

December 4, 2019

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: Newfoundland Power Inc.'s 2020 Capital Budget Application – Newfoundland and Labrador Hydro's Submissions

On July 5, 2019, Newfoundland Power Inc. ("Newfoundland Power") filed its 2020 Capital Budget Application ("CBA") with the Board of Commissioners of Public Utilities ("Board"). On July 24, 2019, Newfoundland and Labrador Hydro ("Hydro") filed its Notice of Intention to Participate. The Consumer Advocate also filed a Notice of Intention to Participate. Hydro provided Requests for Information ("RFIs") on August 12, 2019, to which Newfoundland Power filed responses on September 6, 2019. The Consumer Advocate subsequently requested a technical conference on Newfoundland Power's 2020 CBA, which was held on November 14, 2019. At the technical conference, Hydro asked specific questions for clarification and further understanding of Newfoundland Power's replacement criteria for transmission line rebuilds and policies surrounding capitalization of internal costs, General Expenses Capitalized ("GEC") and overhead costs. Following the technical conference, Hydro asked an additional three RFIs on November 19, 2019. Newfoundland Power provided its responses on November 28, 2019.

On November 15, 2019, the Board proposed certain dates for the completion of the process surrounding Newfoundland Power's 2020 CBA. The dates were acceptable to all parties. As a result, written comments from the parties are due December 4, 2019.

The following are Hydro's comments on Newfoundland Power's 2020 CBA.

1.0 Capitalization

Included in Newfoundland Power's Capital Budget Applications ("CBAs") are both direct and indirect capitalized internal costs associated with new capital assets. Newfoundland Power's capitalized internal costs include labour, vehicle overheads, inventory overheads, and GEC.¹ Newfoundland Power and Hydro's approaches to capitalization of internal costs vary greatly.

1.1 Capitalization of Internal Costs

With respect to internally capitalized labour, Hydro notes that Newfoundland Power's total amount of capitalized labour has increased substantially over the past 20 years, from \$10.9 million in 2000 to \$24.1

¹ Please refer to NLH-NP-021.

million in 2018. This increase is also visible as a percentage of total labour costs, increasing from 26% to 34% over this same time frame.²

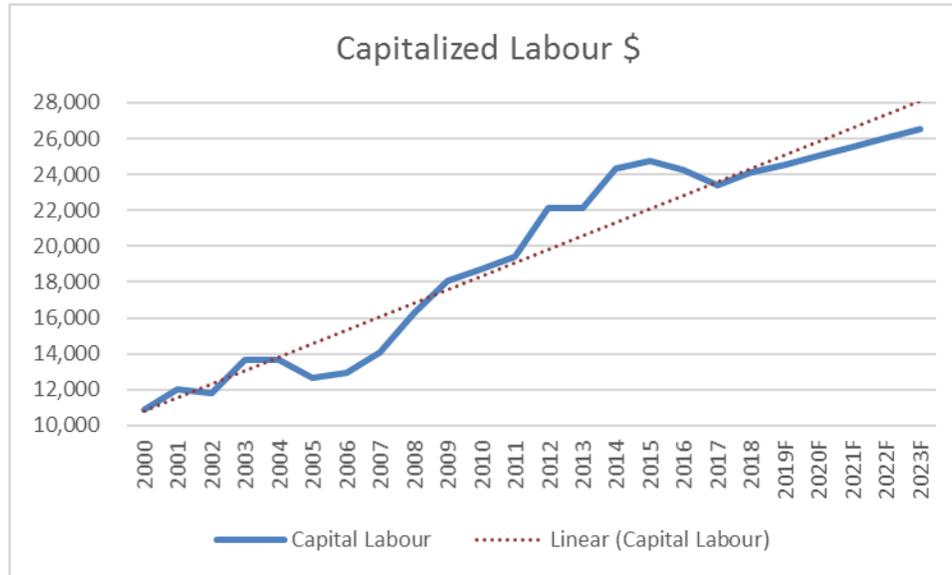


Figure 1: NLH-NP-018 Capital Labour (\$000)

Over the past five years (2014–2018), Newfoundland Power has capitalized 35% of its labour costs on average. Labour costs recorded as capital are excluded from operating expenses and included in total capital assets, which form part of a utility’s rate base. While the variation in Newfoundland Power’s capitalized labour appears to be as a result of the increase in Newfoundland Power’s capital program, the ratio of internal labour as a portion of new capital has also changed over time. Specifically, during the five-year period from 2000 to 2004 approximately 22% of Newfoundland Power’s capital additions were comprised of internal labour costs; this same ratio increased to approximately 25% from 2014 through 2018.³ Based on Newfoundland Power’s 2020 CBA of approximately \$96.6 million, a 3% increase in the internal labour component equates to \$2.9 million in additional capitalized labour when compared to Newfoundland Power’s earlier historical ratios.

