Q. Further to the response to PUB-NP-076 c), in June 2005, Newfoundland Power filed a report on the transition from the invested capital approach to Asset Rate Base Methodology in compliance with the 2003 GRA Order.

a) Please provide the 2005 report.

b) Page 1 of the report stated: "However, the ARBM is less complicated and has fewer variables as it is simply calculated by applying the weighted average cost of capital to rate base." Please explain why Newfoundland Power is not following the approach presented to the Board in its 2005 report.

c) Page 1 also includes the statement: "Both the rate base and weighted average cost of capital are regulated by the Board." Please confirm that the proposed approach to calculating return on rate base is equivalent to applying weighted average cost of capital to average invested capital.

d) Please confirm that the transition to ARBM from the invested capital method was approved in the 2008 GRA.

e) Please confirm that the return on rate base approved in each test year since the 2008 GRA was equal to the approved test year weighted average cost of capital times the approved average rate base.

f) Is Newfoundland Power proposing to transition from ARBM back to the invested capital method in the current application?

A. a) Attachment A provides the Asset Rate Base Method ("ARBM") Review report.[1]

b) In Order No. P.U. 19 (2003), the Board found that the ARBM should be used to calculate Newfoundland Power's average rate base.[2]

Newfoundland Power's transition to the ARBM was therefore based on conforming the Company's calculation of average rate base to its average invested capital. This was predicated on the concept that all assets of a utility which are attributable to regulated activities (i.e. invested capital) should be included in its rate base.

The most significant adjustment in the transition to the ARBM was including average deferred charges in the computation of average rate base, which was approved by the Board in Order No. P.U. 19 (2003). The Company subsequently implemented Board approved rate base changes that substantially conformed its calculation of rate base to its invested capital in its *2008 General Rate Application*.

The Board approved Newfoundland Power's proposal to complete the transition to the ARBM in the calculation of its 2008 average rate base in Order No. P.U. 32 (2007).[3]

[1] The Asset Rate Base Method Review was filed as a part of Newfoundland Power's *2006 Accounting Application.*

[2] See page 71 of Order No. P.U. 19 (2003).

[3] See page 24 of Order No. P.U. 32 (2007).

The Board also approved Newfoundland Power's calculation of its 2008 test year return on rate base, as well as its 2008 rate of return on rate base, in Order No. P.U. 32 (2007).

Table 1 provides Newfoundland Power's calculation of its 2008 test year return on rate base and rate of return on rate base, as outlined and approved by the Board in Order No. P.U. 32 (2007).[4]

Table 1:
2008 Approved Test Year Return on Rate Base
and Rate of Return on Rate Base
($000s, unless otherwise noted)

Regulated return on common equity	32,700
Return on debt	34,680
Return on preferred equity	586
Return on rate base	**67,966**
Average rate base	**812,212**
Rate of return on rate base[5]	**8.37%**

The Company's 2008 test year return on rate base was calculated by adding its return on debt, return on common equity and return on preferred equity together as opposed to the formula of rate base x weighted average cost of capital ("WACC").

Newfoundland Power's 2008 test year rate of return on rate base was calculated by dividing the Company's 2008 test year return on rate base by its 2008 test year average rate base.

In approving the Company's 2008 return on rate base and rate of return on rate base, the Board provided that *"as a result of the completion of the transition of the ARBM for calculating rate base [Newfoundland Power's] rate of return on rate base for ratemaking purposes will be the same as its weighted average cost of capital (WACC)."*[6]

In Newfoundland Power's view, Order No. P.U. 32 (2007) set the precedent in determining the Company's average rate base consistent with the ARBM and calculating its return on rate base and rate of return on rate base as outlined in Table 1 above.

