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November 21, 2025

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

Attention: Jo-Anne Galarneau
Executive Director and Board Secretary

Re: Application for Approval of a Deferral Account for an Allowance for Funds Used During Construction

Enclosed is Newfoundland and Labrador Hydro's ("Hydro") application for approval of a deferral account for an allowance for funds used during construction.

Hydro's application, particularly Schedule 1 to the application, provides support for the proposed deferral account, the definition of which is included in Schedule 2.

Should you have any questions, please contact the undersigned.

Yours truly,

NEWFOUNDLAND AND LABRADOR HYDRO

Shirley A. Walsh
Senior Legal Counsel, Regulatory
SAW/rr

Encl.

ecc:

Board of Commissioners of Public Utilities
Jacqui H. Glynn
Ryan Oake
Board General

Consumer Advocate
Dennis M. Browne, KC, Browne Fitzgerald Morgan & Avis
Stephen F. Fitzgerald, KC, Browne Fitzgerald Morgan & Avis
Sarah G. Fitzgerald, Browne Fitzgerald Morgan & Avis
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Linde Canada Inc.
Sheryl E. Nisenbaum
Peter Strong

Newfoundland Power Inc.
Dominic J. Foley
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Regulatory Email

Teck Resources Limited
Shawn Kinsella

Island Industrial Customer Group
Paul L. Coxworthy, Stewart McKelvey
Denis J. Fleming, Cox & Palmer
Glen G. Seaborn, Poole Althouse

Approval of a Deferral Account for an Allowance for Funds Used During Construction

November 21, 2025

An application to the Board of Commissioners of Public Utilities

newfoundland labrador hydro

IN THE MATTER OF the *Electrical Power Control Act, 1994*, SNL 1994, Chapter E-5.1 ("*EPCA*") and the *Public Utilities Act*, RSNL 1990, Chapter P-47 ("*Act*"), and regulations thereunder; and

IN THE MATTER OF an application by Newfoundland and Labrador Hydro ("Hydro") pursuant to Section 58 of the *Act*, for the approval of a deferral account for an Allowance for Funds Used During Construction ("AFUDC").

To: The Board of Commissioners of Public Utilities ("Board")

THE APPLICATION OF HYDRO STATES THAT:

A. Background

1. Hydro is a corporation continued and existing under the *Hydro Corporation Act, 2024*, is a public utility within the meaning of the *Act*, and is subject to the provisions of the *EPCA*.

2. Under the *Act*, the Board has the general supervision of public utilities and requires that a public utility submit for the approval of the Board the rates, tolls, and charges for the service provided by the public utility and the rules and regulations which relate to that service.

3. On April 30, 2020, the Board requested that Newfoundland Power Inc. ("Newfoundland Power") and Hydro each submit a report on the utilities' respective capitalization policies and guidelines.

4. Hydro's *Review of Capitalization Policies and Guidelines* report was submitted on August 14, 2020 and is provided as Schedule 1, Appendix A to this application.

5. Hydro adopted International Financial Reporting Standards ("IFRS") as of January 1, 2014, as approved in Board Order No. P.U. 13(2012). Prior to adopting IFRS, Hydro capitalized borrowing costs directly attributable to capital construction projects with a substantial duration based on its allowed rate of return.[1] This was aligned with regulatory accounting for capitalization of borrowing costs and referred to as AFUDC.

[1] Approved rate of return on average rate base.

6. Upon adopting IFRS, Hydro must capitalize borrowing costs directly attributable to capital construction project with a substantial duration using Hydro's embedded cost of debt referred to as Interest During Construction ("IDC"). Unlike regulatory accounting, IFRS does not recognize the cost of equity in its calculation of capitalization of borrowing costs.

7. A report from JT Browne Consulting, provided as Attachment 1 to Hydro's *Review of Capitalization Policies and Guidelines,* Schedule 1, Appendix A, provided discussion on the topic of Hydro's capitalization and the differences between accounting and regulatory views of capitalization. The capitalization of borrowing costs is one of the differences between accounting and regulatory capitalization highlighted in that report.

8. The differences between the capitalization of borrowing costs under IFRS and regulatory accounting since Hydro's adoption of IFRS have been relatively small; however, as of 2025, the minimal nature of the differences is not expected to continue. With a number of longer-term, higher cost construction projects anticipated over the next number years, combined with a decreasing embedded cost of debt, Hydro is expecting significant increases in the differences between the two approaches. This is illustrated in Table 1 of Schedule 1 to this application.

9. As noted in Schedule 1, continued utilization of the IFRS methodology for capitalization of borrowing costs would be inconsistent with accepted regulatory accounting practices as customers would not be paying for all financing costs associated with capital assets that provide benefit beyond a single year.

10. Hydro submits that it is appropriate for Hydro to capitalize borrowing costs based on its allowed rate of return. Hydro proposes to calculate the capitalization of borrowing costs using the AFUDC methodology. The AFUDC methodology capitalizes directly attributable borrowing costs during asset construction using Hydro's allowed rate of return. This approach will align Hydro more accurately with accepted regulatory treatment of capital borrowing costs.

11. To facilitate this, Hydro proposes the creation of a new deferral account called the AFUDC Deferral Account, effective January 1, 2025, the definition of which is attached as Schedule 2 to this application. Any variances between the calculation of AFUDC and IDC for IFRS reporting purposes will be captured in the AFUDC Deferral Account on a monthly basis.

12. As discussed in Section 2.2 of Schedule 1, Hydro is also proposing to amortize the balance in the proposed deferral account using the composite depreciation rate derived from the most recent

depreciation study accepted by the Board, commencing in the year after the variance transfers to the AFUDC Deferral Account.

13. The proposed AFUDC Deferral Account enables the deferral and recovery of variances between IFRS and regulatory accounting for capitalized borrowing costs over an amortization period consistent with capitalization.

B. Hydro's Requests

14. Hydro requests the Board approve:

(i) The proposed AFUDC Deferral Account, for which the account definition is provided in Schedule 2, to be effective as of January 1, 2025; and

(ii) Hydro's amortization of the balance in the AFUDC Deferral Account using the composite depreciation rate derived from the most recent depreciation study accepted by the Board, commencing in the year after the variance transfers to the AFUDC Deferral Account.

C. Communications

15. Communications with respect to this application should be forwarded to Shirley A. Walsh, Senior Legal Counsel, Regulatory for Hydro.

DATED at St. John's in the province of Newfoundland and Labrador on this 21st day of November 2025.

NEWFOUNDLAND AND LABRADOR HYDRO

Shirley A. Walsh
Counsel for the Applicant
Newfoundland and Labrador Hydro
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St. John's, NL A1B 4K7
Telephone: (709) 685-4973

Schedule 1

Allowance for Funds Used During Construction

Contents

List of Appendices

1.0 Background

On April 30, 2020, the Board of Commissioners of Public Utilities ("Board") requested that Newfoundland Power Inc. ("Newfoundland Power") and Newfoundland and Labrador Hydro ("Hydro") each submit a report on the utilities' respective capitalization policies and guidelines.

Hydro's *Review of Capitalization Policies and Guidelines* ("Review"), included as Appendix A to this report, was submitted on August 14, 2020. The Review included a discussion of Hydro's capitalization practices in the context of the results of a jurisdictional scan as well as a report from JT Browne Consulting, provided as Attachment 1 to the Review, on the topic of Hydro's capitalization and the differences between accounting and regulatory views of capitalization.

The capitalization of borrowing costs is one of the differences between accounting and regulatory capitalization highlighted in the JT Browne Consulting report. Prior to adopting IFRS,[1] Hydro capitalized borrowing costs directly attributable to capital construction projects with a substantial duration[2] based on its allowed rate of return.[3] This was aligned with regulatory accounting for capitalization of borrowing costs and referred to as AFUDC.[4] Upon adopting IFRS, Hydro capitalized borrowing costs directly attributable to capital construction projects with a substantial duration using Hydro's embedded cost of debt referred to as IDC.[5] Unlike regulatory accounting, IFRS doesn't recognize the cost of equity in its calculation of capitalization of borrowing costs.

The JT Browne Consulting report indicates that a major difference between Regulatory Accounting Principles and IFRS is the capitalization of borrowing costs. Since Hydro's adoption of IFRS, the differences between the capitalization of borrowing costs under IFRS and regulatory accounting have been relatively small. This is due to the comparability between Hydro's allowed rate of return and its embedded cost of debt, as well as the smaller spend on projects of substantial duration upon which capitalization of borrowing costs would be applied. Therefore, implementing one methodology versus the other would have little impact on customers and the exclusion of the cost of equity from capitalized borrowing costs would not materially impact cost recovery. However, Hydro is expecting the differences

[1] International Financial Reporting Standards ("IFRS").
[2] Hydro considers substantial duration to be projects with a construction period greater than six months.
[3] Approved rate of return on average rate base.
[4] Allowance for funds used during construction ("AFUDC") includes the cost of debt and equity financing.
[5] Interest during construction ("IDC").

between approaches to increase significantly, beginning in 2025, as a result of the increasing spend on projects of substantial duration over the next number of years, combined with a decreasing embedded cost of debt. These changes are resulting in less borrowing costs being capitalized under IFRS than would be under regulatory accounting. As a result, Hydro's current approach under IFRS methodology for capitalization of borrowing costs is inconsistent with accepted regulatory accounting principles as customers are currently not paying the full financing cost associated with the construction of assets which provide benefit beyond a single year.

Hydro believes it is appropriate to capitalize borrowing costs based on its allowed rate of return. Hydro is proposing an AFUDC Deferral account to capture the variance between the capitalization of borrowing costs under IFRS and those capitalized under regulatory accounting to be amortized and recovered over a period consistent with capitalization.