While Newfoundland Power has capitalized 35% of its total labour costs over the past five years, Hydro has capitalized approximately 25% over this same time frame.⁴ A difference of 10% in costs allocated to capital versus operations and maintenance represents approximately \$7.5 million in the context of Newfoundland Power’s forecast 2020 total labour costs.⁵

1.2 Accounting Standards

Hydro and Newfoundland Power follow different accounting standards; Newfoundland Power has adopted United States Generally Accepted Accounting Principles (“US GAAP”) and Hydro has adopted International Financial Reporting Standards (“IFRS”).

As noted in Newfoundland Power’s presentation at the technical conference on its capitalization practices, the definition of a capital cost under US GAAP is “all costs necessary to bring it to the

² Please refer to NLH-NP-018.

³ “Capital Internal Labour” per NLH-NP-018 divided by “Capital Asset Additions” per NLH-NP-024.

⁴ Please refer to NLH-NP-018.

⁵ Please refer to NLH-NP-018, 2020F “Total Internal Labour” \$74,187,000 * 10%.

condition and location necessary for its intended use.”⁶ Similar guidance is provided under IFRS, which states that “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” should be included in the cost of a capital asset.⁷

The application of these accounting standards allow for interpretation within a range of acceptable outcomes. However, the choice to allocate a cost as either a capital or operating expense can have a material impact on customer rates. For example, \$100 in labour costs recorded as an operating expense will result in ratepayers contributing the same \$100 in revenue requirement. If a utility with the same weighted average cost of capital as Newfoundland Power capitalized \$100 in labour costs towards an asset with a 30-year life, ratepayers would ultimately pay more than \$200 in revenue requirement over the 30-year life of the asset.⁸

While the two utilities follow different accounting standards, the differing standards alone do not account for the difference in the levels of capitalization. As noted in Newfoundland Power’s response to NLH-NP-039, under US GAAP a regulated entity may, with approval of its regulator, modify its accounting treatment. Similarly for Hydro, under IFRS 14 a regulated entity may also, with approval of its regulator, modify its accounting treatment. As a result, Hydro submits that the Board has the ability to order Newfoundland Power and/or Hydro to modify capitalization approaches to ensure lowest possible cost consistent with reliable service.⁹

1.3 Recommendation

Newfoundland Power and Hydro have different approaches to the capitalization of costs. This difference makes comparing costs across utilities problematic, as one utility may record certain labour costs as an expense while another utility would record them as a capital asset. It is Hydro’s position that an examination of the practices for capitalization, including GEC, in this jurisdiction is warranted to determine an approach that would result in the lowest possible cost for ratepayers, taking into consideration both short- and long-term revenue requirement impacts. Hydro proposes that a comprehensive review of the capitalization practices of both Newfoundland Power and Hydro with respect to generally accepted sound public utility practice would benefit ratepayers and promote least-cost service in Newfoundland and Labrador.

2.0 Transmission Line Rebuilds

Hydro does not object to the specific transmission line rebuild project contained in Newfoundland Power’s 2020 CBA; however, Hydro has concerns over the level of analysis Newfoundland Power performs generally in its Inspection and Maintenance Practices related to wood pole transmission lines. As noted in the responses to NLH-NP-001, Newfoundland Power completes a visual inspection of the pole from the ground line to the top, completes a sounding test from the ground line to two metres above grade and performs core sampling to test for deterioration. Newfoundland Power does not require its technicians to climb each pole fully for inspection unless a visual inspection from the ground has identified an issue or an acceptance inspection of a newly constructed line is required.¹⁰ Newfoundland Power does not have a treatment program for its poles.

⁶ “Capitalization Practices,” Slide 3, Newfoundland Power Technical Conference, November 14, 2019.

⁷ IAS 16 Property, Plant and Equipment, Section 16(b).

⁸ Return on rate base of 7.04%, 30-year useful life, straight line depreciation.

⁹ Revenue requirement impact and the promotion of least cost service are not capitalization criteria from an accounting standards perspective.

¹⁰ Please refer to NLH-NP-001, App. B, p.5.

In 2019, Hydro asked other utilities to complete a survey on their wood pole management practices through the CEATI consortium. Seventeen utilities with wood pole transmission lines responded. Fifteen of those utilities advised that they utilized a "test and treat" program. Of the Canadian respondents, BC Hydro, FortisBC, SaskPower, NB Power, and NS Power reported a similar program to Hydro's Wood Pole Line Management program in terms of:

- Inspection and treatment philosophy;
- Inspection cycles; and
- Condition based refurbishment of lines.

Based on these survey results, Hydro believes that a test and treatment program is sound utility practice. Hydro believes that Newfoundland Power should reassess their existing Transmission Inspection and Maintenance Practices to ensure the most accurate and comprehensive information is obtained to justify future projects and to ensure its inspection and maintenance practices are consistent with the provision of least-cost, reliable service.

3.0 Conclusion

Hydro does not object to the approval of Newfoundland Power's 2020 CBA and the projects contained therein; however, Hydro believes that further process and examination of Newfoundland Power's capitalization of internal costs as well as Newfoundland Power's transmission line inspection process and replacement criteria is warranted.

Should you have any questions, please contact the undersigned.

Yours truly,

NEWFOUNDLAND AND LABRADOR HYDRO



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cc: **Newfoundland Power**
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