

- 1 **Q. (Reference General Expenses Capitalized; CA-NP-042; 2022/23 GRA) The**
2 **Application forecasts approximately \$5.0 million of General Expenses**
3 **Capitalized ("GEC"). The Application describes GEC as general expenses**
4 **related directly or indirectly to capital projects. CA-NP-042 explains that,**
5 **effective January 1, 2023, pension costs were removed from the GEC**
6 **calculation following the 2022/23 GRA and are now directly charged to**
7 **capital projects through NP's labour loader.**
- 8 **d) Please provide, for each year from 2023 actual through 2027 forecast:**
9 **i) total GEC; ii) the principal categories of costs included in GEC and the**
10 **amount associated with each category; and iii) GEC as a percentage of**
11 **total annual capital expenditures, excluding GEC.**
- 12 **e) Please describe the current methodology used to determine GEC,**
13 **including: i) the allocation factors or percentages applied; ii) the basis**
14 **upon which each allocation factor or percentage was established; and**
15 **iii) when and through what proceeding or other process each allocation**
16 **factor or percentage was most recently reviewed or approved.**
- 17 **f) Please identify any time-study, activity analysis or other review**
18 **undertaken since the applicable allocation factors or percentages were**
19 **established to determine whether they continue to reflect current**
20 **activities and cost causation. Please summarize the results of the most**
21 **recent review. If no such review has been undertaken, please explain**
22 **why not.**
- 23 **g) Please explain whether, and to what extent, the amount of GEC varies**
24 **with the overall level of capital activity. In particular: i) does an**
25 **increase in capital expenditures, all else equal, result in an increase in**
26 **GEC; and ii) if yes, please explain the mechanism by which the level of**
27 **capital activity affects the amount capitalized.**
- 28 **h) Please identify the categories of costs included in GEC that, but for**
29 **their assignment to capital activities, would be recorded as operating**
30 **expenses, and describe the accounting criteria applied to determine**
31 **the portion appropriately attributable to capital investment.**
- 32 **i) Please describe the controls, review or other processes used to verify**
33 **that costs included in GEC: i) satisfy NP's applicable capitalization**
34 **criteria; and ii) are appropriately attributable to capital investment**
35 **rather than ongoing utility operations.**
- 36 **j) CA-NP-042 states that, beginning in 2023, pension costs have been**
37 **included in internal labour recorded to capital projects and programs**
38 **rather than through GEC. With respect to the current methodology**
39 **please: i) describe how the portion of pension costs included in internal**
40 **labour charged to capital projects and programs is determined; ii)**
41 **provide the amount of pension costs capitalized through internal**
42 **labour in 2025 actual, 2026 forecast and 2027 budget; and iii) describe**
43 **the process used to periodically review whether the portion of pension**
44 **costs charged to capital continues to appropriately reflect labour**
45 **attributable to capital activities.**

- 1 **A.** d) Table 1 provides total GEC by category for each year from 2023 actual to 2027
2 forecast.

Table 1 Annual GEC by Category 2023 Actual through 2027 Forecast					
Type	Direct ¹ (\$M)	Indirect ² (\$M)	Total (\$M)	Capital Expenditure Less GEC (\$M)	% of Capital Expenditure Less GEC
2023	1.8	3.3	5.1	133.5	3.8%
2024	1.6	3.1	4.7	127.5	3.7%
2025	1.6	3.0	4.6	129.6	3.5%
2026F	1.6	3.7	5.3	149.0	3.6%
2027F	1.7	3.3	5.0	144.3	3.5%

- 3 e) Newfoundland Power's current methodology for determining GEC was the
4 subject of inquiry during the Company's *2022/2023 General Rate Application* (the
5 "2022/2023 GRA") and was approved by the Board in Order No. P.U. 3 (2022).
6 See Attachment A for the *Review of General Expenses Capitalized* that was filed
7 with the Board as part of the Company's 2022/2023 GRA and outlines the
8 Company's current methodology, allocation factors and percentages used to
9 calculate GEC. Newfoundland Power observes that annual GEC totals have been
10 consistent under this methodology and continues to record GEC in the manner
11 approved by the Board.
12
13 f) See the response to part e).
14
15 g) No, an increase in capital expenditures does not necessarily result in an increase
16 in GEC. Annual GEC amounts reflect the allocation factors and percentages
17 approved by the Board to determine the general expenses required to execute
18 the Company's capital plan. Overall, the results are consistent from 2023 actual
19 to 2027 forecast.
20
21 h) See the response to part e).

¹ These costs reflect the direct charges for employees who are deemed incremental as a result of the capital program.

² These costs reflect indirect allocations of overheads that are considered incremental as a result of the capital program.

1 i) Costs included in GEC are subject to established controls and review processes
2 designed to ensure that only costs appropriately attributable to capital activities
3 are capitalized.

4
5 Indirect GEC is recorded monthly by the Finance department using the allocation
6 factors and percentages approved by the Board. As part of the monthly
7 calculation process, Finance verifies that the approved allocation methodology
8 has been applied correctly. The monthly GEC entry is subject to a hierarchical
9 review and approval process prior to finalization.

10
11 Direct GEC is recorded through individual labour and non-labour transactions that
12 are specifically associated with capital planning activities. These transactions are
13 reviewed through established authorization and approval processes.

14
15 j) i) Total pension costs are forecast based on actuarial valuations and internal
16 forecasts that reflect inflation and other known and measurable changes.
17 Pension costs are included in Newfoundland Power's labour loading rates and
18 are allocated to capital projects based on the underlying labour charged to
19 capital activities. As employees charge time directly to capital projects and
20 programs, the applicable labour loading rate is applied to those labour
21 charges, resulting in the associated portion of pension costs being recorded
22 to capital.

23
24 ii) Pension costs capitalized through internal labour were approximately \$2.8
25 million in 2025 and are forecast to be approximately \$3.0 million in 2026 and
26 \$3.2 million in 2027.

27
28 iii) See the responses to parts i) and j).



ATTACHMENT A:

Newfoundland Power Inc.: Review of General Expenses Capitalized:
May 2021

6. *Review of General Expenses Capitalized*

Review of General Expenses Capitalized

May 2021

6. Review of General Expenses Capitalized

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6. *Review of General Expenses Capitalized*

1.0 **Executive Summary**

In February 2021, the Newfoundland and Labrador Board of Commissioners of Public Utilities (the “Board”) requested that Newfoundland Power Inc. (“Newfoundland Power” or the “Company”) include with its next general rate application a review of its methodology and cost ratios used to determine General Expenses Capitalized (“GEC”).

The Board requested that the review address why the Company includes pension costs in GEC and how capitalizing pension costs by way of a labour loader would impact revenue requirement and customer rates.

Newfoundland Power’s review determined that, excluding pension costs, the Company’s GEC methodology and calculation are consistent with established regulatory principles of the Board and sound public utility practice.

Certain changes to the calculation of GEC are proposed to account for changes in Newfoundland Power’s operations since the matter was last considered by the Board in 1999. The proposed changes include removing general expenses for printing services from the GEC calculation, adding general expenses for information systems to the GEC calculation, and revising certain cost ratios used to allocate general expenses to GEC.

These changes to the calculation of GEC are proposed to be effective January 1, 2023 and would decrease 2023 revenue requirement by approximately \$0.1 million.

Newfoundland Power proposes to remove pension costs from its GEC calculation and directly charge pension costs to capital projects by way of a labour loader, effective January 1, 2023.

The use of a labour loader to directly charge pension costs to capital projects is consistent with the Company’s current treatment of Other Post-Employment Benefit costs and sound public utility practice.

The allocation of pension costs to capital projects by way of a labour loader would increase the 2023 revenue requirement by approximately \$1.4 million. This is primarily the result of income tax effects. The estimated customer rate impact of this proposal is an increase of 0.2%.

The income tax effects associated with the proposed change in capitalizing pension costs would reverse over time and reduce revenue requirements in subsequent years. Ultimately, there would be no impact on total revenue requirement collected through customer rates over the lives of the related capital assets.

6. *Review of General Expenses Capitalized*

2.0 **Background**

2.1 **General**

On August 14, 2020, Newfoundland Power filed with the Board a *Review of Capitalization Policies and Guidelines* (the “Capitalization Practices Report”).¹

The Capitalization Practices Report concluded that Newfoundland Power’s capitalization practices comply with United States generally accepted accounting principles (“U.S. GAAP”) and relevant orders of the Board. A survey of 11 Canadian utilities confirmed that the Company’s capitalization practices are consistent with sound public utility practice, including the capitalization of general expenses.²

On February 16, 2021, the Board commented on the Capitalization Practices Report. The Board acknowledged that Newfoundland Power’s GEC methodology was last considered by the Board in 1999 and should be revisited.³

The Board requested that Newfoundland Power include a review of its methodology and cost ratios used to determine GEC with its next general rate application.⁴ The Board also requested that the review address why the Company is the only utility surveyed that includes pension costs in its GEC and the potential impact on revenue requirement and customer rates if Newfoundland Power capitalized pension costs by way of a labour loader.

2.2 **Current GEC Methodology**

Newfoundland Power follows the incremental cost method to allocate general expenses to GEC. Use of the incremental cost method to allocate general expenses to GEC was approved by the Board in Order No. P.U. 3 (1995-96) (the “GEC Order”).⁵

Consistent with the GEC Order, only costs that vary with the level of capital work, as compared to no capital program whatsoever, are allocated to GEC. Otherwise, costs are expensed as incurred.⁶

¹ See Attachment 1 for a copy of the Capitalization Practices Report.