Hydro's proposed AFUDC Deferral account definition, provided as Schedule 2 to this Application, and evidence on this matter as outlined below is provided to support the deferral of variances between AFUDC and IDC effective January 1, 2025.

2.0 AFUDC

Hydro proposes to calculate the capitalization of borrowing costs using the AFUDC methodology. The AFUDC methodology capitalizes directly attributable borrowing costs during asset construction using Hydro's allowed rate of return. This approach will align Hydro more accurately with accepted regulatory treatment of capital borrowing costs.

2.1 Capitalization of AFUDC

Since adopting IFRS, Hydro has been capitalizing borrowing costs using IDC. Table 1 shows the comparison between the two capitalized borrowing cost calculations, AFUDC and IDC. The table includes actual IDC balances recorded by Hydro during the years 2015 to 2024, as well as forecasted[6] IDC for 2025, 2026 and 2027. The AFUDC balances are calculated using Hydro's allowed rate of return and applying it to the same qualifying capital construction costs used to calculate the IDC in each year.

[6] Forecasted 2025, 2026 and 2027 IDC is using the most recent forecasted 2025 data for IDC based on actuals to September 2025 and forecast for the remainder of the 2025, 2026 and 2027 forecast is based on the latest budget information available at this time for 2026 and 2027.

Table 1: Comparison of Capitalized Financing Costs using AFUDC versus IDC[7]

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
AFUDC	3.3	3.6	10.7	2.9	2.2	1.7	1.8	1.0	2.1	2.2	5.7	10.0	19.7
IDC	3.4	4.0	10.6	2.7	2.0	1.5	1.6	0.9	1.9	2.0	5.0	7.4	16.1
Difference	**(0.1)**	**(0.3)**	**0.0**	**0.2**	**0.2**	**0.2**	**0.2**	**0.1**	**0.3**	**0.3**	**0.7**	**2.6**	**3.6**

As shown in the table the difference between IDC and AFUDC grows, commencing in 2025, as a result of decreasing cost of debt compared to the allowed rate of return and increasing capital spend on capital projects with substantial duration, such as the projects contained in Hydro's 2025 Build Application (Bay d'Espoir Unit 8 and the Avalon Combustion Turbine), Life Extension of Bay d'Espoir Unit 7, Penstock 1 Life Extension Project, and Life Extension Projects for Penstocks 2 and 3.

2.2 Implementation Approach

In calculating the capitalization of borrowing costs using AFUDC, any variances between the calculation of AFUDC and IDC for IFRS reporting purposes will be captured in the AFUDC Deferral Account on a monthly basis. Hydro is proposing the deferral account be effective January 1, 2025.

Hydro is also proposing to amortize the balance in the deferral account using the composite depreciation rate derived from the most recent depreciation study accepted by the Board, commencing in the year after the variance transfers to the AFUDC Deferral Account.[8] The composite annual rate derived from the 2016 Depreciation Study is 2.28%,[9] reflecting Hydro's average composite depreciation expense across all assets. Similar to depreciation expense, the risk of growth in amortization expense associated with the AFUDC Deferral Account between test years would be borne by Hydro.

Table 2 provides an illustrative calculation of the amortization expense recovery for the first three years.

[7] Numbers may not add due to rounding.
[8] Amortization of variances transferred to the AFUDC Deferral Account during 2025 will commence in January 2026.
[9] As approved in Board Order No. P.U. 16(2019).

Table 2: Illustrative Amortization of AFUDC Deferral Account Balance

Year	Annual Deferred Cost (A) $	Annual Amortization Expense (B= D x Rate[10]) $	Cumulative Amortization Expense (C) $	Unamortized Balance (D) $
2025	682,250	-	-	682,250
2026	2,550,740	15,555	15,555	3,217,435
2027	3,615,824	73,358	88,913	6,744,345

The proposed AFUDC Deferral Account definition is provided as Schedule 2 to this application.

3.0 Summary

Hydro has compared the impacts of calculating the capitalization of borrowing costs using IDC and AFUDC and, based on the results, is recommending that Hydro be permitted to use the AFUDC methodology to capitalize borrowing costs. This methodology better captures the cost of borrowing associated with Hydro's capital projects and, therefore allows for the recovery of all financing costs associated with these capital assets from customers. Hydro is proposing that any variance between the calculation of IDC and AFUDC should be deferred in the proposed AFUDC Deferral Account, effective January 1, 2025, and recovered from customers over a period consistent with capitalization, and therefore effectively treated the same as a capital cost. Implementation of the use of AFUDC would increase Hydro's current estimated capitalization rate from 4.8%[11,12] to approximately 4.9% in 2025 and 6.3% in 2026. Hydro would continue to be below the Canadian industry average of 8.1% for general expenses capitalized and Newfoundland Power's rate of 9%.[13]

The proposed approach is consistent with regulatory accounting principles.

[10] Rate equals the composite rate in the most recent Depreciation Study approved by the Board.
[11] Includes Hydro's direct billing methodology of vehicle charge outs and capital related general expenses.
[12] "Approval of a Proposed General Expenses Capitalized Deferral Account," Newfoundland and Labrador Hydro, sch. 1, sec. 2.2, p. 3/7-9.
[13] "Approval of a Proposed General Expenses Capitalized Deferral Account," Newfoundland and Labrador Hydro, sch. 1, app. A, sec 2.2.

Schedule 1, Appendix A

Review of Capitalization Policies and Guidelines

newfoundland labrador hydro
a nalcor energy company

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August 14, 2020

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: Review of Capitalization Policies and Guidelines – Newfoundland and Labrador Hydro's Report

As per the Board of Commissioners of Public Utilities' request on April 30, 2020, attached is Newfoundland and Labrador Hydro's ("Hydro") report describing its capitalization practices and guidelines.

Also enclosed is a summary of the results of a jurisdictional scan of the capitalization practices of other Canadian utilities and a report from JT Browne Consulting. The consultant's report discusses Hydro's capitalization practices as including the differences between accounting and regulatory views of capitalization.

If you have any questions on the enclosed, please contact the undersigned.

Yours truly,

NEWFOUNDLAND AND LABRADOR HYDRO

Shirley A. Walsh
Senior Legal Counsel, Regulatory
SAW/kd

Encl.

ecc: **Board of Commissioners of Public Utilities**
Jacqui Glynn
PUB Official Email

Newfoundland Power
Gerard M. Hayes
Kelly C. Hopkins
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Ms. C. Blundon
Public Utilities Board

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Paul L. Coxworthy, Stewart McKelvey
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Dean A. Porter, Poole Althouse

Praxair Canada Inc.
Sheryl E. Nisenbaum

Teck Resources Limited
Shawn Kinsella

Review of Capitalization Policies and Guidelines

August 14, 2020

A report to the Board of Commissioners of Public Utilities

newfoundland labrador hydro
a nalcor energy company

Contents

List of Attachments

1.0 Background

On April 30, 2020, the Board of Commissioners of Public Utilities ("Board") requested that Newfoundland Power Inc. ("Newfoundland Power") and Newfoundland and Labrador Hydro ("Hydro") each submit a report on the utilities' respective capitalization policies and guidelines. The Board requested the reports include the following:

- The particular accounting standards being followed by the utility with respect to its capitalization policies and guidelines;
- A discussion of how the capitalization practices and/or guidelines are in accordance with sound public utilities practice and provide least-cost service to customers;
- Any other alternatives that may be available to be used by the utility, with advantages and disadvantages with respect to sound public utility practice and the provision of least-cost service to customers; and
- A jurisdictional scan of other utilities in Canada with respect to their capitalization policies.

This report provides Hydro's response to the Board's request, including a discussion of Hydro's capitalization practices in the context of the results of the jurisdictional scan. Hydro has also included a report from JT Browne Consulting in Attachment 1 on the topic of Hydro's capitalization, including differences between accounting and regulatory views of capitalization.

2.0 International Financial Reporting Standards

In accordance with Board Order No. P.U. 13(2012), Hydro adopted International Financial Reporting Standards ("IFRS") effective January 1, 2012. Hydro's capitalization policy is consistent with IFRS, and a detailed discussion surrounding accounting standards applicable to Hydro as well as direct, indirect, avoidable, non-avoidable and allocation of costs are found in Attachment 1 to this report.

Under IFRS, the capitalization of costs is addressed in International Accounting Standard ("IAS") 16: *Property, Plant and Equipment*. IAS 16.16 defines the cost of a capital asset as:

> The cost of an item of property, plant and equipment comprises:

a. Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

b. Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

c. The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

[Emphasis Added]

While the term "directly attributable" is not specifically defined in IAS 16, other IASs refer to directly attributable costs as those costs that otherwise "would have been avoided."[1] Hydro's application of this accounting standard follows this principle; therefore, only otherwise avoidable costs[2] that are directly attributable to capital projects are capitalized by Hydro (e.g., an employee's time directly coded to a capital project). Avoidable costs in aggregate, such as the salary and benefits associated with a manager who works on capital projects generally but does not directly work on any individual capital project directly, are expensed by Hydro.[3]

While IAS 16 provides guidance on the capitalization of costs, IFRS 14: *Regulatory Deferral Accounts* permits Hydro to recognize regulatory assets or liabilities following an order of the Board. Therefore, to the extent that Hydro capitalizes costs for regulatory purposes that would not normally be capitalized under IAS 16, the amounts can be recognized as a regulatory deferral. While regulatory assets are recorded differently than capital assets under IFRS, for revenue requirement purposes they are similar in that they reside in rate base, attract financing costs, and are recognized as an expense over time.