The general expectation with the ARBM is that Newfoundland Power's average rate base and average invested capital will be similar. In that scenario, the Company's rate

[4] See page 21 of Order No. P.U. 32 (2007).
[5] $67,966 / $812,212 = 8.37%.
[6] See page 22 of Order No. P.U. 32 (2007).

of return on rate base and its WACC would also be similar, if not the same. However, differences in invested capital and rate base still exist related to construction work in progress, materials and supplies, and cash working capital amounts.[7]

To illustrate, Table 2 provides the reconciliation between average rate base and invested capital for the 2022 and 2023 test years.[8]

Table 2:
Average Rate Base vs. Average Invested Capital Reconciling Items
2022 and 2023 Test Years
($millions)

	2022TY	**2023TY**
Average rate base (A)	1,239	1,288
Construction work in progress	21	16
Materials and supplies[9]	2	2
Cash working capital[10]	(24)	(19)
Average invested capital (B)	**1,238**	**1,287**
Difference (B - A)	(1)	(1)

Table 2 shows that while 2022 and 2023 test year average rate base and invested capital were aligned, there were offsetting impacts in those years. Further, as outlined in the response to Request for Information PUB-NP-076, Newfoundland Power removed Rate Stabilization Account balances from its proposed 2022 and 2023 test year forecasts in an effort to lessen the impact of the volatility of power supply cash flow effects that have occurred since the current wholesale rate was implemented on October 1, 2019. The adjustments served to better align the Company's average invested capital and its rate base for the 2022 and 2023 test years.[11]

While similar adjustments have been made to Newfoundland Power's 2025 and 2026 test years, differences in average rate base and invested capital still remain for those years as detailed in the response to Request for Information PUB-NP-076.

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7 Newfoundland Power excludes construction work in progress from its rate base as the associated assets are not yet used and useful in the provision of service. However, construction work in progress still has to be financed and therefore, is reflected in the Company's invested capital. Both the Company's materials and supplies and cash working capital requirements are reflected in its rate base through an allowance. As these are allowances, as opposed to invested capital amounts, differences arise.

8 A similar analysis for the 2025 and 2026 test years is provided in the response to Request for Information PUB-NP-076.

9 Materials and supplies (invested capital) versus the rate base allowance.

10 Cash working capital (invested capital) versus the rate base allowance.

11 Without the adjustments, the difference in average invested capital and rate base would have been approximately ($15) million and ($18) million in 2022 and 2023, respectively.

In summary:

- Since 2008, Newfoundland Power has calculated its average rate base consistent with the ARBM, and as required in Order No. P.U. 32 (2007).

- Since 2008, the Company has calculated its test year return on rate base by adding its return on debt, return on common equity and return on preferred equity together, consistent with the calculation outlined in Order No. P.U. 32 (2007).

- Since 2008, Newfoundland Power has calculated its test year rate of return on rate base by dividing the Company's test year return on rate base by its test year average rate base, consistent with the calculation outlined in Order No. P.U. 32 (2007).

- Larger variances in the Company's cash working capital requirements have occurred in recent years due to volatility in power supply costs since the current wholesale rate was implemented. Newfoundland Power has adjusted its 2025 and 2026 test year forecasts to lessen the impact of this volatility, consistent with the adjustments made to the 2022 and 2023 test years. As more fully detailed in part f) to this response, a new wholesale rate will reduce differences in rate base and invested capital and provide more stability in the Company's cash working capital requirements.

c) Yes, Newfoundland Power's WACC is a function of its return on equity and its return on debt. As such, multiplying the Company's average invested capital by its WACC would provide an amount equivalent to its test year return on rate base.

d) It is confirmed that the Board approved Newfoundland Power's proposal to complete the transition to the ARBM in the calculation of its 2008 average rate base in Order No. P.U. 32 (2007).

See part b) for further information.

e) It is not confirmed that Newfoundland Power's return on rate base for all test years since 2008 would equal its average rate base multiplied by its WACC. However, the Company can confirm that differences in average rate base and average invested capital were relatively minor in those test years, resulting in Newfoundland Power's rate of return on rate base and WACC being equal. Accordingly, there would be relatively small differences in the Company's calculation of its test year return on rate base approved by the Board and an amount calculated by multiplying its average rate base by its WACC in the test years over the 2008 to 2023 timeframe.

f) No, Newfoundland Power is not proposing to transition its calculation of average rate base away from the ARBM.

In the Company's view, the fact that there are differences between rate base and invested capital suggests that adjustments may be required to its calculation of average rate base to better align it with its invested capital, consistent with the purpose of the ARBM.

As provided in part b), as well as in the response to Request for Information PUB-NP-076, larger differences between rate base and invested capital have arisen in recent years related to purchased power costs. Newfoundland Power is currently in discussions with Hydro on the implementation of a new wholesale rate.[12] A new wholesale rate will significantly reduce the volatility in purchased power costs and, in the Company's view, likely reduce differences in its rate base and invested capital.