² See Attachment 1, Appendix E for the survey results.

³ Section 58 of the *Public Utilities Act* states that the Board may prescribe the form of all books, accounts, papers and records to be kept by a public utility. Section 78(2)(h) of the *Public Utilities Act* states that, in fixing a rate base, the Board may include other fair and reasonable expenses that: (i) the Board thinks appropriate and basic to the public utility’s operation; and (ii) have, with the approval of the Board, been charged to a capital account.

⁴ The Board’s correspondence, dated February 16, 2021, stated: “*The Board is requesting that Newfoundland Power include a review of its methodology and general expense cost ratios used to determine GEC in its general rate application that is scheduled to be filed on June 1, 2021. This will provide the Board with the opportunity to revisit the methodology, and determine if the cost ratios used to allocate cost are appropriate or whether any changes may be warranted for the benefit of rate payers.*”

⁵ In the GEC Order, the Board stated: “*Overhead costs will be considered to be incremental costs of capital projects to the extent that they vary with the level of construction as compared to no capital projects whatsoever. Otherwise the overhead costs are expenses of the period in which they are incurred.*” See Order No. P.U. 3 (1995-96), page 28.

⁶ See Order No. P.U. 3 (1995-96), page 28.

6. *Review of General Expenses Capitalized*

Newfoundland Power's allocation of general expenses to GEC is, in effect, a 3-step process:

- (i) The first step requires identifying which general expenses would vary if there was no capital program whatsoever. The general expenses currently included in the calculation of GEC are outlined in the GEC Order.⁷ This includes general expenses related to capital planning, operating supervision, tools, equipment and safety clothing, system operations and certain non-construction activities.
- (ii) The second step involves determining the amount of each general expense to be allocated to GEC. Ratios are applied to each general expense based on how the expense would vary if there was no capital program whatsoever.⁸ For example, capital planning is only required due to the capital program. All general expenses for capital planning are therefore allocated to GEC.
- (iii) The third step involves allocating the total GEC amount across capital projects. The total GEC amount is allocated across capital projects using a flat rate. The flat rate is calculated by dividing the total GEC amount by the total capital expenditures.⁹ The flat rate is then applied to the cost of each capital project to determine the amount of GEC allocated to that project. For example, the flat rate was 7.93% in 2020 and distribution capital expenditures totaled \$42.4 million. Approximately \$3.4 million of GEC was therefore allocated to distribution projects in 2020.¹⁰

2.3 *Current Utility Practice*

The capitalization of general expenses is a generally accepted accounting practice in the electric utility industry. For example, the *Federal Energy Regulatory Commission ("FERC") Uniform System of Accounts* provides for the capitalization of all overhead construction costs, such as engineering, supervision and general office salaries and expenses.¹¹

Under U.S. GAAP, rate-regulated entities are permitted to capitalize costs that would otherwise be expensed in the year incurred, where such treatment is approved by the utility regulator. In other jurisdictions, such capitalized expenses may be referred to as "Capitalized Overheads."

A 2020 survey of Canadian utilities confirmed that the capitalization of general expenses is standard industry practice. Of 11 responding utilities, 7 employ an approach similar to that of Newfoundland Power for the capitalization of overhead costs.¹²

⁷ See Order No. P.U. 3 (1995-96), pages 16-22.

⁸ In Order No. P.U. 36 (1998-99), the Board stated that any adjustments to the GEC ratios are intended to be at the discretion of Newfoundland Power.

⁹ The GEC Order provided that GEC should be allocated to capital assets on a flat rate basis. The flat rate is determined in a given year by dividing the annual GEC amount by the total capital expenditures in that year, adjusted for projects that are work-in-progress.

¹⁰ \$42.4 million x 7.93% = \$3.4 million.

¹¹ See section 4 of the *FERC Uniform System of Accounts – Electric Plant Instructions*.

¹² See Attachment 1, Appendix E, Page E-3, Question 5.

6. *Review of General Expenses Capitalized*

The method used to determine capitalization rates varied among surveyed utilities.¹³ Capitalization rates ranged from 1.6% to 26% in 2019. The average capitalization rate of surveyed utilities was 10%.¹⁴

Newfoundland Power's capitalization rate is comparable to that of other utilities. Excluding pension costs, the Company's overall capitalization rate was 9% in 2019.¹⁵

3.0 **Review of GEC Methodology**

3.1 **General**

Newfoundland Power reviewed its approach to GEC to determine its continued appropriateness and any necessary changes. The review considered:

- (i) The basis of the GEC methodology;
- (ii) Which general expenses are appropriate to include in the calculation of GEC; and
- (iii) The ratios applied to determine the portion of general expenses allocated to GEC.

Section 3 provides the results of Newfoundland Power's review of its approach to GEC.

The capitalization of pension costs was reviewed separately. The results of the review of pension costs are provided in section 4.

3.2 **Comparison of Methodologies**

There are 2 standard methodologies that can be applied when capitalizing general expenses:

- (i) The incremental cost method capitalizes only those general expenses that are incremental to a utility as a result of its capital program.
- (ii) The full cost method capitalizes any general expenses incurred in connection with a capital program, including expenses that benefit both a utility's operations and its capital program.

For example, Newfoundland Power's Internal Audit function performs work related to the Company's operations and its capital program. The full cost method would capitalize a portion of Internal Audit costs. However, there would be no material reduction in the work requirements of Internal Audit in the absence of a capital program. The incremental cost method would therefore not capitalize any costs associated with this function.

¹³ Of the 7 responding utilities, 5 utilities use the full cost method to allocate general expenses and 2 utilities use the incremental cost method. The types of overhead costs capitalized vary among respondents.

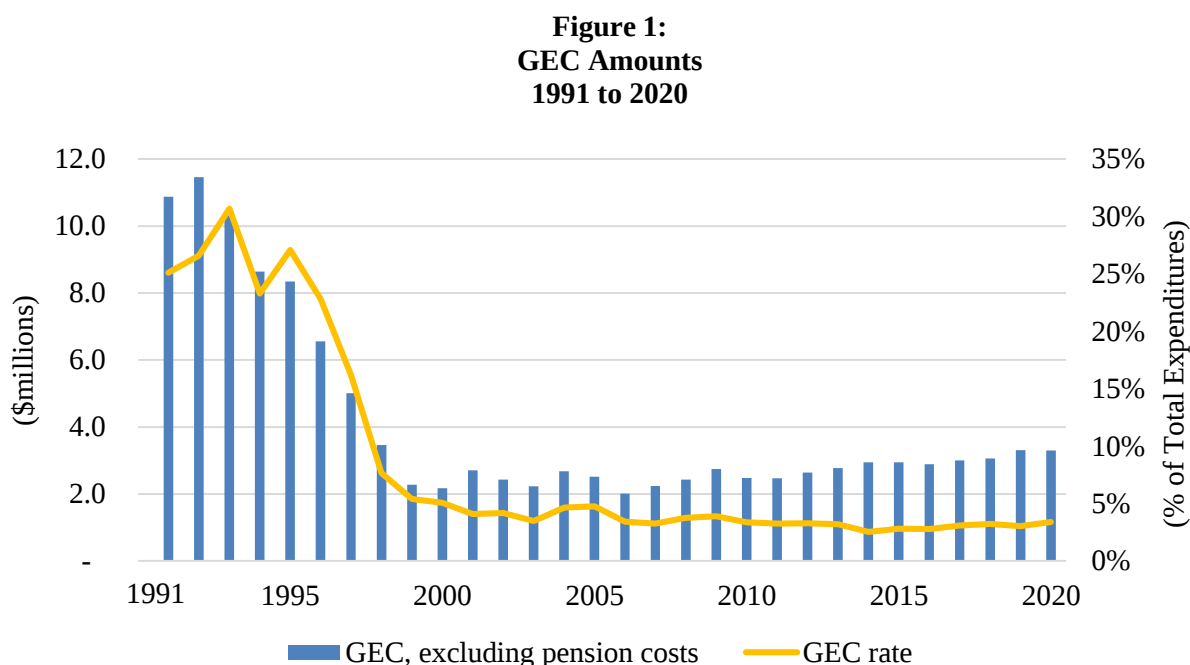
¹⁴ Two utilities responded "N/A." See Attachment 1, Appendix E, Page E-3, Question 7
((13.8 + 5.1 + 10.0 + 9.0 + 2.5 + 26.0 + 1.6 + 10.0 + 12.0) / 9 = 10.0).

¹⁵ Of the 9.0% capitalization rate, 3.1% related to GEC and the remaining 5.9% related to capitalized interest and vehicle and inventory overheads. See Attachment 1, Appendix E, Page E-3, footnote 1.

6. Review of General Expenses Capitalized

Prior to 1995, Newfoundland Power used the full cost method to allocate general expenses to GEC. The Company implemented the incremental cost method in 1999, following a 5-year phase in period.¹⁶

Figure 1 shows Newfoundland Power's GEC amounts over the period 1991 to 2020, expressed both in dollars and as a percentage of total capital expenditures.¹⁷



Using the full cost method, GEC averaged approximately \$10.3 million annually, or 26% of total capital expenditures, from 1991 to 1995. GEC amounts ranged from approximately \$8.3 million to \$11.5 million annually using the full cost method, or from 23% to 31% of total capital expenditures.

Using the incremental cost method, GEC averaged approximately \$2.7 million annually, or 3.5% of total capital expenditures, from 2000 to 2020. GEC amounts ranged from approximately \$2.1 million to \$3.1 million annually using the incremental cost method, or from 2.6% to 5.0% of total capital expenditures.

