.8	32.2	5.9
Variance	**(2.6)**	**2.7**	**2.2**	**(13.2)**	**13.1**

As noted in Table 1, taking into account all of Hydro's approved Holyrood accelerated capital expenditures, it is clear that Hydro has not seen "material reductions in depreciation expense" which served to "increase Hydro's net income" as purported by the IIC.[14] Further, the forecast depreciation

[10] IIC-NLH-020.
[11] "Hydro Supply Cost Accounting Application – Island Industrial Customer Group Submission," Island Industrial Customer Group, p. 9/3–9.
[12] Newfoundland and Labrador Hydro v. Newfoundland and Labrador (Board of Commissioners of Public Utilities), 2012 NLCA 38 (CanLII), para. 63.
[13] Including assets that were subsequently identified as Holyrood TGS Accelerated.
[14] "Hydro Supply Cost Accounting Application – Island Industrial Customer Group Submission," Island Industrial Customer Group, p. 8.

variances in 2022 is materially higher than what is currently recovered through customer rates, and is of such a magnitude that Hydro may not have the opportunity to earn a just and reasonable return in 2022.

Hydro's proposal to defer material variations in depreciation expense at the Holyrood TGS is consistent with the *EPCA*, the *Act,* and the findings of the Newfoundland and Labrador Court of Appeal with respect to deferral accounts.

Newfoundland Power is supportive of Hydro's proposed Holyrood TGS Accelerated Depreciation Deferral Account; however, Newfoundland Power suggested that Hydro should also include 2023 depreciation expense in the proposed deferral account as it is forecast to be materially lower than what is reflected in current customer rates. Hydro anticipates that 2023 will likely be a test year for its next GRA and inclusion of the 2023 Holyrood TGS depreciation in the deferral account is unnecessary. However, if that assumption were to change, Hydro would not object to including 2023 depreciation in the deferral account; however, the deferral account definition would need to be revised to allow it.

4.0 Deviation from IFRS

Hydro's proposal to deviate from IFRS would allow Hydro to recognize the power purchase costs relating to the delivery of post-commissioning energy in accordance with the commercial terms of the Muskrat Falls PPA and TFA. This deviation would not impact customers, but would be consistent with Hydro's past regulatory accounting practices. Hydro further proposed the creation of the Muskrat Falls PPA Sustaining Capital Deferral Account to defer the contributions made by Hydro, in accordance with the Muskrat Falls PPA, for sustaining capital investments.

4.1 Intervenor Submissions

Newfoundland Power's submissions indicated their support for these IFRS deviations. The IIC indicated they did not have any objection to, or comment to make on, the IFRS deviations or the Muskrat Falls PPA Sustaining Capital Deferral Account. The Consumer Advocate did not make any comment with respect to Hydro's proposed IFRS deviations.

5.0 Summary

Hydro's proposed Supply Cost Variance Deferral Account, proposed to become effective in the month when the initial payment is required under the Muskrat Falls PPA, will serve to enable deferral of material supply cost variances from those reflected in current rates until the conclusion of Hydro's next GRA. Hydro submits that its proposals are necessary for deferral of the net increase in costs incurred by Hydro as a result of the Project until rate mitigation is provided by government or a cost recovery plan can be established for future recovery from customers, to enable the supply cost deferral accounts to operate and reflect changes in future supply cost variability on the Island Interconnected System, and to be consistent with legislation and provide Hydro the opportunity for recovery of Project charges.

The proposed changes outlined in the Application will enable Hydro's next GRA to proceed in an orderly manner and enable the development of a long-term plan for establishment of customer rates to provide recovery of Project costs, net of rate mitigation funding that may be made available. Hydro requests that its Application be approved as submitted.

Should you have any questions, please contact the undersigned.

Yours truly,

NEWFOUNDLAND AND LABRADOR HYDRO

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