[1] "Newfoundland & Labrador Hydro Capitalization Policies," JT Browne Consulting, August 14, 2020, p. 6.
[2] "Newfoundland & Labrador Hydro Capitalization Policies," JT Browne Consulting, August 14, 2020, p. 2. states "An avoidable cost is a cost that would have been avoided (or will be avoided) if the cost object did not exist. For example, an employee may work exclusively on the construction of capital projects. Without the capital projects, there would be no need for the employee. As a result, the cost of the employee would be an avoidable cost of the capital projects. Direct costs would be avoidable costs."
[3] "Newfoundland & Labrador Hydro Capitalization Policies," JT Browne Consulting, August 14, 2020, p. 3. states "Whether a cost is avoidable or non-avoidable can depend on the scope of the cost object. For example, there may be a manager of capital projects: whether or not individual capital projects are undertaken, the cost of the manager will be the same; however, if there were no capital projects, there would be no need for the manager. Where the cost object is an individual capital project, the cost of the manager would be a non-avoidable cost; where the cost object is all capital projects, the cost of the manager would be an avoidable cost."

Increased levels of capitalization beyond that contemplated in IAS 16 are therefore permitted under IFRS 14, following an order of the Board. As noted in Hydro's expert report "…the primary purpose of GAAP is to support financial reporting, not pricing or rate setting decisions. As a result, regulators frequently deviate from GAAP where it is deemed appropriate in setting just and reasonable rates."[4]

Attachment 1 to this report includes a more detailed discussion of Hydro's accounting standards and current capitalization approach. Hydro's capitalization policy is consistent with IAS 16 and results in a lower level of capitalization than would occur if Hydro were to also capitalize avoidable costs in aggregate, as these costs are not permitted to be capitalized under IAS 16.

3.0 Public Utility Practice

Hydro, in conjunction with Newfoundland Power, conducted a survey of eleven utilities across Canada with respect to their capitalization practices. The results of this survey are included as Attachment 2 to this report.

In Hydro's view, the results of the survey indicate a general trend between Crown-owned utilities that have adopted IRFS (including Hydro), and investor-owned utilities that have adopted US GAAP[5] (including Newfoundland Power). A summary of the results are provided in Table 1.

Table 1: Analysis of Survey Results

Respondent	Ownership	Accounting	Capitalized Overhead	Internal Labour Capitalized	Total Labour Capitalized
Utility 2	Crown	IFRS	5.1%	16.3%	13.5%
Utility 5	Crown	IFRS	2.5%	17.0%	NA
Utility 7	Crown	IFRS	26.0%	36.0%	27.0%
Utility 10	Crown	IFRS	10.0%	22.4%	71.9%
Crown-owned Average[6]			**10.9%**	**22.9%**	**37.5%**
Investor-owned Average[7]			**7.7%**	**39.4%**	**42.1%**
Hydro	Crown	IFRS	2.9%	26.8%	37.1%
Newfoundland Power	Investor	US GAAP	11.7%	35.0%	43.0%

[4] "Newfoundland & Labrador Hydro Capitalization Policies," JT Browne Consulting, August 14, 2020, p. 5.
[5] Generally Accepted Accounting Principles ("GAAP").
[6] Excludes Hydro.
[7] Excludes Newfoundland Power.

The results in Table 1 show that Canadian Crown-owned utilities that have adopted IFRS capitalize less labour costs, on average, than their investor-owned counterparts that have adopted US GAAP. Capitalized overhead costs are more consistent across all utilities surveyed. By way of comparison, Hydro capitalizes significantly less relative to investor-owned utilities who have adopted US GAAP as well as Newfoundland Power. Comparing Hydro's results to Crown-owned utilities that have adopted IFRS, Hydro's capitalized overhead percentage is materially lower than average, while capitalized labour percentages are more consistent with the Crown/IFRS industry average.

In Hydro's view, the survey responses indicate that Hydro capitalizes less than Newfoundland Power and other investor owned utilities, and Hydro capitalizes less overhead when compared to utilities with the same ownership structure and accounting standards as Hydro.

4.0 Regulatory Principles

The *Electrical Power Control Act, 1994* states that the electrical system should be managed such that power is delivered to customers at the lowest possible cost consistent with reliable service. The policies of a utility which result in a cost being classified as either a capital or operating expense can have an impact on customer rates and the provision of least-cost service over the long-term.

For example, $100 in labour costs recorded as an operating expense will result in ratepayers contributing the same $100 in revenue requirement to be recovered in a single year. If a utility with the same weighted average cost of capital as Hydro capitalized $100 in labour costs towards an asset with a 30-year life, ratepayers would ultimately pay more than $180 in revenue requirement over the 30-year life of the asset.[8] In this respect, lower levels of capitalization result in lower costs for customers over the long term. However, in Hydro's opinion, consideration can be given to other regulatory principles in addition to least-cost when adopting policies and setting customer rates.

As noted in Hydro's expert evidence included as Attachment 1, the concepts of intergenerational equity, rate stability and predictability, and materiality are also important considerations in the determination of just and reasonable rates and the provision of reliable service at the lowest possible cost. As noted by Mr. Browne:

[8] WACC of 5.43%, useful life of 30 years, straight line depreciation.

The principle of intergenerational equity helps to determine when costs should be recovered. Under this principle, customers in a given period should pay only the costs necessary to provide them with service in that period. They should not have to pay for any costs incurred to provide service to customers in another period. This principle is consistent with setting just and reasonable rates within each period.

In the case of capital projects, the avoidable costs should be capitalized; these would be the costs that would be avoidable in relation to all capital projects, and not just the individual projects. These costs are incurred solely for the benefit of future customers and should be capitalized and recoverable from future customers, not current customers.

While Hydro's current approach to capitalization is consistent with accounting regulations and results in lower revenue requirements from its customers over the long term, the principle of intergenerational equity would support an increased level of capitalization to better match customer costs with the services provided in the current period. A summary of the differences in these principles with respect to capitalized overheads can be found in Table 2.

Table 2: Comparison of Capitalization Principles

	Regulatory Principles	IFRS	Hydro - Current
Overhead Capitalization[9]	Yes	No	No

Balancing against increased capitalization is the need for rate stability and predictability; to the extent that a utility capitalizes too much, operating costs could vary materially over time with the levels of capital projects. Such an approach could contribute to rate instability. Further, the concept of materiality is important to ensure the level of accuracy sought through increased levels of capitalization does not result in a significant increase in administration costs which would outweigh the benefit of improved accuracy.[10]

In summary, Hydro's current approach to capitalization is consistent with the principle of least cost service over the long-term; however, increased levels of capitalization could be appropriate with a view

[9] "Newfoundland & Labrador Hydro Capitalization Policies," JT Browne Consulting, August 14, 2020, Table 4, p. 17., Avoidable – Capital Projects in Aggregate Only. Excludes Avoidable – Specific Assets and Non-avoidable – Indirect.
[10] " Newfoundland & Labrador Hydro Capitalization Policies," JT Browne Consulting, August 14, 2020, p. 10., states "Attempting to achieve theoretical accuracy can be difficult and costly. For example, it is not always easy to identify the avoidable costs, especially where they are a small part of a cost category. In some cases, there is a significant cost to collect and report the information necessary for that accuracy."

towards improved intergenerational equity, as long as rate stability, predictability, and materiality are maintained and potential administrative burdens minimized.

5.0 Capitalization Alternatives

The Board's correspondence requested that Hydro identify any alternatives that may be available in the context of its capitalization policies, along with advantages and disadvantages of these alternatives. When examining alternatives Hydro considered the upcoming impact of Muskrat Falls on customer rates and the manner in which its capitalization policies could represent a small source of rate mitigation, provide better operating cost comparability with Newfoundland Power, and still adhere to sound regulatory principles.

On September 5, 2018 the Government of Newfoundland and Labrador requested that the Board undertake a review of electricity rate mitigation options and impacts in relation to the Muskrat Falls Project in accordance with the reference from the Lieutenant-Governor in Council under section 5 of the *Electrical Power Control Act, 1994*. As a part of this review, the Board engaged the Liberty Consulting Group ("Liberty"); Liberty issued its Final Report on Phase Two of Muskrat Falls Project Potential Rate Mitigation Opportunities on September 3, 2019.

In its report, Liberty noted there was a material difference in the rate mitigation opportunities that existed in the first 10 years of the in-service of Muskrat Falls versus the next 10 years.

> …insufficient revenue mitigation potential in the early years, keeps rates higher in the first decade following LCP operation than they can become in the second ten years. LCP financing requires significant payments (e.g., sinking fund payments) in that first decade. They add to revenue requirements. Figure I.3 shows the limits in the first decade, leaving a significant initial jump even after mitigation, followed by stability, and ending with a reduction as the Reference's 10-year period comes to a close.
>
> …
>
> Not surprisingly, as Figure I.4 shows, growing revenue requirements, as compared with the first decade mitigation sources available, limit rate-influencing ability through 2030.[11]

[11] "Final Report on Phase Two of Muskrat Falls Project Potential Rate Mitigation Opportunities," The Liberty Consulting Group, September 3, 2019, pp. 9–10.

One alternative to Hydro's current capitalization policy would be to begin capitalizing overheads, which are currently expensed, in aggregate under IFRS 14. This approach would increase Hydro's level of capitalization at the same time as increased revenue requirements associated with the Muskrat Falls project are coming into effect. The advantage of this alternative is that additional capitalization would increase Hydro's level of overhead capitalization to a level more consistent with the Crown/IFRS average, decrease Hydro's revenue requirement in the short term, contribute to rate mitigation efforts, increase intergenerational equity for Hydro's customers, and result in greater alignment between Newfoundland Power and Hydro with respect to their approaches to capitalization. More comparable capitalization approaches would result in better comparability of cost management practices.