Newfoundland Power considered the appropriateness of continuing to apply the incremental cost method from 3 perspectives.

¹⁶ In the interest of rate stability for customers, the Board ordered that the new GEC methodology be phased in over a 5-year period from 1995 to 1999. See Order No. P.U. 3 (1995-96).

¹⁷ The GEC amounts exclude pension costs.

6. *Review of General Expenses Capitalized*

First, the Company considered the regulatory principle of customer rate stability.¹⁸ Stability in capital expenditures is conducive to stability in customer rates. The incremental cost method results in a reasonably stable amount of capitalization for general expenses on a year-over-year basis.

Second, Newfoundland Power considered the principle of intergenerational equity.¹⁹ General expenses that are incremental due to the capital program exist only to bring assets into service that provide an enduring benefit to customers. The incremental cost method allocates these costs to GEC so that the costs are recovered over the useful service lives of the related capital assets. This ensures costs are recovered only from customers who benefit from the service provided by those capital assets.

Third, the Company considered current Canadian utility practice. As described in section 2.3, the incremental cost method has provided for capitalization rates that are reasonably consistent with other Canadian utilities.

Based on this review, use of the incremental cost method to allocate general expenses to GEC continues to be appropriate.

3.3 General Expenses

The GEC Order provided guidelines on which general expenses are to be allocated to GEC. Newfoundland Power reviewed its operations to determine whether any changes are required to the general expenses allocated to GEC.

The review confirmed that all general expenses included in the Company's calculation of GEC remain appropriate, with the exception of those related to printing services. The reduction in printing services would be immaterial if there was no capital program. This is largely due to the digitization of forms for capital projects since the 1990s.²⁰ It is therefore appropriate to remove general expenses for printing services from the calculation of GEC.

The review also determined that certain general expenses related to information systems should be included in the calculation of GEC. Information systems have become integral to Newfoundland Power's operations since the 1990s. There would be lower work requirements associated with information systems if there was no capital program. Specifically, there would be lower work requirements related to information systems planning, including software enhancements and system upgrades. There would also be lower work requirements associated

¹⁸ The principle of customer rate stability establishes that rates and revenues should be stable and predictable from year to year, with a minimum of unexpected changes seriously adverse to either ratepayers or the utility. The principle of customer rate stability has been previously recognized by the Board. See, for example, Order No. P.U. 14 (2004), page 24.

¹⁹ The principle of intergenerational equity establishes that customers in a given period should pay only the costs necessary to provide them with service in that period. They should not be required to pay for costs incurred to provide service to customers in another period. The principle of intergenerational equity has been previously recognized by the Board. See, for example, Order No. P.U. 14 (2015), page 12.

²⁰ Approximately \$37,000 of printing services expenses were allocated to GEC in 2020. Printing services primarily relate to customer service requirements, such as printing customer bills.

6. *Review of General Expenses Capitalized*

with providing technical support for information systems, as the Company would have fewer employees and fewer personal computers.

All general expenses proposed to be included in the calculation of GEC, including information systems, are consistent with the definition of Capitalized Overheads in the FERC System of Accounts and reflect sound public utility practice.²¹

Appendix A provides the detailed review of general expenses.

3.4 GEC Ratios

Newfoundland Power reviewed the cost ratios used to allocate general expenses to GEC (“GEC ratios”). The review indicated that certain changes to GEC ratios would be appropriate to better reflect the Company’s current operations.

Appendix B provides the detailed review of the GEC ratios, which is summarized below.

Capital Planning

Capital planning general expenses would not exist if there was no capital program. Capital planning general expenses are currently charged directly to GEC. Directly charging capital planning general expenses to GEC continues to be appropriate.

Operating Supervision

Operating supervision requirements would be lower if there was no capital program. This is because Newfoundland Power would have fewer employees and would consolidate regional work tasks if there was no capital program.²²

The existing GEC ratio of 15% for operating supervision was based on an assessment of the number of regional employees that would no longer be required if there was no capital program. In 1999, it was estimated that approximately 7 regional employees would no longer be required if there was no capital program. This equated to approximately 15% of operating supervision general expenses.²³

²¹ Section 4 of the *FERC Uniform System of Accounts – Electric Plant Instructions* provides for the capitalization of all overhead construction costs, such as engineering, supervision and general office salaries and expenses.

²² In 2020, there were 611.5 full-time equivalents (“FTEs”), of which 214 FTEs were attributed to completing capital work.

²³ Regional employees are employees who work in 1 of the Company’s 3 operating regions: St. John’s region, Eastern region and Western region.

6. *Review of General Expenses Capitalized*

In 2020, it is estimated that approximately 7 regional employees would no longer be required if there was no capital program.²⁴ Maintaining the GEC ratio of 15% for operating supervision is therefore appropriate.²⁵

Tools, Equipment and Safety Clothing

Tools, equipment and safety clothing requirements would be lower if there was no capital program.

The existing GEC ratio of 48% reflected the percentage of Newfoundland Power's regional labour that was related to capital work in 1999.

In 2020, the percentage of Newfoundland Power's regional labour related to capital work is 65%.²⁶ Adjusting the GEC ratio for tools, equipment and safety clothing to 65% is therefore appropriate.

System Operations

System operations requirements would be lower if there was no capital program. As examples, the System Control Centre ("SCC") would no longer be required to complete switching orders, protection guarantees, or isolation and grounding requirements related to capital work.

General expenses for system operations are currently charged directly to GEC.

Newfoundland Power estimates there would be a reduction of 2 FTEs in the SCC if there was no capital program.²⁷ A reduction of 2 FTEs represents a reduction of 10% in the operating costs for system operations.²⁸ Applying a GEC ratio for system operations of 10% is therefore appropriate.

²⁴ The 7 positions are: (i) 1 supervisor; (ii) 1 analyst; (iii) 4 engineering technologists; and (iv) 1 area customer representative.

²⁵ Operating supervision general expenses were \$4,431,000 in 2020. Applying a GEC ratio of 15% results in a GEC allocation amount of \$665,000. Dividing this amount by 7 employees equates to an average labour cost per FTE of \$95,000. This figure is comparable to the Company's overall labour cost per FTE of approximately \$106,000 in 2020.

²⁶ This percentage is based on the Company's regional labour allocation. It includes 54% in labour charged to capital projects and 11% in labour charged to retirement projects. Labour charged to retirement projects reflects the amount of time associated with removing plant from service.

²⁷ The SCC is required to operate 24 hours a day. Currently, the Company employs 4 teams of 3 Power System Operators in the SCC. If there was no capital program, the Company would reduce its Power System Operators to 4 teams of 2, plus 2 relief workers required for breaks, vacation and unplanned leave. This represents a reduction from 12 to 10 Power System Operators, or 2 FTEs.

²⁸ System operations general expenses were approximately \$2,156,000 in 2020. Applying a GEC ratio of 10% results in a GEC allocation amount of \$216,000. Dividing this amount by the Company's overall labour cost per FTE of approximately \$106,000 in 2020 equates to 2 FTEs.

6. *Review of General Expenses Capitalized*

Non-Construction Activities

Finance, human resources and information systems requirements would be lower if there was no capital program.²⁹

Given the nature of these departments, it is challenging to estimate a specific reduction in general expenses that would occur if there was no capital program. The Board has suggested the use of a nominal rate of 10% as a reasonable proxy in these circumstances.³⁰

Adjusting the GEC ratio for these non-construction activities to a nominal rate of 10% is therefore appropriate.

3.5 *Summary of Proposed Changes*

Newfoundland Power's GEC methodology is consistent with established regulatory principles of the Board and sound public utility practice.

Three minor changes to the calculation of GEC are proposed to account for changes in the Company's operations since the matter was last considered by the Board in 1999. These are:

- (i) Removing general expenses for printing services from the GEC calculation;
- (ii) Adding general expenses for information systems to the GEC calculation; and
- (iii) Adjusting the GEC ratios for tools, equipment and safety clothing, system operations, and non-construction activities.

Newfoundland Power completed a *pro forma* analysis to assess the appropriateness of the proposed changes to its calculation of GEC.

²⁹ See Appendix B, Section 3.0 Non-Construction Activities for further details on these departments, including work requirements.

³⁰ See Order No. P.U. 3 (1995-96), page 19.

6. Review of General Expenses Capitalized

Table 1 summarizes the results of the *pro forma* analysis of the proposed changes to the calculation of GEC.

**Table 1:
GEC Ratios and Amounts**

General Expense	Existing Ratios	2020 Actual (\$000s)	Revised Ratios	2020 Pro Forma (\$000s)
<u>Construction Activities</u>				
Capital Planning	Direct	805	Direct	805
Operating Supervision ³¹	15%	558	15%	665
Tools, Equipment and Safety Clothing	48%	745	65%	1,009
System Operations	Direct	598	10%	216
Subtotal		2,706		2,695
<u>Non-Construction Activities</u>				
Finance	13%	243	10%	187
Human Resources	13%	304	10%	252
Information Systems	-	-	10%	317
Employee Welfare ³²	31%	57	-	-
Printing Services ³³	13%	37	-	-
Subtotal		641		756
Total GEC		3,347		3,451

The proposed changes to the calculation of GEC do not materially change the total amount allocated to GEC. The total GEC amount incurred in 2020 using the existing calculation was approximately \$3,347,000. The *pro forma* GEC amount based on the proposed changes is approximately \$3,451,000.

As there is no material change in the total amount capitalized, the proposed changes to the calculation of GEC will continue to provide an overall capitalization rate that is consistent with current utility practice.³⁴

³¹ The existing calculation only includes the Account 52000 – Supervisory and Administrative Support. The revised calculation adds Account 52050 – Engineering and Technical Support. Both accounts include charges associated with Administrative and Engineering Support. See Appendix A, page 1 and Appendix B, page 2.