Following the implementation of a new wholesale rate, Newfoundland Power plans to review the cash working capital allowance in its rate base to ensure it sufficiently reflects its cash working capital requirements (i.e. invested capital). Any necessary adjustments would be outlined in the subsequent cash working capital allowance report, which has been historically filed with the Board as part of the Company's general rate applications.

Newfoundland Power submits that determining its test year return on rate base by adding its return on debt and return on common equity together is consistent with past practice of the Board as well with the recovery of prudently incurred costs associated with the cost of financing the Company's regulated activities.

[12] See the response to Request for Information PUB-NP-132.

Asset Rate Base Method Review
September 2005

Asset Rate Base Method Review
(filed in compliance with Order No. P.U. 19 (2003))

September 2005

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1.0 BACKGROUND

1.1 The 2003 General Rate Order

In Order No. P.U. 19 (2003) (the "2003 GRO"), the Board found that the Asset Rate Base Method ("ARBM") should replace the Invested Capital Method used to calculate the return on rate base for Newfoundland Power ("the Company"). Both methods are valid accounting methodologies applied to convert cost of capital to return on rate base. However, the ARBM is more widely recognized, less complicated and has fewer variables. ARBM is calculated simply by multiplying the weighted average cost of capital by the average rate base. Both the average rate base and weighted average cost of capital are regulated by the Board.

As approved in the 2003 GRO, the transition to the ARBM began with the Company including average deferred charges in the computation of average rate base.[1] Including average deferred charges in the computation of average rate base brought the Company closer to the full implementation of ARBM. As a further step toward full implementation of ARBM, the Board ordered Newfoundland Power to review the remaining reconciling items between average rate base and average invested capital as identified by Grant Thornton.

1.2 Adopting ARBM

In compliance with the 2003 GRO, the Company filed *A Report on the Asset Rate Base Methodology* ("the Report") with its 2006 Capital Budget Application. The Report provided a review of each of the remaining reconciling items, assessed the appropriateness of their inclusion in Newfoundland Power's rate base, and provided an illustration of the impact on revenue requirement of moving to the ARBM based on 2004 test year costs.

The Report concluded that no change to the rate base will be required to address the reconciling items under the ARBM. However, the method used to calculate each item may need review from time-to-time.

This *Asset Rate Base Method Review* (the "Review") provides an update on the transition to ARBM based on the recommendations of the Report, taking into account the impact of Newfoundland Power's proposals with respect to recognizing revenue on an accrual basis beginning in 2006.

2.0 RECONCILING ITEMS

2.1 The Reconciling Items

In Newfoundland Power's 2003 general rate application (the "2003 GRA"), Grant Thornton provided a reconciliation of average invested capital and average rate base (the "Grant Thornton Reconciliation"). The Grant Thornton Reconciliation is provided in Table 1.

[1] The calculation of average rate base is provided in Return 3 of the Company's Annual Report to the Board.

Table 1
Reconciliation of Average Invested Capital and Average Rate Base [2]
2004 Test Year
(000s)

Average Invested Capital	$700,244
Average Rate Base	703,102
Difference	$(2,858)
Reconciliation:	
Plant (primarily construction in progress)	$1,674
Corporate income tax deposit	6,949
Materials and supplies (actual vs. allowance)	773
Working capital (actual vs. allowance)	(20,957)
Common equity (book vs. regulated)	8,703
	$(2,858)

A brief discussion of each of the reconciling items follows.

2.2 Plant (primarily construction in progress)

Plant refers to Newfoundland Power's investment in those physical assets necessary to deliver service to its customers. Plant is the principal component and the starting point for the calculation of average rate base.[3]

The difference in plant as reflected in the Company's average invested capital and its average rate base relates primarily to construction work in progress ("CWIP").

Newfoundland Power's invested capital reflects the cash investment in CWIP at December 31st, as reflected in the Company's financial statements. The inclusion of CWIP in the financial statements is in accordance with accepted financial accounting practice.

The calculation of Newfoundland Power's average rate base specifically excludes CWIP on the conceptual basis that CWIP is not yet "used and useful" in the provision of service to customers.