The disadvantage of this approach is that the total revenue requirement paid by ratepayers would be greater over the long term than if these costs continued to be expensed under Hydro's existing capitalization approach. Further, there is risk that the level of administrative effort would significantly increase under this alternative as Hydro could potentially be required to maintain two sets of capital accounting records for regulatory and financial reporting purposes. However, Hydro believes that a simplified regulatory deferral which strikes the appropriate balance of costs and accuracy could be achieved.[12]

If it is determined that this alternative would be in the best interest of ratepayers, Hydro would undertake a detailed review of this proposed approach for inclusion in its next general rate application. While the results would be subject to the outcome of this detailed review, increasing Hydro's level of overhead capitalization more in line with the overall survey average of 7.7% would reduce Hydro's operations and maintenance expense by approximately $6.4 million (4.8%).[13]

Further, Hydro also suggests that if the Board was to provide such direction, it should also consider the inclusion of a requirement for re-evaluation of capitalization policies in this jurisdiction at regular intervals (e.g. every ten years) to ensure the utilities' capitalization policies are well understood and continue to be in the best interest of ratepayers.

[12] Hydro would likely propose to defer a percentage of operations and maintenance expense in a new regulatory deferral consistent with IFRS 14. This percentage would be based on an internal study of avoidable costs in aggregate, and would be amortized over the average useful life of Hydro's capital assets.
[13] Average of all survey responses to question 7.

6.0 Conclusion

Hydro's current approach to capitalization is in accordance with IFRS; however, survey results indicate that Hydro capitalizes less overhead than other Crown/IFRS utilities. The results of the utility survey also indicate that investor-owned utilities that have adopted US GAAP, including Newfoundland Power, capitalize more labour costs than their Crown-owned counterparts, including Hydro. Increased capitalization decreases revenue requirement in the short term but increases revenue requirement from customers over the long term when compared to expensing such costs.

While Hydro's current capitalization approach adheres to accounting guidelines, the primary purpose of accounting standards is to support financial reporting, not pricing or rate-setting decisions. As a result, as noted in the attached report from JT Browne Consulting, regulators frequently deviate from accounting standards where it is deemed appropriate in setting just and reasonable customer rates. As such, the Board may want to consider whether the ownership structure and accounting policy differences between utilities in this jurisdiction should be the sole reason for differing capitalization outcomes or if a deviation from standard accounting practices would be justified to better reflect regulatory principles in establishing just and reasonable rates.

Finally, an alternative to Hydro's current capitalization approach would be to capitalize more directly attributable costs in aggregate (overheads related to capital work); these costs are currently expensed. This approach would reduce revenue requirement in the short term and increase total costs to ratepayers over the long term; however, it would provide rate mitigation benefits, increase intergenerational equity for Hydro's customers, and bring Hydro's level of overhead capitalization more in line with other Canadian electric utilities. This approach would also improve comparability between Hydro and Newfoundland Power's operating and capital costs.

Attachment 1

Expert Report - JT Browne Consulting

newfoundland labrador hydro
a nalcor energy company

JTBrowne Consulting

Newfoundland & Labrador Hydro

Capitalization Policies

August 14, 2020

Costing & Regulatory Consulting

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Appendices:

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INTRODUCTION

In a letter dated April 30, 2020, the Board of Commissioners of Public Utilities ("Board") requested that each of Newfoundland and Labrador Hydro ("Hydro") and Newfoundland Power Inc. ("NP")

> *... complete a report for the Board describing its capitalization policies and any guidelines relating to capital asset additions, including but not limited to, direct costs, indirect costs (example: overhead recoveries and AFUDC) and GEC.*

As part of the review, the utilities were requested to provide the following:

- *the particular accounting standards being followed by the utility with respect to its capitalization policies and guidelines;*
- *a discussion of how the capitalization practices and/or guidelines are in accordance with sound public utility practice and provide least-cost service to customers; and*
- *any other alternatives that may be available to be used by the utility in the development of capitalization policies and guidelines, along with advantages and disadvantages, with respect to the provision of sound utility practice and provide least-cost service to customers.*

To assist with the Board's request, Hydro has asked for my assistance as a CPA, CA and economist with experience in addressing regulatory issues.[1] In particular, Hydro has asked me to provide an opinion on the appropriate principles for capitalizing costs related to property plant and equipment from a regulatory perspective.

In developing my opinion, I have relied on information about Hydro that was provided to me by the Company. I was not asked to verify this information and did not undertake the work necessary to provide a professional opinion on the validity of the information.

The next three sections of this report address the relevant costing, financial reporting and regulatory principles. This is followed by a discussion of Hydro's capitalized costs and the application of the relevant principles to the capitalization of Hydro's costs. The final section sets out my conclusion.

[1] A copy of my resume has been attached as Appendix JTBC-1.

COSTING PRINCIPLES

Costing principles help to establish how costs should be determined and allocated to cost objects – i.e., whatever is being costed.

DIRECT / INDIRECT

In determining the costs of a cost object, costs are often divided into direct and indirect costs. A direct cost can be traced to a specific cost object whereas an indirect cost cannot, it is incurred for at least one other cost object. For example, in the Glossary for "Guide to Cost Estimating" produced by the Treasury Board, direct and indirect costs are defined as follows:

> *Costs are considered direct when they are incurred solely to support the initiative. Costs are considered indirect when they are incurred to support more than one initiative and are not attributed only to the initiative that is being costed.*[2]

An alternative division of costs is between avoidable and non-avoidable costs. Avoidable costs may also be referred to as incremental costs.

AVOIDABLE / NON-AVOIDABLE

An avoidable cost is a cost that would have been avoided (or will be avoided) if the cost object did not exist. For example, an employee may work exclusively on the construction of capital projects. Without the capital projects, there would be no need for the employee. As a result, the cost of the employee would be an avoidable cost of the capital projects. Direct costs would be avoidable costs.

A non-avoidable cost is a cost that would not have been avoided (or will not be avoided) if the cost object did not exist. Consider a payroll system that supports all the operations of a company, but contains small parts designed to meet the specific requirements of individual operations. Most of the costs of the payroll system would be a non-avoidable cost of the individual operations – without any one operation, the costs would still have been incurred. However, the cost of any portion of the system designed to meet the specific requirements of an individual operation would be an avoidable cost of that operation – i.e., without the operation, the cost of that portion of the system would have been avoided.

Whether indirect costs are completely non-avoidable or largely non-avoidable depends on how indirect costs are defined in practice. Using the example of the payroll system, if the

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[2] Government of Canada; Government of Canada; Guide to Cost Estimating; Appendix A: Glossary; 2019-06-04; https://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=32600.

total cost is considered an indirect cost of individual operations, this indirect cost would contain both non-avoidable and avoidable costs. If only the cost that is required for at least two or more operations is considered as the indirect cost of individual operations (i.e., excludes costs that are avoidable in relation to individual operations), the entire indirect costs would be non-avoidable.

Whether a cost is avoidable or non-avoidable can depend on the scope of the cost object. For example, there may be a manager of capital projects: whether or not individual capital projects are undertaken, the cost of the manager would be the same; however, if there were no capital projects, there would be no need for the manager. Where the cost object is an individual capital project, the cost of the manager would be a non-avoidable cost; where the cost object is all capital projects, the cost of the manager would be an avoidable cost. At the level of the entire organization, all costs are avoidable.

ALLOCATING COSTS

Avoidable costs are caused by their associated cost objects – i.e., without the cost object the cost could be avoided. These costs should be allocated to their associated cost object for all costing purposes.

In the case of non-avoidable costs, there is no causal relationship to individual cost objects – i.e., whether or not any one cost object existed, the cost could not be avoided. Without a causal relationship, there is no economic basis to support an allocation. However, there may be a need to allocate non-avoidable costs, such as in the case of cost-based pricing. In such cases, a reasonable basis must be found for allocating these costs.

Where non-avoidable costs do not benefit the provision of a cost object, they should not be allocated to the cost object. If the cost object was provided on its own, there would be no need for the costs, and they could be avoided. This leaves the non-avoidable costs that benefit the provision of a cost object.

In dealing with the non-avoidable costs that benefit the provision of a cost object, a possible fair and reasonable basis for allocating the costs is a measure of relative benefits received. For example, incurring the cost of the human resources department may benefit all departments in a company, but the cost is non-avoidable in relation to each department. Allocating the cost to cost objects on the basis of the number of employees may be viewed a fair and reasonable basis for allocating the costs on the basis of relative benefits received.

Even where a company develops a reasonable basis for allocating non-avoidable costs, it should be noted that these costs are not affected by the existence of individual cost objects. As a result, there is no economic basis to support the allocation; any allocation would be based on a subjective assessment of what was appropriate.

CONCLUSION

Avoidable cost are the costs that would have been avoided (or will be avoided) if a particular cost object did not exist, while non-avoidable costs are the costs that would not have been avoided (or will not be avoided). Whether a cost is avoidable or not depends on the scope of the cost object. As the scope expands, non-avoidable costs tend to become avoidable costs; for example, where the scope of the cost object is the entire organization, all costs are avoidable.

Avoidable costs are caused by the associate cost object and should be allocated to it. Non-avoidable costs would continue to be required if the cost object alone did not exist. As a result, whether or not the cost object existed, the non-avoidable costs would be the same, and there is no economic basis to support allocating the nonavoidable costs to the cost object.

Where non-avoidable costs must be allocated, they should only be allocated to cost objects that benefit from the incurrence of the costs – i.e., the cost objects for which in aggregate the cost would be avoidable. A possible fair and reasonable basis for allocating these costs is some measure of relative benefits received; however, any allocation will be based on subjective criteria.

FINANCIAL REPORTING PRINCIPLES

Financial reporting principles establish how a company should report its financial position and results of operations to outsiders, i.e., existing and potential investors, lenders and other creditors.

GAAP

Financial reporting is governed by generally accepted accounting principles ("GAAP"). In Canada, GAAP is established by the Accounting Standards Board and set out in the CPA Canada Handbook – Accounting ("Handbook"). For publicly accountable enterprises, Canadian GAAP generally consists of the International Financial Reporting Standards ("IFRS"); however, newly issued, amended or revised IFRS Standards are part of Canadian GAAP only after they are approved by the Accounting Standards Board.