³² Employee welfare expenses are proposed to be grouped with human resources expenses. See Appendix B.

³³ Printing services are proposed to be removed from the GEC calculation. See Appendix A.

³⁴ See Attachment 1, Appendix E, Page E-3, Question 7. Expressed as a percentage, overhead construction costs averaged 10% among the survey respondents in relation to the utilities' total capital expenditures in 2019. This compares to 9% for Newfoundland Power (adjusted to remove the impact of pension costs). Capitalized overhead for Newfoundland Power includes GEC, Allowance for Funds Used During Construction ("AFUDC"), and vehicle and inventory overheads.

6. *Review of General Expenses Capitalized*

Newfoundland Power proposes to implement the identified changes to its calculation of GEC effective January 1, 2023.³⁵

The proposed changes to the calculation of GEC will reduce the Company's 2023 revenue requirement by approximately \$0.1 million.

4.0 **Pension Capitalization**

4.1 *Allocation Methodology*

Newfoundland Power's GEC calculation presently includes a portion of current service costs associated with its pension plans.³⁶ The GEC calculation allocates 46% of these pension costs to GEC in accordance with Order No. P.U. 2 (2019).³⁷

Pension costs are employee benefits that are directly related to labour. Under U.S. GAAP, these costs are to be capitalized similar to labour costs necessary to complete capital work. The appropriateness of capitalizing pension costs is therefore not in question.

The allocation of pension costs directly to capital projects by way of a labour loader is an alternative to the current practice of allocating pension costs to capital projects through GEC.³⁸ The use of a labour loader is consistent with the Company's current approach for allocating Other Post-Employment Benefit ("OPEB") costs to capital projects.

Conceptually, there is no material difference to total capital expenditures whether pension costs are capitalized by way of a labour loader or through GEC. Both approaches ultimately allocate pension costs to capital projects based on the Company's overall labour allocations.

The use of a labour loader would result in a more accurate allocation of general expenses to capital projects. This is because a labour loader would follow the labour that is directly charged to a capital project, whereas the GEC calculation uses a flat rate to allocate the total GEC amount across capital projects.

³⁵ Newfoundland Power currently expects an order to be issued for its *2022/2023 General Rate Application* in early 2022 to enable the implementation of changes to customer rates effective March 1, 2022. This is consistent with timing of the order issued following the Company's last general rate application, which was filed during a similar time of year. Implementing the proposed changes to GEC part way through 2022 would be administratively complex as general expenses incurred throughout the year would be allocated to GEC on different bases. An effective date of January 1, 2023 would mitigate these administrative complexities.

³⁶ Current service costs relate to the Company's defined benefit and defined contribution pension plans.

³⁷ The 46% is based on the Company's overall labour allocation in its 2020 test year. The 46% includes 36% in labour charged to capital projects and 10% in labour charged to retirement projects and rechargeable accounts. Labour charged to retirement projects reflects the time associated with removing plant from service. Rechargeable accounts include time charged to the inventory and vehicle overhead accounts, which are primarily reallocated to capital projects.

³⁸ A labour loader involves a loading rate being applied to a base labour cost as a method of allocating certain costs to the same general ledger account as the base labour cost. Loading rates are assessed on an annual basis to ensure they are reasonably allocating the total overhead cost. Any over or under-recovery of allocated costs versus the total cost is trued up at year end. Using a labour loader to allocate costs is a standard practice.

6. *Review of General Expenses Capitalized*

The use of a labour loader to directly charge pension costs to capital projects is consistent with current utility practice. Based on the survey conducted in 2020, 10 of 11 responding utilities capitalize pension costs by way of a labour loader.³⁹

Removing pension costs from the GEC calculation and directly charging pension costs to capital projects by way of a labour loader is consistent with sound public utility practice and the treatment of Newfoundland Power's OPEB costs.

The Company proposes to implement this change effective January 1, 2023.⁴⁰

4.2 *Revenue Requirement Effects*

Directly charging pension costs to capital projects by way of a labour loader will increase the 2023 revenue requirement, primarily due to income tax effects.

For income tax purposes, GEC is recognized as an expense in the year incurred. This results in a tax deduction in the initial year of the GEC calculation. However, the annual depreciation expense associated with GEC must be added back to taxable income each year over the lives of the related capital assets. The add back increases income taxes each year and ensures the expense is not deducted twice for tax purposes.⁴¹

By removing pension costs from the GEC calculation, the associated tax deduction for this portion of GEC will no longer exist in 2023. The annual depreciation expense for this portion of GEC will also no longer exist in subsequent years.

³⁹ See Attachment 1, Appendix E, Page E-3, Question 5a.

⁴⁰ Newfoundland Power currently expects an order to be issued for its *2022/2023 General Rate Application* in early 2022 to enable the implementation of changes to customer rates effective March 1, 2022. Implementing the proposed change to the capitalization of pension costs part way through 2022 would be administratively complex as costs incurred throughout the year would be capitalized on different bases. An effective date of January 1, 2023 would mitigate these administrative complexities.

⁴¹ Typically, deferred income tax calculations counteract these timing effects to ensure there is no impact on annual revenue requirement. However, the approved deferred income tax mechanism related to plant investment explicitly excludes GEC from the calculation. In accordance with Order No. P.U. 17 (1987), GEC has been excluded from post-1986 additions to plant in determining depreciation expense for the Plant Investments deferred income taxes calculation. See, for example, Newfoundland Power's *2020 Annual Report* filed with the Board, *Return 23 Accumulated Deferred Income Taxes*.

6. *Review of General Expenses Capitalized*

Table 2 provides the change in 2023 revenue requirements based on capitalizing pension costs by way of a labour loader.

**Table 2:
2023 Revenue Requirement
Pension Capitalization – Labour Loader
(\$000s)**

Pension Costs – General Expenses	-
Income Taxes – Change in Pension Capitalization	999
Change in 2023 Revenue Requirement Before Income Taxes	999
Income Taxes - Change in Revenue Requirement	428
Total Change in 2023 Revenue Requirement	1,427

By capitalizing pension costs by way of a labour loader, approximately \$3.4 million in pension costs will be removed from GEC in 2023. The associated tax deduction will therefore not exist in 2023. This will increase income taxes included in the 2023 revenue requirement by approximately \$999,000.⁴²

The increase in revenue requirement resulting from this proposal will be subject to taxation.⁴³ As a result, the total increase in revenue requirement in 2023 is approximately \$1.4 million.

By removing pension costs from GEC, the associated annual add back for depreciation expense will also not exist. This will decrease revenue requirements in each subsequent year. Ultimately, there would be no impact on revenue requirement over the total lives of the related capital assets.⁴⁴

Appendix C illustrates the income tax effects on 2023 revenue requirement resulting from capitalizing pension costs via GEC versus a labour loader.

Appendix D illustrates the income tax effects resulting from capitalizing pension costs via GEC versus a labour loader.

⁴² Appendix C shows the calculation of the increase in income taxes of \$999,000. Appendix C also shows that, by allocating pension costs by way of a labour loader, the deferred income tax calculations for both plant investment and pension costs will operate to offset any timing differences that may arise as a result of pension expense recognition for financial reporting and income tax purposes.

⁴³ The increase in revenue requirement of \$999,000 will attract income tax expense of \$428,000. Therefore, the total revenue requirement is \$1,427,000 ($999,000 / (1 - 30\%) = 1,427,000$ x $30\% = 428,000$).

⁴⁴ The decrease in revenue requirement of \$999,000 in subsequent years will result in an associated income tax reduction of \$428,000. Therefore, the revenue requirement decrease over the period will total \$1,427,000. ($999,000 / (1 - 30\%) = 1,427,000$ x $30\% = 428,000$).

6. Review of General Expenses Capitalized

Review of General Expenses

6. Review of General Expenses Capitalized

Review of General Expenses

Expense Description	Account Number	Does the expense vary with the level of construction as compared to no capital projects whatsoever?	Include in GEC calculation?	Notes
Power Purchased	500xx	No	No	
Transfer (to) From Rate Stabilization Account	50004	No	No	
Power Produced				
Generation Plan	510xx	No	No	
Hydro Production	512xx	No	No	
Internal Combustion Plants	513xx	No	No	
Wind Turbines	514xx	No	No	
Administrative and Engineering Support				
Supervisory and Administrative Support	52000	Yes	Yes	1
System Operations	522xx	Yes	Yes	2
Tools, Equipment, Safety Clothing and Company Uniforms	525xx	Yes	Yes	3
Engineering and Technical Support	52050	Yes	Yes	4
Environmental Policy	53xxx	No	No	
Substations	54xxx	No	No	
Transmission				
Line Maintenance and Repairs	550xx	No	No	
Line Inspections	554xx	No	No	
Line Vegetation Management	555xx	No	No	
Distribution				
Repair / Maintain Lines	561xx	No	No	
Repair / Maintain Services	563xx	No	No	
Repair / Maintain Street Lights	564xx	No	No	
Pre-Issue of Materials	565xx	Yes	No	5
Maintain Transformers	566xx	No	No	
Maintain Meters	567xx	No	No	
Line Inspections	574xx	No	No	
Line Vegetation Management	577xx	No	No	