Since the average invested capital calculation includes the average CWIP in that year and the average rate base calculation excludes CWIP, there will continue to be ongoing differences

[2] Newfoundland Power 2003 General Rate Application, Grant Thornton, Supplementary Evidence April 4, 2003, Exhibit II.
[3] See Returns 3 and 4 of the Company's Annual Report to the Board.

between plant amounts for average rate base and average invested capital even after the ARBM has been fully adopted.

2.3 Corporate Income Tax Deposit

The corporate income tax deposit was included in the calculation of regulated average invested capital for the 2004 test year. However, it was not included in the calculation of average rate base for the 2004 test year.

In June 2005, Newfoundland Power settled the outstanding tax reassessments related to the income tax deposit. The income tax deposit was refunded to Newfoundland Power in August 2005, thus eliminating it as a reconciling item between average invested capital and average rate base as of 2006.

2.4 Materials and Supplies (actual vs. allowance)

Newfoundland Power's average invested capital recognizes its actual investment in materials and supplies inventory in that year, as reflected in its financial statements. The amount included in the financial statements is calculated in accordance with accepted financial accounting practice.

Current regulatory practice in the utility industry provides for a materials and supplies allowance to be included in rate base. The materials and supplies allowance recognizes, and permits recovery of, the cost of inventory for day-to-day operations. Newfoundland Power calculates a materials and supplies allowance in accordance with Board Orders by averaging the monthly balance of materials and supplies less an expansion factor.[4]

Use of an expansion factor in calculating the materials and supplies allowance for inclusion in Newfoundland Power's average rate base is the primary reason for the difference between average rate base and average invested capital related to materials and supplies.

2.5 Working Capital

Working capital from an accounting perspective (i.e., balance sheet working capital) is the difference between current assets and current liabilities at the balance sheet date. It is only a snapshot of working capital at a specific point in time (e.g. year-end) and is not indicative of (nor intended to be indicative of) a company's ongoing working capital requirement which varies from day-to-day.

Current regulatory practice in the utility industry provides for a cash working capital allowance ("CWC Allowance") to be included in rate base. A CWC Allowance is typically calculated using a lead/lag study that examines the timing differences between when revenue is collected and when particular expenses are paid. The Company's method for calculating the CWC Allowance to be included in average rate base was approved by the Board in Order No. P.U. 37 (1984).

[4] This method of calculating the materials and supplies allowance was approved by the Board in Order No. 1 (1974).

The historically large negative working capital calculated from Newfoundland Power's year-end balance sheet primarily reflects the Company's current accounting practices for revenue recognition. At the end of each financial year, the Company's balance sheet historically included amounts payable to Hydro for purchased power to December 31st.[5] However, the Company's balance sheet has not reflected unbilled amounts due from customers in respect of electricity deliveries for December that are billed in January of the following year.

2.6 Common Equity (book vs. regulated)

Book common equity is the common shareholders' equity as reflected in the Company's financial statements.

Newfoundland Power's regulated common equity is higher than book common equity. This is because regulated common equity has been increased by the cumulative amount of non-regulated expenses net of income taxes.[6]

The inclusion of cumulative non-regulated expenses in calculating regulated common equity is essentially a legacy issue for Newfoundland Power. As there appears to be no regulatory policy justification for continuing this practice, it would be practical and in the interests of regulatory transparency to discontinue its use.

3.0 IMPACTS OF ACCOUNTING POLICY CHANGES

The Company is proposing a change from recognizing revenue on a billed basis to an accrual basis as of January 1, 2006. The Company also proposes to discontinue the use of regulated common equity in favour of book equity in determining average invested capital beginning in 2006. (This combination of proposals is referred to as the "Proposed Method").

In addition, the recent CICA accounting guideline, AcG-19,[7] requires rate-regulated entities like Newfoundland Power to record regulatory assets and liabilities[8] on their balance sheet. To comply with AcG-19, Newfoundland Power will be required to report Unbilled Revenue on its December 31, 2005 balance sheet separately as (i) accounts receivable and (ii) a corresponding regulatory liability.[9]

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5 Purchased power from Hydro is Newfoundland Power's largest expense. It represents over 60% of revenue on an annual basis.