The recognition of costs under GAAP is generally deemed appropriate for regulatory purposes. Also, differences between GAAP and regulatory accounting principles ("RAP") can add to the complexity and cost of a utility's accounting system. As a result, GAAP is usually the starting point for establishing the amount of costs, and the period in which they should be recognized for rate setting purposes. However, the primary purpose of GAAP is to support financial reporting, not pricing or rate setting decisions. As a result, regulators frequently deviate from GAAP where it is deemed appropriate in setting just and reasonable rates.

In regard to capitalizing costs, there are two GAAP standards that are particularly relevant: International Accounting Standard ("IAS") 16, Property, Plant and Equipment, and IFRS 14, Regulatory Deferral Accounts.

IAS 16, PROPERTY, PLANT AND EQUIPMENT

IAS 16, sets out the costs that should be capitalized as part of property, plant and equipment. In addition to the purchase price and the initial estimate of dismantling and removal costs:

> *The cost of an item of property, plant and equipment comprises:*
>
> *… (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. …*[3]

[3] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 16 Property, Plant and Equipment; para. 16.

The Handbook does not define "directly attributable." However, in describing borrowing costs that can be capitalized, the Handbook states:

> *The borrowing costs that are **directly attributable** to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. …*[4] (underlining added)

And in discussing the transaction costs of an equity transaction, the Handbook states:

> *… The transaction costs of an equity transaction are accounted for as a deduction from equity to the extent that they are incremental costs **directly attributable** to the equity transaction that otherwise would have been avoided. …*[5] (underlining added)

It therefore appears that GAAP requires that costs directly attributable to a property, plant or equipment asset should be capitalized as part of the cost of the asset, where the directly attributable costs are those that would been avoided without the asset – i.e., avoidable costs. However, only avoidable costs of each particular asset can be capitalized.

In addition to general direction, IAS also provides specific examples of costs that are "directly attributable." Among the examples of directly attributable costs are:

> *(a) costs of employee benefits (as defined in IAS 19 Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment; …*
>
> *(c) initial delivery and handling costs; …*[6]

It also identifies costs that are not directly attributable (i.e., should not be capitalized), including "administration and other general overhead costs."[7]

A major difference between RAP and GAAP is the recognition of the cost of equity: RAP recognizes it as a cost while GAAP does not. However, IAS 16 specifically allows for the capitalization of borrowing costs:

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[4] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 23 Borrowing Costs; para. 10.

[5] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 32 Financial Instruments; para. 37.

[6] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 16 Property, Plant and Equipment; para. 17.

[7] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 16 Property, Plant and Equipment; para. 19.

> *An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset.* [8]
>
> *To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period. …*[9]

IFRS 14, REGULATORY DEFERRAL ACCOUNTS

Rate regulation can result in the creation of regulatory assets and liabilities, which the Handbook refers to as regulatory deferrals. These deferrals represent timing differences – i.e., the opportunity to recovery costs in a period other than the one in which the costs would normally be recognized under GAAP.

Under certain circumstances that usually apply to Hydro, the Handbook allows for the recognition of regulatory deferral accounts; however, it requires separate disclosure:

> *… the regulatory deferral account balances are recognised in the statement of financial position in addition to the assets and liabilities that are recognised in accordance with other Standards. These presentation requirements separate the impact of recognising regulatory deferral account balances from the financial reporting requirements of other Standards.*[10]
>
> *An entity shall present separate line items in the statement of financial position for:*
>
> *(a) the total of all regulatory deferral account debit balances; and*
>
> *(b) the total of all regulatory deferral account credit balances.*[11]

The impact of the regulatory deferrals must also be separately reported in the statement of profit and loss.[12]

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[8] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 23 Borrowing Costs; para. 8.

[9] Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IAS 23 Borrowing Costs; para. 14.

[10] Handbook; Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IFRS 14 Regulatory Deferral Accounts; para. 18.

[11] Handbook; Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IFRS 14 Regulatory Deferral Accounts; para. 20.

Therefore, to the extent that Hydro capitalizes costs for regulatory purposes that would not normally be capitalized under GAAP, the amounts can be recognized as a regulatory deferral account but must be reported separately with the other regulatory deferrals.

CONCLUSION

In the case of property, plant and equipment, GAAP requires Hydro to capitalize the avoidable costs "to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management." However, it can capitalize only the avoidable costs of the individual assets.

To the extent that the Board directs Hydro to capitalize costs that would not normally be capitalized under GAAP, it would have to account for them separately.

[12] Handbook; Accounting Part I – IFRS Standards, 2020 Edition, IFRS Standards in effect on January 1, 2020, IFRS 14 Regulatory Deferral Accounts; para. 22 & 23.

REGULATORY PRINCIPLES

Regulatory principles help to establish how costs should be established for the purpose of setting regulated rates.

JUST & REASONABLE

The primary regulatory principle is that rates must be just and reasonable – where "just and reasonable" considers the legitimate interests of both customers and the regulated entity. Unfortunately, "just and reasonable" tends to be a vague concept and other regulatory principles help to establish what is "just and reasonable" in a particular situation.

In establishing just and reasonable, the most significant principle is the cost of service standard. Under this standard, a regulated entity is permitted to set rates that allow it the opportunity to recover its costs for regulated operations, including a fair rate of return on its investment devoted to regulated operations – no more, no less. The importance of this principle has been recognized by the Supreme Court of Canada:

> *… a key principle in Canadian regulatory law is that a regulated utility must have the opportunity to recover its operating and capital costs through rates …* [13]

The cost of service standard does not require that a regulated entity be guaranteed a fair return, only that it has an opportunity to earn it. In most cases, rates are set prospectively, based on estimated future costs. If the entity over-recovers, it normally keeps the excess; if it under-recovers, it bears the deficiency.

In the context of capitalizing costs, the issue is not whether costs should be recoverable in rates, but when.[14] To establish when costs should be recoverable, regulators frequently consider the principles of intergenerational equity, and rate stability and predictability. Also, they generally consider materiality in setting just and reasonable rates.

INTERGENERATIONAL EQUITY

The principle of intergenerational equity helps to determine when costs should be recovered. Under this principle, customers in a given period should pay only the costs necessary to provide them with service in that period. They should not have to pay for any costs incurred to provide service to customers in another period. This principle is consistent with setting just and reasonable rates within each period.

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[13] ATCO Gas and Pipelines Ltd. v. Alberta (Utilities Commission); 2015; SCC 45; para. 61.

[14] Determining when costs will be recoverable will impact rates to the extent that a deferral impacts a utility's financing costs.

In the case of capital projects, the avoidable costs should be capitalized; these would be the costs that would be avoidable in relation to all capital projects in aggregate, and not just the individual assets. These costs are incurred solely for the benefit of future customers and should be capitalized and recoverable from future customers, not current customers.

The principle of intergenerational equity does not provide any direction in regards to costs that benefit capital projects, but are non-avoidable costs of capital projects – i.e., if the capital projects did not exist, the costs would still exist to support other operations. It might be argued that is fair that capital projects, and future customers, bear a share of the costs. However, whether or not the capital projects existed, the costs would have to be incurred to provide current operations. As a result, current customers do not bear any costs in addition to what they would have to bear if there were no capital projects. Similarly, whether or not the current operations existed, the costs would have to be incurred for the capital projects.

RATE STABILITY AND PREDICTABILITY

The principle of rate stability and predictability also helps to establish when costs should be recovered. It requires that rates remain stable and predictable – at least to the extent practical. It may, therefore, justify smoothing out changes in rates to avoid sharp rate increases or temporary fluctuations. This principle recognizes that it is usually easier for ratepayers to deal with gradual and predictable rate changes.

The intent of this principle is to establish only when costs are recovered, not the amounts actually recovered.

If any of the avoidable costs of capital projects in aggregate were charged to current operations, rather than being capitalized, costs charged to operations would tend to vary with the level of capital projects. If any non-avoidable costs in relation capital projects were capitalized, the amounts charged to operations would decrease and this reduction would tend to vary with the level of capital projects. In both cases this would tend to reduce rate stability and predictability. Therefore, capitalizing all avoidable costs in relation capital projects in aggregate, and only these costs, would tend to enhance rate stability and predictability.

MATERIALITY

Attempting to achieve theoretical accuracy can be difficult and costly. For example, it is not always easy to identify the avoidable costs, especially where they are a small part of a cost category. In some cases, there is a significant cost to collect and report the information necessary for that accuracy.

Where the pursuit of greater accuracy is difficult or costly, regulators will often weight the benefit of the improved accuracy against the cost. Especially where the impact of

improved accuracy has an immaterial impact on rates, regulators will generally not require it. It should be remembered that any additional costs would normally be passed onto customers through higher allowed rates.

CONCLUSION

Regulatory principles would require the capitalization of the avoidable costs of capital projects in aggregate, not just the avoidable costs of individual assets. It might be fair to also allocate a "fair" share of the costs that benefit capital projects but are not avoidable in relation to capital projects in aggregate; however, such an allocation is not required. Moreover, such an allocation would tend to reduce rate stability and predictability since the level of operating expenses would vary with the level of capital activity.

Where the impact of a deviation from what is normally required by regulatory principles has an immaterial impact on rates, especially where there is a cost or it is difficult to achieving greater accuracy, such deviations are normally allowed by regulators.

HYDRO'S CAPITALIZED COSTS

The costs that Hydro capitalizes as part of the cost of property plant and equipment are determined by the requirements of "IAS 16 - Property, Plant and Equipment" – this is for both financial reporting and regulatory purposes.

IMPLICATIONS OF FOLLOWING IAS 16

In accordance with IAS 16, Hydro recognizes the directly attributable costs of bringing an asset to the location and condition required for use in its operations. The directly attributable costs are those that would be avoided if the specific asset were not acquired or constructed. However, it recognizes only the directly attributable costs of specific assets; it does not recognize costs that are directly attributable to capital projects in aggregate, but not individual assets.