6. Review of General Expenses Capitalized

Expense Description	Account Number	Does the expense vary with the level of construction as compared to no capital projects whatsoever?	Include in GEC calculation?	Notes
Telecommunications				
Supervision and Miscellaneous	580xx	No	No	
Repeater Sites	581xx	No	No	
Mobile Radios	582xx	No	No	
Communication Cables	583xx	No	No	
Leased Facilities	584xx	No	No	
Supervisory Control Systems	585xx	No	No	
Telephone Systems	586xx	No	No	
Wide Area Networks	587xx	No	No	
Customer Service				
Supervision and Miscellaneous	605xx	No	No	
Customer Accounting	607xx	No	No	
Credit and Collections	608xx	No	No	
Call Centre	609xx	No	No	
Curtailable Rates	62550	No	No	
Conservation Programs and Energy Services Costs	626xx-629xx	No	No	
Uncollectible Bills	61521	No	No	
Financial Services				
Finance	612xx	Yes	Yes	6
Risk Management	615xx	No	No	
Amortization of Conservation Costs	690xx	No	No	
Pension Costs	642xx	Yes	No	7
Other Post Employment Benefits	643xx	Yes	No	5
Information Systems				
Supervision and Miscellaneous	630xx	Yes	Yes	8
Computer Operations	631xx	Yes	Yes	8
Systems Development and Support	632xx	Yes	Yes	8
Infrastructure	633xx	Yes	Yes	8
Corporate and Employee Services				
Printing Services	617xx	Yes	No	9
Corporate Communications	621xx	No	No	

6. Review of General Expenses Capitalized

Expense Description	Account Number	Does the expense vary with the level of construction as compared to no capital projects whatsoever?	Include in GEC calculation?	Notes
Corporate Offices	650xx	No	No	
Internal Audit	65300	No	No	
Miscellaneous Administrative Costs	655xx	No	No	
Mail Costs	61610	No	No	
Regulatory and Legal Affairs	65700	No	No	
Human Resources Planning and Administration	64020	Yes	Yes	6
Health, Safety and Training	6403x	Yes	Yes	6
Employee Relations	64040	Yes	Yes	6
Miscellaneous Employee Related Costs	64xxx	Yes	Yes	10
Building Operations and Maintenance	67xxx	No	No	
Municipal Taxes and PUB Assessments	656xx	No	No	
Vehicle Operating and Maintenance Costs	59000	Yes	No	5
Vehicle Service Centre	37xxx	Yes	No	5

¹ Currently included in GEC calculation (operating supervision - 15%).

² Portion currently included in GEC calculation (direct charges).

³ Currently included in GEC calculation (48%).

⁴ To add to GEC calculation (with operating supervision).

⁵ Directly charged to capital projects.

⁶ Currently included in GEC calculation (13%).

⁷ To remove from GEC calculation and directly charge to capital projects.

⁸ With no capital program, there would be lower work requirements associated with planning information systems related solutions, including software enhancements and upgrades. There would also be lower work requirements associated with providing technical support given the reduction in employees and thus personal computers.

General expenses associated with these activities are proposed to be added to the GEC calculation (10%).

In addition, if there were no capital program there would be no general implementation expenses associated with specific capital projects being implemented. General implementation expenses relate to data conversion, employee training and activities related to the procurement process. General implementation expenses can be directly charged to the specific information system capital project. Therefore, these costs do not need to be included in the GEC calculation.

⁹ While activity may vary, the reduction in general expenses would be small if there were no capital program. General expenses associated with this activity are proposed to be removed from GEC.

¹⁰ Portion currently included in GEC calculation (31%).

6. Review of General Expenses Capitalized

Review of GEC Ratios

6. *Review of General Expenses Capitalized*

Review of GEC Ratios

6. *Review of General Expenses Capitalized***Table of Contents**

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6. Review of General Expenses Capitalized

1.0 Introduction

Appendix A identifies the general expenses proposed to be included in the GEC calculation.

The following provides a review of each general expense to determine the appropriate cost ratios to be applied in allocating these general expenses to GEC.¹

2.0 Construction Activities

2.1 Capital Planning

Capital planning general expenses include labour expenses associated with capital planning activities. This includes engineering reviews conducted as part of long-term asset management strategies and the development of the Company's 5-year capital plan.² While capital planning primarily includes internal labour, contractor labour may also be used for capital planning.

Capital planning general expenses exist only as a result of Newfoundland Power's capital program. Without a capital program, refurbishment and rebuild strategies would not be required and a 5-year capital plan would not exist. Capital planning general expenses are therefore directly charged to GEC.

Directly charging general expenses for capital planning to GEC continues to be appropriate.

2.2 Operating Supervision

Operating supervision general expenses include labour costs associated with operating the electrical system. These general expenses cannot properly be allocated to any specific work order or account number.³

Operating supervision general expenses would be lower if there was no capital program. This is because, without a capital program, the Company would reduce its number of employees and consolidate regional work tasks.⁴

The existing GEC ratio of 15% for operating supervision was based on an assessment of the number of regional employees that would no longer be required if there was no capital program. At the end of the phase-in period in 1999, it was estimated that approximately 7 regional

¹ In Order No. P.U. 36 (1998-99), the Board stated that: "*in P.U. 3 (1995-96), the Board recognized that the company would have to determine how specific general expense cost ratios may have to be adjusted over the period of the five year phase-in from a full cost basis to an incremental cost basis and, thereafter, any adjustments to the ratios was intended to be at the discretion of NP.*" See page 26.

² Examples of long-term asset management strategies include the Company's: (i) *Substation Strategic Plan*; (ii) *Transmission Line Rebuild Strategy*; and (iii) *Distribution Reliability Initiative*.

³ See Newfoundland Power's System of Accounts dated March 31, 2021, paragraph 7.07, page 33 and paragraph 7.11, page 34.

⁴ In 2020, there were 611.5 full-time equivalents ("FTEs"), of which 214 FTEs can be attributed to completing capital work.

6. *Review of General Expenses Capitalized*

employees would no longer be required if there was no capital program. This translated to approximately 15% of operating supervision general expenses.⁵

In 2020, it is estimated that approximately 7 regional employees would no longer be required if there was no capital program.⁶ The GEC ratio of 15% continues to reasonably reflect the reduction in general expenses associated with the reduction in employees if there was no capital program.⁷

Maintaining the GEC ratio of 15% for operating supervision is appropriate.

2.3 *Tools, Equipment and Safety Clothing*

Tools, equipment and safety clothing general expenses include the repair and replacement of normally expendable tools, equipment, instruments, safety clothing and company uniforms, and the salaries and expenses of personnel engaged in the testing of Powerline Technicians' rubber gloves.⁸

Requirements for tools, equipment and safety clothing would be lower if there was no capital program. The reduction in these requirements would reasonably reflect the reduction in overall work requirements for employees completing construction-related work. Construction-related work is primarily completed by employees working in one of the Company's 3 operating regions. The existing GEC ratio of 48% reflected the percentage of Newfoundland Power's regional labour related to capital work in 1999.

In 2020, approximately 65% of the Company's regional labour related to capital work.⁹

Adjusting the GEC ratio for tools, equipment and safety clothing to 65% is appropriate.

2.4 *System Operations*

System operations general expenses primarily include labour costs associated with operating the System Control Centre ("SCC").¹⁰

System operations requirements would be lower if there was no capital program. This is primarily because the SCC would not be required to complete switching orders, protection guarantees, or isolation and grounding requirements associated with capital work.

⁵ Regional employees work in 1 of 3 operating regions: St. John's, Eastern and Western.

⁶ The 7 positions are: (i) 1 supervisor; (ii) 1 analyst; (iii) 4 engineering technologists; and (iv) 1 area customer representative.

⁷ Operating supervision general expenses were \$4,431,000 in 2020. Applying a GEC ratio of 15% results in a GEC allocation amount of \$665,000. Dividing this amount by 7 employees equates to an average labour cost per FTE of \$95,000. This figure is comparable to the Company's overall labour cost per FTE of approximately \$106,000 in 2020.

⁸ See Newfoundland Power's System of Accounts dated March 31, 2021, paragraph 7.09, page 34.

⁹ This percentage is based on the Company's regional labour allocation. It includes 54% in labour charged to capital projects and 11% in labour charged to retirement projects. Labour charged to retirement projects reflects the amount of time associated with removing plant from service.

¹⁰ See Newfoundland Power's System of Accounts dated March 31, 2021, paragraphs 7.08 and 7.11, page 34. The account also includes a low amount of non-labour costs (\$35,000 in 2020).

6. *Review of General Expenses Capitalized*

Currently, general expenses for system operations are charged directly to GEC.

Newfoundland Power estimates there would be a reduction of 2 FTEs in the SCC if there was no capital program.¹¹ A reduction of 2 FTEs represents a reduction of 10% in the operating costs for system operations.¹²

Applying a GEC ratio for system operations of 10% is appropriate.

3.0 Non-Construction Activities

3.1 General

There would be lower work requirements performed by the finance, human resources and information systems departments if there was no capital program.

Given the nature of these departments, it is challenging to determine a specific reduction in general expenses for these non-construction activities if there was no capital program. Currently, a nominal rate is applied as a reasonable proxy to determine the portion of general expenses for non-construction activities allocated to GEC.¹³

The Board has suggested the use of a nominal rate of 10% in these circumstances.¹⁴

Adjusting the GEC ratio for non-construction activities to a nominal rate of 10% is appropriate.

3.2 Finance

Finance general expenses include costs associated with performing accounting functions, including accounts payable, accounts receivable, payroll, cost and plant accounting, general ledger and financial reporting and budgeting.¹⁵

With no capital program, there would be lower work requirements associated with cost and plant accounting, accounts payable processing and payroll-related tasks. However, a specific reduction in finance general expenses if there was no capital program cannot reasonably be determined.¹⁶

¹¹ The SCC is required to operate 24 hours a day. Currently, the Company employs 4 teams of 3 Power System Operators at the SCC. If there was no capital program, the Company would reduce its Power System Operators to 4 teams of 2, plus 2 relief workers required for breaks, vacation and unplanned leave. This represents a reduction from 12 to 10 Power System Operators, or 2 FTEs.