6 See Return 19 of the Company's Annual Report to the Board.

7 CICA accounting guidelines are a component of the CICA Handbook and are therefore a source of GAAP. Accounting guideline ACG-19 titled *disclosures by entities subject to rate regulation* was issued in May 2005.

8 Regulatory assets and liabilities are created when regulators require revenues and/or expenses to be recognized in a manner other than that normally required by GAAP. Regulatory assets are amounts expected to be recovered from customers in future periods through the ratemaking process. Regulatory liabilities are amounts expected to be refunded or applied for the benefit of customers in future periods through the ratemaking process.

9 This differs from previous disclosure of the assets and regulatory liability associated with unbilled revenue when the two were netted for balance sheet reporting purposes.

This section of the Review highlights the impacts of the Proposed Method and AcG-19 on the reconciliation between average invested capital and average rate base. Specific *pro forma* impacts on working capital, average rate base, and average invested capital for the period 2006 to 2009 are identified, together with a summary of the overall impacts associated with the Proposed Method.

3.1 Working Capital

The new balance sheet reporting requirements introduced in AcG-19 will change Newfoundland Power's balance sheet working capital from a large negative balance to a positive balance. This occurs because the Company's balance sheet at December 31, 2005 will fully reflect all current receivables and payables to December 31st, including all unbilled amounts due from customers in respect of electricity deliveries. This also assumes that disposition of the corresponding regulatory liability is subject to Board determination and is therefore not recorded as a current liability.

As a result of the new balance sheet reporting requirements, the difference between Newfoundland Power's CWC Allowance and balance sheet working capital will be substantially eliminated.

Table 2 provides a comparison of the *pro forma* differences between the CWC Allowance and balance sheet working capital for 2006 to 2009 before and after implementation of the new balance sheet reporting requirements introduced in AcG-19.

Table 2
***Pro Forma* Working Capital Differences**
2006 – 2009
(000s)

Reconciling Item	2006	2007	2008	2009
Before Implementation of AcG-19				
Balance Sheet Working Capital	($18,316)	($18,549)	($18,856)	($18,811)
CWC Allowance	5,709	5,824	5,897	5,989
Difference	($24,025)	($24,373)	($24,753)	($24,800)
After Implementation of AcG-19				
Balance Sheet Working Capital	$6,174	$6,277	$6,207	$6,546
CWC Allowance	5,709	5,824	5,897	5,989
Difference	$465	$453	$310	$557

There will likely always be small differences between balance sheet working capital and the CWC Allowance because of the different methodologies which underlie the calculations.

3.2 Average Rate Base

Newfoundland Power's proposal to change from recognizing revenue on a billed basis to an accrual basis as of January 1, 2006 creates a transitional amount equal to the unbilled revenue at December 31, 2005 (the "Transitional Amount"). The Transitional Amount will be shown as a regulatory liability on Newfoundland Power's balance sheet at December 31, 2005.

Prospective recognition of the Transitional Amount over a transition period will enable customers to receive full benefit from the Transitional Amount in a manner which does not jeopardize Newfoundland Power's financial integrity. This approach is also consistent with past practice of the Board with respect to changes in accounting policy.[10]

If the Transitional Amount is recognized as revenue over a transition period, the remaining balance (the "Unrecognized Transitional Amount") will be shown as a regulatory liability on the balance sheet in subsequent years. This will continue until such time as the Transitional Amount has been fully recognized as revenue and the Unrecognized Transitional Amount is reduced to zero.

The Unrecognized Transitional Amount reflects revenue for which recognition has been deferred until future accounting periods, i.e., it is a deferred liability. For reasons similar to those which support the inclusion of Newfoundland Power's Weather Normalization Reserve and the deduction of deferred income taxes in the calculation of rate base, the average Unrecognized Transitional Amount should also be deducted in the calculation of Newfoundland Power's rate base commencing in 2006 (the "Transitional Adjustment").

The Transitional Adjustment and resulting *pro forma* average rate base for the period 2006 to 2009 are provided in Table 3.