A more extensive discussion of IAS 16 was provided in the section "Financial Reporting Principles".

ADOPTION OF IFRS STANDARDS

In a 2012 Order and Decision, the Commission accepted Hydro's proposal to modify its capital expenditure methodology to align it with IFRS requirements. These changes are set out in Appendix 2 and resulted in an increase to the amount of costs capitalized (at least in 2012).

Prior to adopting IFRS, Hydro followed Auditing Guideline 19 "Disclosures by Entities Subject to Rate Regulation" ("AcG 19") in pre-IFRS GAAP. Under AcG 19, separate disclosure of regulatory deferrals was required only when a separate asset or liability was recognized solely because of the effects of rate regulation. As a result, where an amount was recognized as a regulatory deferral under GAAP and capitalized as part of property plant and equipment, there was no need for separate disclosure; and no need to separately track and account for the regulatory deferral on an ongoing basis.

As previously discussed, differences between RAP and GAAP can be recognized as a regulatory deferral under IFRS; however, the aggregate amount of regulatory deferrals must be separately reported on a company's financial statements. As a result, a regulatory deferral capitalized as part of property plant and equipment would have to be tracked and accounted for separately, as would the amount amortized in any period.

Hydro maintained that differences between its capitalization policies for regulatory purposes and those required by IFRS would require keeping two sets of records, resulting in an increase in regulatory burden and costs. As summarized by the Board in the 2012 Order and Decision:

> *… Hydro explains that the primary rationale to use the relevant IFRS requirements in its capital expenditures relates to transparency and the administrative burden required to maintain duplicate asset records. Hydro states that calculating separate capital costs and the resulting depreciation variances and reconciling the two sets of records for the foreseeable future would require additional investment in both personnel and systems.*[15]

In accepting Hydro's proposal, the Commission stated:

> *The Board accepts Hydro's evidence in relation to the administrative burden and costs associated with maintaining regulatory reporting differences. The Board also agrees that moving to IFRS will enhance transparency. Hydro's proposed changes have been fully reviewed by Grant Thorton (sic). The Board will approve Hydro's proposed IFRS related changes to its capital expenditure methodology.*[16]

SIGNIFICANCE OF CAPITALIZED COSTS

Capitalized costs represent a significant proportion of Hydro's total costs. Over the most recent five years, on average, these costs have equaled 34% of its annual expenses and 141% of its operating costs.

Table 1

CAPITALIZED EXPENDITURES RELATIVE TO						
	2015	2016	2017	2018	2019	AVERAGE
Annual Expense[17]	22%	38%	64%	29%	22%	34%
Operating Costs	83%	165%	262%	115%	95%	141%

[15] Newfoundland and Labrador Board of Commissioners of Public Utilities; Order No. P. U. 2(2012); January 24, 2012; pg. 3.

[16] Newfoundland and Labrador Board of Commissioners of Public Utilities; Order No. P. U. 2(2012); January 24, 2012; pg. 4.

[17] Annual expense consists of operating costs, other income and expense, fuel, purchased power, amortization and interest.

COSTS CAPITALIZED

The following are the major components of Hydro's capitalized costs.

Paid to 3rd Parties

These costs include payments to third parties for raw materials, contract materials, contract labour and consultants. There are no loadings added to these payments.

Hydro Allocation -Labour:

These costs consist of the cost of Hydro and inter-company employee time allocated to specific capital assets on the basis of time records. This includes both regular and overtime costs.

Hydro's internal and inter-company labour includes a loading factor bill rate that is applied to regular labour to reflect the cost of vacation, employee benefits, other benefits and employer taxes. The bill rate is calculated annually and updated accordingly. Hydro's current bill rate is 68%. The bill rate does not contain a profit component and it is not included on overtime hours.

Hydro Allocation – Materials

These costs consist of the cost of material that has been inventoried and then used for a specific asset. No loadings are applied to these costs.

Hydro Allocation – Borrowing (IDC)

These are the borrowing costs applied to specific assets. Interest during construction ("IDC") is charged to projects estimated to be of a substantial duration (e.g., greater than six months). The IDC rate is based upon Hydro's cost of debt. The rate is reviewed on a quarterly basis and is updated accordingly.

Hydro Allocation – Other

These costs consist mainly of travel, equipment rentals and direct vehicle and equipment billings. The vehicle bill rates are based upon the type of vehicle or equipment utilized. The rate is calculated by multiplying the usage time by the daily hourly rental rate for the applicable vehicle or equipment. The rates are reviewed annually and updated accordingly.

Table 2

CAPITALIZED COSTS ($millions)							
	2015	**2016**	**2017**	**2018**	**2019**	**AVERAGE $**	**AVERAGE %**
Paid to 3rd Parties	69	114	258	98	64	121	63.2
Hydro Allocation - Labour	23	30	28	26	29	27	14.3
Hydro Allocation - Materials	28	53	40	27	27	35	18.3
Hydro Allocation – Borrowing (IDC)	3	3	10	2	2	4	2.1
Hydro Allocation - Other	2	4	5	4	5	4	2.1
Total	**$125**	**$204**	**$341**	**$157**	**$127**	**$191**	**100.0%**

FINANCING COSTS

GAAP does not recognize the cost of equity. Consistent with this view, IAS 16 only allows a capitalization of directly attributable borrowing costs – i.e., interest during construction or IDC.

Prior to adopting IFRS, Hydro capitalized financing costs based on its allowed rate of return. This amount was referred to as the allowance for funds used during construction ("AFUDC").

With Hydro's low equity ratio, its allowed rate of return tends to be close to its borrowing rate and the period over which financing costs are capitalized tends to be relative short, As a result, the difference between IDC and AFUDC tends to be relatively small.

Table 3

Capitalized Financing Costs ($ millions)						
	2015	2016	2017	2018	2019	Average
IDC	3.4	4.0	10.6	2.7	2.0	4.5
AFUDC	3.3	3.6	10.7	2.9	2.2	4.5
Difference	0.1	0.4	(0.1)	(0.2)	(0.2)	0.0

DIRECTLY ATTRIBUTABLE COSTS EXCLUDED

Consistent with IAS 16, Hydro capitalizes only the directly attributable costs of individual assets. Costs that are directly attributable to capital projects in aggregate, but not directly attributable to individual assets, are not capitalized but expensed in the current period.

Hydro does not track the costs that are avoidable only at the level of capital projects in aggregate and was not able to provide an estimate of these costs. To provide an estimate of costs that are avoidable only at the level of capital projects in aggregate, Hydro has stated that it would need to complete an in-depth analysis, including a detailed review of Hydro's departments with interviews of key personnel.

NON-AVOIDABLE INDIRECT COSTS

Hydro does not track non-avoidable indirect costs – i.e., costs that benefit capital projects but would not be avoided if Hydro did not have any capital projects. To provide an estimate of non-avoidable indirect costs, Hydro has stated that it would need to complete an in-depth analysis, including a detailed review of Hydro's departments with interviews of key personnel.

CONCLUSION

Hydro's capitalized costs are significant. The Company capitalizes the avoidable costs of specific assets; however, it does not capitalize, or even track, costs that are avoidable only at the level of capital projects in aggregate, or any non-avoidable indirect costs.

APPLICATION OF PRINCIPLES

Considering only regulatory principles, the avoidable costs of capital projects in aggregate should be capitalized; while there is no clear direction as to whether non-avoidable indirect costs should be capitalized. Considering only financial reporting principles, the avoidable costs of specific assets should be capitalized - i.e., the costs that would be avoided if the specific capital projects did not exist, but only these costs. A summary of these principles is provided in Table 4.

Table 4

COSTS CAPITALIZED			
	REGULATORY REPORTING	**FINANCIAL REPORTING**	**HYDRO (Currently)**
Avoidable – Specific Assets	**YES**	**YES**	**YES**
Avoidable – Capital Projects in Aggregate Only	**YES**	**NO**	**NO**
Non-avoidable - Indirect	DEPENDS	**NO**	**NO**

AVOIDABLE COSTS – INDIVIDUAL CAPITAL PROJECTS

The avoidable costs of individual capital assets should be capitalized as part of the cost of those assets. This is required by the principle of intergenerational equity.

Hydro is currently capitalizing these costs for financial reporting purposes. As a result, capitalizing these costs for regulatory purposes does not impose any additional accounting and reporting costs.

AVOIDABLE COSTS – CAPITAL PROJECTS IN AGGREGATE

As required by the principle of intergenerational equity, all of the avoidable costs of the capital projects in aggregate should be capitalized, even where they are non-avoidable costs in relation to individual assets.

This raises the issue of how to allocate these costs to individual assets. There is no economic basis for such an allocation: if any individual project did not exist, the costs would still have to be incurred for other projects. However, a "fair" basis might be some measure of relative benefits received. For example, consider the costs of the manager for capital projects where these costs are non-avoidable costs of individual capital projects. The dollar value of each project as a percent of the total, or the number of labour hours allocated to each project as a percent of the total, might be a reasonable measure of the relative benefits that each project receives.

A problem with allocating these costs, is that such allocations would not be in accordance with Hydro's financial reporting. As a result, Hydro would have to maintain separate records to account for the capitalization and amortization of these costs separately. As discussed in the previous section, this was a major reason (if not the most significant reason) the Board allowed Hydro to modify its capitalization polices to be consistent with the requirements of IFRS.

As noted in the previous section, Hydro does not have an estimate of these costs. As a result, it is not possible to determine the materiality of these costs.