¹² System operations general expenses were approximately \$2,156,000 in 2020. Applying a GEC ratio of 10% results in a GEC allocation amount of \$216,000. Dividing this amount by the Company's overall labour cost per FTE of approximately \$106,000 in 2020 equates to 2 FTEs.

¹³ Newfoundland Power currently applies a nominal rate of 13% for non-construction activities. This reflects the nominal rate applied at the end of the phase-in period of the incremental cost method in 1999.

¹⁴ See Order No. P.U. 3 (1995-96), page 19.

¹⁵ See Newfoundland Power's System of Accounts dated March 31, 2021, paragraph 7.51, page 38.

¹⁶ A specific reduction in finance general expenses cannot reasonably be determined due to the unique requirements and timelines for each job function. For example, deadlines associated with payroll processing tasks would limit the ability of that same person to also meet deadlines for accounts payable-related tasks. Options to consolidate work requirements in the absence of a capital program are therefore limited.

6. *Review of General Expenses Capitalized*

Applying a nominal rate of 10% for allocating finance general expenses to GEC is appropriate.

3.3 *Human Resources*

Human resources general expenses include costs of providing services to other departments, such as human resource planning and administration, and activities related to health, safety, training and employee relations.¹⁷ Newfoundland Power proposes to also include employee welfare general expenses in this grouping.¹⁸

With no capital program, there would be lower work requirements associated with human resources due to the reduction in Company employees that currently complete capital work.¹⁹ However, a specific reduction in human resources general expenses if there was no capital program cannot reasonably be determined.²⁰

Applying a nominal rate of 10% for allocating human resources general expenses to GEC is appropriate.

3.4 *Information Systems*

Information systems general expenses include costs associated with coordinating and developing corporate technology solutions, and providing technical support and training to Company employees. These general expenses also include planning and managing the design, acquisition, programming, testing, operation and maintenance of Company information systems.²¹

With no capital program, there would be lower work requirements associated with planning information systems, including software enhancements and system upgrades. There would also be lower work requirements associated with providing technical support for information systems, as the Company would have fewer employees and fewer personal computers. However, a specific reduction in information systems general expenses if there was no capital program cannot reasonably be determined.²²

Applying a nominal rate of 10% for allocating information systems general expenses to GEC is appropriate.

¹⁷ See Newfoundland Power's System of Accounts dated March 31, 2021, paragraphs 7.75, 7.76 and 7.77, page 41.

¹⁸ Historically, employee welfare expenses were their own category in the GEC calculation. Employee welfare expenses primarily relate to Employee Assistance Programs, the Employee Association and miscellaneous supplies. Employee welfare expenses are part of Miscellaneous Employee Related Costs. See Newfoundland Power's System of Accounts dated March 31, 2021, paragraph 7.78, page 42. While these costs will be lower if there was no capital program, a specific reduction cannot reasonably be determined.

¹⁹ In 2020, there were 611.5 FTEs, of which 214 FTEs can be attributed to completing capital work.

²⁰ A specific reduction in human resources general expenses cannot reasonably be determined due to the various services and activities of that department. For example, the requirements of certain human resources and safety services would require different jobs based on employees' qualifications to complete the necessary work. Options to consolidate work requirements in the absence of a capital program are therefore limited.

²¹ See Newfoundland Power's System of Accounts dated March 31, 2021, paragraphs 7.57 to 7.60, page 39.

²² A specific reduction in information systems general expenses cannot reasonably be determined due to the ongoing maintenance requirements for the Company's existing information systems.

6. Review of General Expenses Capitalized

4.0 Summary

Table 1 summarizes the existing and revised GEC ratios, including actual and *pro forma* GEC amounts based on 2020 costs.

**Table 1:
GEC Ratios and Amounts**

General Expense	Existing Ratios	2020 Actual (\$000s)	Revised Ratios	2020 Pro Forma (\$000s)
<u>Construction Activities</u>				
Capital Planning	Direct	805	Direct	805
Operating Supervision	15%	558	15%	665
Tools, Equipment and Safety Clothing	48%	745	65%	1,009
System Operations	Direct	598	10%	216
Subtotal		2,706		2,695
<u>Non-Construction Activities</u>				
Finance	13%	243	10%	187
Human Resources	13%	304	10%	252
Information Systems ²³	-	-	10%	317
Employee Welfare ²⁴	31%	57	-	-
Printing Services ²⁵	13%	37	-	-
Subtotal		641		756
Total GEC		3,347		3,451

Using the revised GEC ratios, the *pro forma* 2020 GEC amount is approximately \$3.5 million, which is comprised of approximately \$2.7 million in construction-related activities and approximately \$0.8 million in non-construction-related activities. These amounts are reasonably consistent with actual 2020 GEC amounts determined using the existing GEC ratios.

²³ Information systems general expenses were previously excluded from the GEC calculation. See Appendix A.

²⁴ Employee welfare general expenses are proposed to be grouped with human resources expenses. See section 3.3.

²⁵ Printing services are proposed to be removed from the GEC calculation. See Appendix A.

2023 Revenue Requirement – Income Tax Effects

Pension Cost Allocation
GEC Calculation versus Labour Loading
2023 Revenue Requirement - Income Tax Effects¹
(\$000s)

See supporting notes on page 2.

		GEC Allocation	Labour Loader
Current Tax Effects			
<u>Additions to taxable income</u>			
Depreciation		57 ²	57 ³
Pension expense		4,046 ⁴	2,185 ⁵
<u>Deductions to taxable income</u>			
GEC		(3,387) ⁶	-
Capital cost allowance		-	(143) ⁷
Pension funding		<u>(2,699) ⁸</u>	<u>(2,699) ⁸</u>
Total current tax effects	A	<u>(1,983)</u>	<u>(600)</u>
Deferred income tax effects			
<u>Plant Investment ⁹</u>			
CCA		-	143
Depreciation (excluding GEC)		-	(57)
<u>Pension Costs ¹⁰</u>			
Funding		2,699	2,699
Expense ¹¹		<u>(4,046)</u>	<u>(2,185)</u>
Total deferred tax effects	B	<u>(1,347)</u>	<u>600</u>
Net income tax effects	C = A + B	<u>(3,330) ¹²</u>	<u>-</u>
Income taxes @ 30%	D = C x 30%	<u>(999)</u>	<u>-</u>

6. Review of General Expenses Capitalized

Supporting notes (\$000s)

¹ All amounts relate to 2023 forecast current service pension costs only, as outlined below:

	<u>Total</u>	<u>Capital</u>	<u>Expense</u>
Funded pension plans	4,046	1,861	2,185
RRSP employer contributions (plan is not funded)	3,318	1,526	1,792
Total	7,364	3,387	3,977

² Based on allocating GEC to capital projects on a flat rate basis and half year rule.

³ Any differences in 2023 depreciation expense due to directly charging pension costs to capital projects by way of a labour loader would be immaterial. For illustrative purposes, depreciation expense under the labour loader scenario is equal to depreciation expense calculated under the GEC allocation scenario.

⁴ Under the GEC method, pension expense for both financial and income taxes is the total amount. For income tax purposes, pension expense amounts related to the funded pension plans must be added back to calculate taxable income. Only the cash funding amounts associated with these plans are deductible for income tax purposes. As RRSP plans are not funded, the RRSP expense is the same for both financial reporting and income tax purposes. Therefore no additions or deductions to taxable income are required related to the RRSP expense amount of \$1,792.

⁵ Under the labour loader method, the pension expense addition to taxable income would equal the pension expense related to the funded pension plans. The capital amounts would be directly charged to capital projects rather than being indirectly allocated to capital through GEC.

⁶ GEC would be calculated by multiplying the total current service pension costs of \$7,364 by 46% to equal \$3,387. GEC is deductible for income tax purposes.

⁷ The capital portion of RRSP employer contributions are deductible through CCA for income tax purposes.

⁸ Funding amounts associated with the Company's funded pension plans are deductible for income tax purposes.

⁹ In Order Nos. P.U. 20 (1978), P.U. 21 (1980) and P.U. 17 (1987), the Board approved the Company's use of tax accrual accounting to recognize deferred income tax liabilities associated with plant investment.

¹⁰ In Order No. P.U. 32 (2007), the Board approved the use of tax accrual accounting to recognize deferred income taxes related to timing differences between pension funding and pension expense.

¹¹ Under the labour loader method, pension expense in the deferred tax calculation would reflect pension expense for financial reporting purposes (i.e. rather than total pension costs under the GEC method).

¹² The net income tax effect reflects the GEC deduction of \$3,387 less the depreciation add back of \$57. [3,387 - 57 = 3,330].