[10] For example, in Order No. P.U. 3 (1995-96), the Board ordered that the change in accounting policy for general expenses capitalized be phased in prospectively over the period from January 1, 1995 to December 31, 1999. In Order No. P.U. 19 (2003), the Board also approved adoption of the market-related method of valuing Newfoundland Power's pension assets on a prospective basis beginning in 2003, and true-up adjustments to depreciation expense on a prospective basis over three years also commencing in 2003. Other examples of prospective changes in accounting policy include Order Nos. P.U. 17 (1987), P.U. 20 (1978) and P.U. 21 (1980), wherein the Board approved adoption of the CICA recommendations on pension accounting and the recording of certain deferred taxes on a prospective basis.

Table 3
***Pro Forma* Average Rate Base**
Existing Method vs. Proposed Method
2006 – 2009
(000s)

Rate Base	2006	2007	2008	2009
Existing Method [11]	$763,651	$781,325	$800,390	$813,989
Transitional Adjustment [12]	(19,325)	(10,791)	(3,597)	-
Proposed Method	$744,326	$770,534	$796,793	$813,989

3.3 Average Invested Capital

The proposed use of book equity for regulatory reporting purposes will eliminate common equity (book vs. regulated) as a reconciling item between average invested capital and average rate base.

3.4 Summary of Overall Impacts

As a result of new CICA pronouncements, Newfoundland Power's December 31, 2005 balance sheet reporting requirements will effectively eliminate the largest reconciling item between Newfoundland Power's average invested capital and average rate base; i.e., the difference between Newfoundland Power's CWC Allowance and balance sheet working capital.

Refund of the corporate income tax deposit, and the proposed use of book common equity for regulatory reporting purposes, also eliminates these two amounts as reconciling items between average rate base and average invested capital.

Of the remaining reconciling items, only slight differences exist. These slight differences will continue to occur because of the different accounting and regulatory treatments for calculating CWIP, working capital, other assets and liabilities, and materials and supplies.

Table 4 shows the *pro forma* differences and the reconciliation between average invested capital and average rate base under the Proposed Method for 2006 – 2009.

[11] Based on Newfoundland Power's 5-year capital plan filed with Board in the Company's 2006 Capital Budget Application

[12] Assumes recognition of the liability in 2006, 2007 and 2008 of $9,579,000, $7,194,200 and $7,194,200 respectively. This results in the liability being fully recognized as of year-end 2008.

Table 4
Proposed Method
***Pro Forma* Reconciliation of Average Invested Capital and Average Rate Base**
2006-2009
(000s)

Reconciling Item	2006	2007	2008	2009
Average Invested Capital	$745,752	$771,858	$798,100	$815,419
Average Rate Base	744,326	770,534	796,793	813,989
Difference	$1,426	$1,324	$1,307	$1,430
Reconciliation:				
Plant (primarily construction in progress)	$2,045	$2,102	$2,228	$2,105
Corporate Income Tax Deposit [13]	-	-	-	-
Materials and supplies (actual vs. allowance)	1,006	1,006	1,006	1,006
Working capital (actual vs. allowance)	465	453	310	556
Common Equity (book vs. regulated) [14]	-	-	-	-
Other Assets net of Other Liabilities [15]	(2,090)	(2,237)	(2,237)	(2,237)
	$1,426	$1,324	$1,307	$1,430

4.0 CONCLUSION

The assets of a utility which are attributable to regulated activities should be included in its rate base. Conceptually, therefore, the average rate base and the average invested capital of a utility should be essentially equal. If they are, then providing a rate of return on rate base equal to the weighted average cost of capital (i.e., the ARBM) should result in recovery of the full required return on invested capital.

With the implementation of Newfoundland Power's proposed accounting policy changes, average rate base and average invested capital will no longer be materially different. This will mark significant progress towards adoption of ARBM for calculating Newfoundland Power's return on rate base.

[13] The corporate income tax deposit was refunded to the Company in August 2005 as a result of the tax case settlement and is no longer a reconciling item.

[14] With the proposed use of book common equity for regulatory purposes, this will no longer be a reconciling item.

[15] This includes other assets and other liabilities which are not currently included in average rate base but which are included in average invested capital, as shown in Appendix A. Other assets net of other liabilities were shown in previous reconciliations as part of working capital differences.

Newfoundland Power will address the small differences that will continue to exist as a result of the different accounting and regulatory treatments for calculating CWIP, working capital, other assets and liabilities, and materials and supplies, at its next general rate application.