NON-AVOIDABLE COSTS – INDIRECT

Costs that benefit capital projects but are non-avoidable in relation to capital projects in aggregate – i.e., non-avoidable indirect costs, do not have to be capitalized under the principle of intergenerational equity. Whether or not the capital projects existed, these costs would still have had to be incurred for current operations. As a result, current operations would not be required to bear any additional costs as a result of the capital projects.

It might be argued that it is "fair" that a portion of these costs be capitalized and borne by future customers rather than current customers. This would not be inconsistent with the principle of intergenerational equity. Both current operations and capital projects would not the allocated any more costs than what they would have to bear if they were provided alone.

As in the previous situation, there is no economic basis for allocating these costs to individual projects: if the capital projects did not exist, the costs would still have to be incurred for the current operations; if the current operations did not exist, the costs would still have to be incurred for the capital projects. As in the previous situation, a "fair" basis for allocating these costs between capital projects and current operations might be some measure of relative benefits received.

Although capitalizing a "fair" portion of these costs would not be inconsistent with the intergenerational equity, it would tend to reduce rate stability and predictability. Since these costs are not affected by the level of capital activity, the amount recognized in current operations would tend to vary with the level of capital projects under construction.

Again, there would be issue that the capitalization of these costs would not be in accordance with Hydro's financial reporting. As a result, Hydro would have to maintain separate records to account for the capitalization and amortization of these costs separately.

COST OF CAPITAL

The allowed return on rate base that would be avoidable without the capital projects in aggregate should be capitalized. This return recognizes both the cost of debt and equity. However, GAAP only recognizes the cost of debt and Hydro has been following GAAP for both financial reporting and regulatory purposes.

As discussed in the previous section, the difference between IDC and AFUDC appears to be immaterial.

CONCLUSION

Based on the discussion in this report, Hydro should continue to capitalize the avoidable costs of specific assets, and where significant, it should also capitalize the costs that are avoidable only at the level of capital projects in aggregate.

Ignoring the practical issue of the cost and complexity it would impose, all of the avoidable costs (i.e., directly attributable costs) of capital projects in aggregate should be capitalized:

- The avoidable costs of specific assets should be capitalized as part of the cost of the related assets.

- The costs that are only avoidable at the level of capital projects in aggregate should be allocated to specific assets on some measure of relative benefits received.

However, where the costs that are avoidable only at the level of capital projects in aggregate are not significant, especially where the cost of tracking and accounting for the costs is significant, it would be acceptable to expense the costs.

In the case of non-avoidable indirect costs (i.e., costs that are non-avoidable in relation to capital projects in aggregate but benefit those projects), it would be consistent with the principle of intergenerational equity to either capitalize or not capitalize these costs. However, capitalizing these costs would tend to reduce rate stability and predictability; would require Hydro to maintain separate records for the amounts capitalized leading to higher costs; and there would be no economic basis to support any allocation.

Since it is unlikely that there would be a significant difference between IDC and AFUDC, Hydro should continue to capitalize IDC rather than AFUDC so as to avoid the cost of separately tracking and accounting for the difference.

JT BROWNE CONSULTING Appendix JTBC-1
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RESUME - JOHN T. BROWNE

Summary: John Browne has been assisting clients in applying regulatory principles and resolving financial, accounting and costing issues related to rate regulation for over 30 years. Prior to establishing his own practice 20 years ago, he was a consultant with Deloitte and Touche LLP, the last seven years as a partner.

He has directed and worked on a wide range of studies for rate-regulated entities that have dealt with accounting and cost allocation principles, the determination of rate base, cost of service determination, product costing/pricing, rate of return, capital structure, and methods of regulation.

He has appeared as an expert witness on accounting, costing and financial issues before the following regulatory tribunals: Canadian Radio-television and Telecommunications Commission, Canadian Transport Commission, the Alberta Public Utilities Board / the Alberta Energy and Utilities Board, the Manitoba Public Utilities Board, Newfoundland and Labrador Board of Commissioners of Public Utilities and the Nova Scotia Board of Commissioners of Public Utilities.

Education / Professional Qualifications:

- Bachelor of Commerce - Queen's University
- Master of Arts (Economics) - Queen's University
- Chartered Professional Accountant, Chartered Accountant

Committees/ Publications

Mr. Browne was Chairman of the Canadian Institute of Chartered Accountants ("CICA") Study Group that produced the CICA research report "Financial Reporting By Rate Regulated Enterprises."

He authored or co-authored the CA Magazine articles "A Matter Of Principles - Part I" "A Matter Of Principles - Part II" and "Regulatory Assets." These articles dealt with accounting by rate-regulated enterprises.

He co-authored the Deloitte & Touche publication "Basics of Canadian Rate Regulation" and authored the Deloitte & Touche monograph "The Contractual Pitfalls of Relying on GAAP." He has also authored a number of papers for distribution to clients and potential clients such as "Fundamentals of Rate Regulation" (an update of "Basics of Canadian Rate Regulation") and "Comments on Deferral Accounts to Deal With Uncertainty."

Key Clients: Mr. Browne's major clients have included: Newfoundland Power Inc., Nova Scotia Power Inc., New Brunswick Power Corporation, Hydro Quebec, Ontario Hydro, Manitoba Hydro, SaskPower, Edmonton Power, Ottawa Hydro, Canadian Electricity Association, Ontario Energy Board, Atco Gas, Enbridge, Newfoundland Telephone Company Ltd., Bell Canada, Manitoba Telephone System, Saskatchewan Telecommunications, AGT/TELUS, Teleglobe, Telesat Canada, Southwestern Bell Telephone Company, New York Telephone, The Telecommunication Authority of Singapore and Dhiraagu (Maldives).

Selected Assignments:

- Completed a survey of Canadian regulators to determine what they viewed as their objectives and how they interpreted those objectives.
- Assisted Ontario Hydro Services Company (currently Hydro One), one of the successor companies of Ontario Hydro, in understanding its regulatory options by researching and providing advice on a number of regulatory issues related to transfer pricing, structural organization, accounting for income taxes, relationships with affiliated companies, performance-based regulation, etc.
- Participated in the in the OEB consultation process dealing with the transition to IFRS. As part of this participation, made a presentation on proposed principles to guide the development and maintenance of regulatory accounting policies (RAP) and a framework for evaluating proposed changes in RAP.
- Advised the Canadian Electricity Association in the preparation of a paper dealing with the recognition of regulatory assets and liabilities. The assistance included organizing and drafting the report and advising on issues covered in the paper.
- Prepared a draft for the framework and principles section of a utility's cost manual.
- Researched and analysed the issue of a deferral plan for the introduction of a new plant into rate base. Prepared evidence on the issue for Nova Scotia Power and appeared as an expert witness. Subsequently prepared evidence and appeared as an expert witness on changes to the deferral of the costs on the plant due to changes in circumstances.

- Researched and analysed the issues of phase-in and risk sharing for Edmonton Power's Genesee plant and prepared a recommendation that was submitted to the utility's regulator. Expert testimony was also provided.

- Researched, analysed and presented a recommendation that an electric utility should be allowed to defer tax costs so that the utility could avoid a rate increase followed by a rate decrease.

- Provided a written opinion for Nova Scotia Power on its regulatory treatment of amounts related to an income tax dispute. The report dealt with past taxes that had not been recovered in allowed rates, future taxes that may not be payable, and the use of deferral accounts.

- Prepared a report for Nova Scotia Power Inc. that addressed the utility's plan to use market-related value in determining its pension expense. This plan would result in smoothing the impact of pension expense on rates. The report provided an opinion on whether the plan was consistent with generally accepted accounting principles and established regulatory principles.

- Provided a written opinion for Newfoundland Power on accounting and regulatory issues related to future employee benefits and the company's Hydro production equalization reserve. The opinion was included in the company's rate submission.

- Advised New Brunswick Power Distribution and Customer Service Corporation on regulatory issues related to a proposed fuel deferral account.

- Prepared two reports for NSPI: the reports addressed the recovery of unrecovered costs of a retired generating station. The utility's proposal included the recognition of a deferral account for both the unrecovered costs and the related capitalized financing costs.

- Provided a written opinion on a proposal by a not-for-profit electric system operator to deal with surpluses and deficits. In preparing the opinion, the treatment of surpluses and deficits by other not-for-profit independent electric system operators was reviewed.

- Analysed the issue of the appropriate accounting and regulatory treatment of Nova Scotia Power's defeasance program. Prepared evidence and appeared as an expert witness on the issue.

CHANGES IN CAPITALIZATION POLICY DUE TO ADOPTION OF IFRS

As set out in a 2012 Decision and Order, Hydro proposed the following changes to its capitalization policy as a result of the adoption of IFRS. The Board accepted all of the changes:

> *Hydro explains further in its 2012 Capital Projects Overview that the five areas of the 2012 Capital Budget Application that are affected by the move to IFRS are:*
>
> *i. Major Overhauls and Inspections - Hydro believes that it is appropriate to capitalize these costs in certain conditions as they represent benefits that will last over periods greater than one year and including these costs in a year could result in volatility in operating costs. Hydro sets out the policies and guidelines that it has adopted in this regard.*
>
> *ii. Training Costs – IFRS no longer allows the capitalization of training costs and Hydro proposes that such costs be included in operating rather than civil expenditures. Hydro submits that the exclusion of training costs in projects does not represent a material change.*
>
> *iii. Capital Labour Overheads – Hydro, in accordance with IFRS, no longer includes an allocation for Engineering Managers and Supervisors in the cost of property, plant and equipment. Hydro reports that it is now able to more accurately capture the hours of all engineers that work on capital as a result of the re-alignment of the Project Execution and Technical Services group, and proposes that hours directly charged to a capital project be included in the project's capital costs.*
>
> *iv. Corporate Overhead Allocation – Hydro, in accordance with IFRS, no longer includes an allocation for time for support business units.*
>
> *v. AFUDC vs. IDC – According to Hydro using Interest During Construction ("IDC") rather than Allowance for Funds Used During Construction ("AFUDC") as required by IFRS does not result in a material change.*[1]

[1] Newfoundland and Labrador Board of Commissioners of Public Utilities; Order No. P. U. 2(2012); January 24, 2012; pg. 3.