Revenue Requirement Timing Differences - Income Tax Effects

Pension Cost Allocation
GEC Calculation versus Labour Loading
Revenue Requirement Timing Differences - Income Tax Effects
(\$000s)

		Labour Loader A	GEC Allocation B	Difference C = A - B	Annual increase (decrease) in income taxes D = C x 30%
Initial Year	GEC deduction	-	(3,387)	3,387	1,016
Initial Year	Depreciation add back	-	57	(57)	(17)
Initial Year	Net impact	-	(3,330)	3,330	999
Year 2	Depreciation add back	-	115	(115)	(34)
Year 3	...	-	115	(115)	(34)
Year 4	...	-	115	(115)	(34)
Year 5	...	-	115	(115)	(34)
Year 6	...	-	115	(115)	(34)
Year 7	...	-	115	(115)	(34)
Year 8	...	-	115	(115)	(34)
Year 9	...	-	115	(115)	(34)
Year 10	...	-	115	(115)	(34)
Year 11	...	-	115	(115)	(34)
Year 12	...	-	115	(115)	(34)
Year 13	...	-	115	(115)	(34)
Year 14	...	-	115	(115)	(34)
Year 15	...	-	115	(115)	(34)
Year 16	...	-	115	(115)	(34)
Year 17	...	-	115	(115)	(34)
Year 18	...	-	115	(115)	(34)
Year 19	...	-	115	(115)	(34)
Year 20	...	-	115	(115)	(34)
Year 21	...	-	115	(115)	(34)
Year 22	...	-	115	(115)	(34)
Year 23	...	-	115	(115)	(34)
Year 24	...	-	115	(115)	(34)
Year 25	...	-	115	(115)	(34)
Year 26	...	-	115	(115)	(34)
Year 27	...	-	115	(115)	(34)
Year 28	...	-	115	(115)	(34)
Year 29	...	-	115	(115)	(34)
Year 30	Depreciation add back	-	115	(115)	(34)
Total of years 2 to 30			3,330	(3,330)	(999)
Difference (initial year, less total of years 2 to 30)		-	-	-	-

6. Review of General Expenses Capitalized

Review of Capitalization Policies and Guidelines

Review of Capitalization Policies and Guidelines

Newfoundland Power Policies and Practices

August 14, 2020

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1.0 Introduction

1.1 Background

On February 21, 2020, the Board of Commissioners of Public Utilities of Newfoundland and Labrador (the “Board”) issued Order No. P.U. 5 (2020) approving Newfoundland Power Inc.’s (“Newfoundland Power” or the “Company”) *2020 Capital Budget Application*. In that order, the Board stated it would establish a process to review the capitalization practices of both Newfoundland Power and Newfoundland and Labrador Hydro (“Hydro”) (collectively, the “Utilities”) to ensure consistency with sound public utility practice and the provision of least-cost service to customers.

On April 30, 2020, the Board requested each utility complete a report for the Board describing its capitalization practices relating to capital asset additions. The report was expected to address:

1. the particular accounting standards being followed by the utility;
2. 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
3. any other alternatives that may be available to be used by the utility in the development of capitalization practices.

The Board also requested that the Utilities conduct a jurisdictional scan of capitalization practices used by other utilities across Canada.

This report addresses the Board’s requests.

1.2 Accounting Standards and Capitalization Practices

An organization that keeps financial records must employ an accounting standard to provide a consistent basis for its accounting. Accounting standards specify how transactions and other events are to be recognized, measured, presented and disclosed in financial statements. In Canada, accounting standards for all entities outside the public sector are issued by the Canadian Accounting Standards Board (the “AcSB”).

Newfoundland Power follows an accounting standard based on United States generally accepted accounting principles (“US GAAP”) for financial reporting and regulatory purposes.

Accounting standards, among other things, provide guidance in determining whether a cost should be recognized as an expense in the year in which it is incurred, or categorized as a capital cost and amortized over a longer period of time. Newfoundland Power’s capitalization policies and practices conform to the requirements of US GAAP, as well as the Board’s orders approving the capitalization of certain general expenses.

2.0 Accounting Standards

2.1 General

Newfoundland Power adopted US GAAP as its accounting standard for financial reporting purposes in 2012. Prior to that time, Newfoundland Power's accounting was based on Canadian GAAP.

The change in Newfoundland Power's accounting standard followed a 2008 decision of the AcSB to replace Canadian GAAP with International Financial Reporting Standards ("IFRS") for publicly accountable enterprises commencing with financial reporting periods beginning on or after January 1, 2011. For Newfoundland Power, uncertainty regarding the treatment of regulatory assets and liabilities under IFRS was a significant concern.¹ Because US GAAP permits recognition of regulatory assets and liabilities for financial reporting purposes, and US GAAP was a sanctioned option for Canadian rate-regulated entities, Newfoundland Power chose to move to that standard instead.²

In November 2011, the Company filed an application with the Board seeking approval of its adoption of US GAAP for regulatory purposes. The Board approved Newfoundland Power's use of US GAAP for regulatory purposes in Order No. P.U. 27 (2011).

2.2 Public Utility Practice

By adopting US GAAP for regulatory purposes, Newfoundland Power avoided an increase in administrative burden, and possible confusion related to the use of different accounting standards for financial and regulatory reporting.³

In approving Newfoundland Power's use of US GAAP for regulatory purposes, the Board confirmed that it was consistent with sound Canadian public utility practice. The Board further noted that the adoption of US GAAP would permit the Company to better reflect the decision-making of the Board in its financial reporting through recognition of regulatory assets and liabilities in a manner consistent with Canadian GAAP. It would also ensure greater transparency in the regulation of Newfoundland Power by ensuring consistency between the Company's accounting for financial reporting purposes and regulatory purposes.⁴

¹ Regulatory assets and liabilities arise as a result of the rate-setting process, and are approved by the Board. As at December 31, 2019, the Company's regulatory assets totaled \$364 million, while regulatory liabilities totaled \$187 million. The adoption of US GAAP allowed the economic impact of rate-regulated activities to be recognized in the Company's financial statements in a manner that was broadly consistent with Canadian GAAP.

² To address the concerns of Canadian rate-regulated users of Canadian GAAP regarding certain aspects of IFRS, Canadian securities regulators provided time-limited exemptions that enabled them to adopt US GAAP as an alternative. Newfoundland Power continues to avail of such an exemption.

³ Newfoundland Power's Application to Adopt US GAAP for Regulatory Purposes dated November 10, 2011, *Newfoundland Power – Adoption of US GAAP for Regulatory Purposes*, JTBrowne Consulting, November 9, 2011, pages 7-8.

⁴ Order No. P.U. 27 (2011), page 3.

Although the International Accounting Standards Board (“IASB”) continues work to develop an international accounting standard for rate-regulated enterprises, the outcome and timing of this exercise is uncertain.⁵

Newfoundland Power periodically reviews the accounting practices of other Canadian rate-regulated entities. These reviews have confirmed that US GAAP continues to be the most commonly used standard for investor-owned utilities across Canada.

Appendix A provides the results of Newfoundland Power’s review of accounting standards followed by utilities across Canada.⁶

3.0 Capitalization Practices

3.1 General

Capitalization, in the context of this report, refers to the categorization of an asset or expenditure as capital in nature, and the recording of the associated cost accordingly in the financial records of an organization. The costs associated with capital assets of Newfoundland Power, ranging from small tools and individual utility poles to buildings and hydroelectric generating facilities, are typically grouped by asset class on the Company’s balance sheet as Property, Plant & Equipment or Intangible Assets.

The determination of whether a cost associated with providing electrical service to customers is an *operating* cost to be recognized in the current financial year, or a *capital* cost that will be amortized and recovered through rates over a longer period, depends on whether the cost provides an enduring benefit. Typically, an asset that provides benefits for a period greater than one year is considered to be a capital asset. If a cost is determined to be capital in nature, it is considered appropriate that recovery of that cost be amortized over a period that corresponds to its service life.⁷

Newfoundland Power’s customer rates are approved by the Board under a cost of service form of regulation. The costs of serving customers, including those costs incurred to maintain and operate the electrical system, include both operating and capital costs, and are recovered from customers through rates.⁸

⁵ Newfoundland Power continues to monitor the IASB’s progress in developing and mandating a standard within IFRS specific to rate-regulated entities.

⁶ Of the 17 investor-owned utilities whose accounting practices were reviewed, 13 follow US GAAP. Those 13 utilities are all former users of Canadian GAAP who adopted US GAAP instead of IFRS following the AcSB decision.

⁷ This is generally consistent with the treatment of costs in unregulated enterprises. In the rate-regulated context, the appropriate timing of recovery of capital costs accords with the fairness principle of intergenerational equity. The principle of intergenerational equity is explained in Section 4.0 of this report.

⁸ The Board’s financial consultant completes a detailed annual financial review of Newfoundland Power. This includes a review of the Company’s accounts and financial statements to confirm compliance with Board orders.

Capitalization of costs affects only the timing of recovery. It is not determinative of whether the costs are recoverable from customers. The recovery of costs associated with capital assets over their service life is consistent with US GAAP, and with the regulatory principles of intergenerational equity and rate stability.⁹

3.2 Capitalization Policy

Newfoundland Power maintains a formal capitalization policy that governs the determination of whether a cost or expenditure should be recognized as a capital cost. The Company's capitalization policy provides that all expenditures are considered to be operating expenses unless they meet specific capitalization criteria.

Newfoundland Power's capitalization policy provides that, in order to be considered capital in nature, an expenditure must:

- i. provide substantial benefits for a period of more than one year;
- ii. extend the useful life of an asset or increase the capacity of an asset or the quality of output efficiency and may reduce operating costs; and
- iii. be held for use to conduct business/generate income.

If a cost meets these criteria, it is deemed to have been incurred to provide service to customers for a period of greater than one year.

Newfoundland Power's capitalization policy is in accordance with US GAAP.¹⁰ The essential elements of Newfoundland Power's capitalization policies and practices have not changed as a result of the adoption of US GAAP as the Company's accounting standard in 2012.

A copy of Newfoundland Power's capitalization policy is provided in Appendix B.

