

Requests for Information

1 NP-CA-004           **Reference: *Comments on Newfoundland Power’s 2022 Capital Budget***  
2 ***Application*, Elenchus Research Associates Inc., August 13, 2021, page**  
3 **14, lines 4-6 and page 24, lines 8-10.**

4  
5           ***“For example, an alternative with a short service life may offer***  
6 ***significant value in terms of future flexibility (option value) that justifies***  
7 ***a higher total cost over the service life of the longest-lived alternative.”***

8  
9           ***and***

10  
11           ***“A more significant consideration when comparing a long-lived asset to***  
12 ***an alternative with a shorter life, such as the hypothetical DER project in***  
13 ***the table above, is the option value provided by the more flexible***  
14 ***alternative.”***

15  
16 **QUESTION:**           **How are utilities and regulators valuing future flexibility in the**  
17 **comparison of alternatives, and how is the “option value” of the**  
18 **hypothetical DER project determined? Please provide examples of**  
19 **regulatory guidance from other Canadian jurisdictions that address**  
20 **option value.**

21  
22 **RESPONSE:**           The “hypothetical DER project” referred to in the quotation is the  
23 illustrative example included in the Elenchus Report. A hypothetical option  
24 value could be calculated by comparing the NPV of the two DER scenario  
25 options (one with sequential projects required versus one with the second  
26 of the two sequential projects not required) and then calculating the option  
27 value as the difference between the two scenarios multiplied by the  
28 estimated probability that the second of the two projects will not be required  
29 as a result of industry evolution / disruption.

30  
31           As far as Elenchus is aware, Canadian electric utilities and regulators have  
32 not yet adopted the standard practice of non-regulated corporations  
33 pursuing profitable projects to use their best estimate of the economic life  
34 of potential asset investments rather than physical lives that they consider  
35 unrealistic. For a shareholder-owned company to justify an investment. in  
36 an asset based on a physical life that exceeds the expected economic life of  
37 the asset would violate management’s fiduciary duty to its shareholders.

38  
39           Enlightened electric utilities appear to be pursuing the modernization of  
40 regulatory guidance through policy processes rather than through  
41 introducing changes to long-standing practices on a case-by-case basis.

42  
43           Australia’s Regulatory Investment test, as mandated by its National  
44 Electricity Rules, requires investment proponents to consider option value

*Requests for Information*

1 in its cost-benefit analyses.<sup>7</sup> Option value is considered by performing a  
2 scenario analysis that compares inflexible long-term investments against  
3 flexible investments in which decisions are made at some point in the future  
4 based on the scenario (i.e., low demand vs. high demand).<sup>8</sup>  
5

---

<sup>7</sup> National Electricity Rules, clause 5.17.1(c)(4)(vi).

<sup>8</sup> An illustrative example is provided as Example 30 in the Australian Energy Regulator's [Regulatory investment test for distribution](#) (page 84 to 89).