Attachment 2

Utility Survey Results

newfoundland labrador hydro
a nalcor energy company

newfoundland labrador hydro
a nalcor energy company

Jurisdictional Scan Results

General

1. What is the primary focus of your organization? For example, is your organization primarily Generation, Transmission, Distribution or some combination?
2. What accounting standards does your organization follow (i.e. US GAAP, IFRS, Private Entity GAAP, etc.)?
3. What form of rate regulation is your organization subject to for rate-setting purposes (eg. Cost of service methodology, performance based, etc.)?
4. Does your organization have any capitalization policies that are approved by your regulator which may be an exception to current accounting standards? If yes, please provide details.

	Ownership	Q1	Q2	Q3	Q4
Utility 1	Investor	Generation, Transmission & Distribution	US GAAP	Performance Based	No
Utility 2	Crown	Generation, Transmission & Distribution	IFRS	Cost of Service	No
Utility 3	Investor	Transmission	IFRS (translate to US GAAP)	Cost of Service	AFUDC, ELG, ARO
Utility 4	Investor	Distribution	US GAAP	Performance Based	No
Utility 5	Crown	Generation & Transmission (Some Distribution)	IFRS	Cost of Service	Regulatory Assets
Utility 6	Investor	Distribution (Some Transmission & Generation)	ASPE (translate to US GAAP)	Cost of Service	IAS 16[1]
Utility 7	Crown	Distribution	IFRS	Custom Incentive Rate-Setting	No
Utility 8	Investor	Transmission & Distribution (Some Generation)	ASPE (translate to US GAAP)	Cost of Service	No
Utility 9	[Redacted]	[Redacted]	[Redacted]	[Redacted]	No
Utility 10	Crown	Generation, Transmission & Distribution	IFRS	Cost of Service	No
Utility 11	Investor	Generation, Transmission & Distribution	US GAAP	Cost of Service	Training
Newfoundland Power	Investor	Distribution, Transmission (Some Generation)	US GAAP	Cost of Service	No
Hydro	Crown	Generation, Transmission & Distribution	IFRS	Cost of Service	No

[1] Utility 6 reports under US GAAP but follows IAS-16, *Property, Plant, and Equipment* with respect to capitalization.

Capitalized Overheads

5. Does your organization capitalize overheads as a component of construction costs? If so:
    a. What types of overhead costs do you capitalize (eg. administration, finance labour, parts, interest, training, pension etc.);
    b. Does your organization follow an established methodology such as the Full Cost or Incremental methods, or another methodology relating to capitalized overhead construction costs?
6. How are the capitalized overhead construction costs allocated amongst the various classes of assets in your organization?
7. Expressed as percentage, what were your overhead construction costs in relation to your total capital expenditures in 2019? Has this ratio changed materially (i.e. >3%) in comparison to your average?

	Q5. a	Q5. b	Q6	Q7
Utility 1	Departmental Costs	Full Cost	Based on asset additions	13.8%
Utility 2	Labour, Meals, Travel Related, Vehicles, IDC	Full Cost	Based on project spend	5.1%
Utility 3	Facility, HR, Finance, Head Office	N/A	Based on monthly CAPEX	10.0%
Utility 4	Departmental Costs	Full Cost	Prescribed percentages	9.0%
Utility 5	AFUDC	N/A	Monthly WIP balance	2.5%
Utility 6	No	N/A	N/A	N/A
Utility 7	2/3 direct labour - Supervision, Engineering, and Supply Chain burden rates. 1/3 vehicle and burdens	Burden Rates	Based on time spent	26.0%
Utility 8	Administration, Finance, 90% Stores Inventory Operating costs, AFUDC	Full Cost	Based on annual CAPEX	1.6%
Utility 9	All directly attributable to projects. Overhead departments charged to O&M	Incremental	Directly charged	N/A[2]
Utility 10	Salaries & Benefits, Administrative where directly attributable, Cost of Energy	Incremental	Prescribed percentages	10.0%
Utility 11	Administration, Labour, Office Supplies, Contracts, Rent, Membership Dues, Materials and proportionate amount of current service pension cost	Full Cost	Based on project spend	12.0%
Newfoundland Power	Construction and Non-Construction Activities, Pension, AFUDC, Inventory, Vehicle	Incremental	Proportionately based on asset additions	11.7%[3]
Hydro	No overhead. Hydro does capitalize Vehicle/Equipment, IDC directly	N/A	N/A for overhead. Time sheet for vehicle/Equip & proportionately based on project spend for IDC	0% overhead. 2.9% direct for vehicle & int.

[2] Not separately identifiable from percentages in Q9.
[3] If the capitalized overhead was adjusted to remove the impact of pension, the percentage of capitalized overhead for 2019 decreases to 9.0%. Capitalized overhead for Newfoundland Power includes GEC, AFUDC, and vehicle and inventory overheads.

Capitalized Internal Labour

8. Does your organization have a loading applied to base salaries for capital asset additions? If so:
    a. what is included in the labour loader (i.e. benefits, vacation, pension, etc.)?
    b. how is it allocated to capital assets (through an hourly charge or some other method)?
9. What percentage of your total internal labour costs (regular and overtime, excluding overheads from question #6) were capitalized in 2019 (i.e. total capitalized internal labour divided by total labour costs)? Has this ratio changed materially (i.e. >3%) in comparison to your average?
10. What percentage of your total labour costs (contract labour, regular and overtime, excluding overheads from question #6) were capitalized in 2019 (i.e. total capitalized internal labour divided by total labour costs)? Has this ratio changed materially (i.e. >3%) in comparison to your average?
11. Does your organization have any other method of allocating labour costs to capital assets; for example, loading labour costs on inventory and/or meter replacement? If so, please provide details below.

	Q8. a	Q8. b	Q9	Q10	Q11
Utility 1	Health Benefits, Leave, Incentives, Pension	Time Entry	50.2%	50.2%	Inventory
Utility 2	Allowances, Absences, Payroll Benefits, Severance, Vehicle	Time Entry	16.3%	13.5%	No
Utility 3	Benefits, Pension	Time Entry	58.0%	58.0%	No
Utility 4	Pension, Medical & Dental, CPP, EI	Time Entry	31.1%	14.0%	Inventory Loader
Utility 5	Benefits, Leave, Pension	Time Entry	17.0%	N/A	No
Utility 6	Vacation, Benefits, Pension, Professional Dues, Education, Protective Equipment, Vehicle	Time Entry	35.0%	N/A	No
Utility 7	Pension, CPP, EI, Health & Dental, Safety Uniforms, Tools, Vacation	Time Entry	36.0%	27.0%	No
Utility 8	Benefits, Vacation, Pension	Time Entry	37.0%	46.0%	No
Utility 9	Allowances and Burden (such as Pension and Dental)	Time Entry	14.0%	N/A	No
Utility 10	Benefits (Health, insurance, dental, life, CPP, EI, Workers Comp., Pension)	Time Entry	22.4%	71.9%	No
Utility 11	Employer payroll costs, benefits (health, dental, life & ADD) and DC/DB Pension	Time Entry	25%	N/A	No
Newfoundland Power	Health Benefits, Payroll, Vacation, Leave	Time Entry	35.0%[4]	43.0%[5]	Inventory Loader
Hydro	Benefits, CPP, EI, Pension, Vacation	Time Entry	26.8%	37.1%	No

[4] Adjusting Newfoundland Power's capitalized internal labour to account for pension increases the percentage to 37.5%.
[5] Adjusting Newfoundland Power's capitalized total labour to account for pension increases the percentage to 44.8%.

Schedule 2

Allowance for Funds Used During Construction Deferral Account – Definition

Newfoundland and Labrador Hydro
Allowance for Funds Used During Construction Deferral Account – Definition

This account shall be charged monthly with the difference between the calculation of Allowance for Funds Used During Construction ("AFUDC") and Interest During Construction ("IDC") on capital projects that attract interest based on Newfoundland and Labrador Hydro's ("Hydro") Capitalization Guidelines. This account will be charged at the conclusion of each calendar month based upon the following formula:

Monthly Transfer = AFUDC - IDC

Where:

AFUDC is calculated using Hydro's approved rate of return on average rate base; and

IDC is calculated using Hydro's embedded cost of debt in accordance with International Financial Reporting Standards ("IFRS").

Disposition of any Balance in this Account

The balance in this account will be amortized using the composite depreciation rate in the latest depreciation study approved by the Board of Commissioners of Public Utilities, commencing the year after the transfer of the cost to the AFUDC Deferral Account.

Affidavit

IN THE MATTER OF the *Electrical Power Control Act, 1994,* SNL 1994, Chapter E-5.1 ("*EPCA*") and the *Public Utilities Act*, RSNL 1990, Chapter P-47 ("*Act*"), and regulations thereunder; and

IN THE MATTER OF an application by Newfoundland and Labrador Hydro ("Hydro") pursuant to Section 58 of the *Act*, for the approval of a deferral account for an Allowance for Funds Used During Construction ("AFUDC").

AFFIDAVIT

I, Dana Pope, of St. John's in the province of Newfoundland and Labrador, make oath and say as follows:

1) I am Vice President, Regulatory Affairs and Stakeholder Relations, Newfoundland and Labrador Hydro, the applicant named in the attached application.
2) I have read and understand the foregoing application.
3) To the best of my knowledge, information, and belief, all of the matters, facts, and things set out in this application are true.

SWORN at St. John's in the province of Newfoundland and Labrador this 21st day of November 2025, before me:

Barrister, Newfoundland and Labrador

Dana Pope, CPA (CA), MBA