3.3 Capital Costs

General

The cost of acquiring an asset includes the cost of bringing the asset "to the condition and location necessary for its intended use."¹¹ Newfoundland Power's capital costs include costs which are directly charged to capital projects, and costs which are indirectly allocated.

For rate-regulated entities, regulators may approve the capitalization of other costs, including operating costs that can reasonably be attributed to capital expenditures. Certain capitalized overheads, or general expenses, are included in Newfoundland Power's capital costs in

⁹ See Section 4.0 Regulatory Considerations for additional information.

¹⁰ Newfoundland Power's financial statements are audited annually by an independent auditor, who provides an opinion confirming that the Company's financial statements are materially in compliance with US GAAP.

¹¹ *US GAAP Accounting Standard Codification ("ASC") 360 Property, Plant, and Equipment* provides that "the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use."

accordance with longstanding practice and Board orders. These are referred to as General Expenses Capitalized, or GEC.

Directly Charged Capital Costs

The vast majority of capital costs can be directly attributed to a capital asset or capital project. These include direct labour charges, external contractor costs and materials costs. Because such items are documented by direct means, including by means of timesheet entries and vendor invoices, accounting administration associated with them is straightforward and not unduly burdensome. For example, the construction of a line extension to connect a new customer incurs direct costs through the purchase of distribution line poles, conductor, associated hardware and the labour required to construct the extension.

Directly charged capital costs account for approximately 90 per cent of Newfoundland Power's capital expenditures. The remaining 10 per cent consists of indirectly allocated costs and GEC.¹²

Indirectly Allocated Capital Costs

Certain capital costs cannot practically or efficiently be charged directly to individual capital assets or capital projects. For example, the conductor used for the line extension in the previous example would be issued through inventory. Although the conductor itself would be charged directly based on the unit cost, allocating the labour associated with the purchasing, storing and handling of a specific inventory item to the individual capital project would be inefficient and unduly costly. The use of an appropriate charge, or loader, on inventory enables a portion of the overhead cost to be allocated to individual projects in a systematic way that is not administratively burdensome.

For Newfoundland Power, the capital costs indirectly allocated to capital expenditures are:

- i. Allowance for Funds Used During Construction ("AFUDC");¹³
- ii. Vehicle overhead costs; and
- iii. Inventory overhead costs.

AFUDC is the cost of financing construction, which is capitalized as part of the cost of plant and equipment.¹⁴ These costs are capitalized based on the capital costs of individual projects in accordance with detailed guidelines.

Newfoundland Power's AFUDC Guidelines are provided in Appendix C.

¹² The response to Request for Information NLH-NP-024 in the Company's 2020 Capital Budget Application proceeding indicates that, on average, approximately 10% of the Company's capital expenditures are indirect in nature. They include AFUDC, vehicle and inventory overhead costs, and GEC.

¹³ Under Canadian GAAP, AFUDC was known as Interest During Construction, or IDC. That is also the term used under IFRS.

¹⁴ ASC 980-835-20 Regulated Operations – Interest.

Vehicle overhead costs are capitalized in accordance with the usage of Company vehicles in connection with capital work. A portion of the cost associated with operating and maintaining the Company's fleet of vehicles is reallocated to capital projects based on how employees' base labour cost is recorded. The allocation is accomplished through a loading rate of 23% applied to individual regional operations employees' base labour charged to capital projects.

Inventory overhead costs are capitalized because the purchasing, storing and handling of inventory is an integral aspect of the provision of material for capital projects. These costs are reallocated to the cost of items issued from inventory, and items purchased directly by purchase order, through a loading rate. Each item is loaded at a rate of 15%, up to a maximum of \$1,350.¹⁵

The indirect allocation of capital costs by equitable methods is consistent with utility industry practice as reflected, for example, in accounting instructions under the Federal Energy Regulatory Commission ("FERC") Uniform System of Accounts.¹⁶

3.4 General Expenses Capitalized

GEC reflects expenses that would not be incurred in the absence of Newfoundland Power's capital program.

Newfoundland Power's GEC consists of direct charges for employees who are deemed incremental as a result of the capital program and indirect allocations of overheads that are considered incremental as a result of the capital program.¹⁷ The capitalization of such costs recognizes that, but for the Company's capital program, a certain number of employees would not be employed and a certain portion of overhead costs would not be incurred.

In the previously noted example of a new line extension, the costs associated with items such as crew scheduling, timesheet approvals, usage of small tools, and vendor invoice review, approval and payment associated with capital work would be captured through GEC.

Newfoundland Power's GEC methodology, as approved by the Board in 1995, is set out in Appendix D.

The capitalization of general expenses is a generally accepted accounting practice in the electric utility industry.¹⁸ Under US GAAP, rate-regulated entities are permitted to capitalize costs that would otherwise be expensed in the year incurred, where such treatment is approved by the

¹⁵ Loading rates for vehicle and inventory overheads are reviewed annually to ensure they remain appropriate.

¹⁶ FERC Uniform System of Accounts – Electric Plant Instructions, Sections 3 and 4. FERC is an independent agency in the United States that regulates utilities. One of FERC's functions is the administration of accounting and financial reporting regulations for rate-regulated entities.

¹⁷ In 2019, GEC totaled \$6.2 million, comprised of Direct GEC of \$1.3 million, Construction Activities of \$1.3 million, Non-Construction Activities of \$0.7 million and Pension of \$2.9 million. A detailed breakdown is provided in Table D1, Appendix D.

¹⁸ For example, FERC Uniform System of Accounts – Electric Plant Instructions, Section 4, provides for the capitalization of all overhead construction costs, such as engineering, supervision and general office salaries and expenses.

utility regulator. In other regulatory jurisdictions, such capitalized expenses may be referred to as Capitalized Overheads.

In 1992, using the full cost method of calculating GEC, Newfoundland Power's total GEC was \$11.5 million, or 27% of total gross capital expenditures. In 1995, Newfoundland Power proposed a change in its GEC calculation.¹⁹ In 1995, the Board approved guidelines to determine the annual calculation of GEC using the incremental cost methodology. In the interest of rate stability for customers, the Board ordered that the new GEC method be phased in over the 5-year period from 1995 to 1999.²⁰

Since the current GEC methodology was fully implemented, GEC has averaged approximately \$3.6 million, or less than 5%, on average, of the Company's annual capital budget.

4.0 Regulatory Considerations

4.1 Intergenerational Equity

Intergenerational equity is a principle of fairness that holds that ratepayers in a given period should pay only the costs necessary to provide them with service in that period. In the context of utility ratemaking, the principle of intergenerational equity requires that the costs of capital assets should be recovered from the customers who will benefit from those assets. According to this principle, it would not be fair to burden current customers with costs associated with providing electricity service in the future.

Capital costs are typically recognized for financial and accounting purposes over a longer period than costs that are considered to be current expenses. For rate-regulated entities, costs that are reasonably attributable to capital assets may be approved for recovery from customers over periods corresponding to the service life of the assets. This ensures that the rates paid by ratepayers in a particular period reasonably reflect the costs necessary to provide service to the ratepayers in that period. This is consistent with the principle of intergenerational equity.²¹

4.2 Sound Public Utility Practice

As noted in Section 3.2 Capitalization Policy, Newfoundland Power's capitalization practices are consistent with the US GAAP accounting standard. Based on prior surveys of the practices of

¹⁹ Newfoundland Power had used the full cost method to determine the amount of GEC since 1967. Under the full cost method, any general expense incurred in connection with the capital program may be capitalized. Under the incremental method, only general expenses that are incremental to the utility as a result of the capital program may be capitalized. For example, Newfoundland Power's internal audit function would be necessary, even in the absence of a capital program. Accordingly, no costs associated with internal audit are capitalized under the incremental method. The full cost method would allocate a portion of internal audit costs to capital because the internal audit function does perform work related to the capital program.

²⁰ Order No. P.U. 3 (1995-1996).

²¹ The principle of intergenerational equity is routinely considered by the Board and other utility regulators. See, for example, Order No. P.U. 14 (2015), page 12.

other Canadian utilities, Newfoundland Power's adoption of US GAAP in 2011 was consistent with generally accepted sound public utility practice in Canada.²²

The recent survey of the capitalization practices of Canadian electric utilities carried out by the Utilities, as directed by the Board, shows that Newfoundland Power's use of US GAAP for financial reporting and regulatory purposes is sound Canadian public utility practice. According to the survey results, US GAAP is commonly used by investor-owned utilities, while most of the Crown utilities surveyed follow IFRS.

The survey also confirms that Newfoundland Power's capitalization practices are broadly consistent with those of other Canadian electric utilities. Of the eleven utilities that responded to the jurisdictional survey, seven employ an approach similar to Newfoundland Power's for the capitalization of overhead costs. The method used to determine the applicable capitalization rates or amounts varied amongst respondents, but the survey confirms that the capitalization of general expenses is standard utility industry practice.

Based on the results of the survey, Newfoundland Power's practice of capitalizing pension in GEC or capitalized overhead is not common among Canadian utilities. Ten of the eleven respondents capitalize pension costs by means of a labour loader. For ease of comparison, the estimated impact of pension on Newfoundland Power's GEC and capitalized labour is normalized in the summary of survey responses provided with this report.

Appendix E provides the results of the survey of Canadian utility capitalization practices, and includes comparative information for Newfoundland Power.

4.3 Alternatives to Current Capitalization Practices

The Board's letter dated April 30, 2020 requested that the Utilities' reports on their accounting standards and capitalization practices address other alternatives that may be available to be used in the development of capitalization policies and guidelines. In Newfoundland Power's view, the alternatives are limited.

Capitalization of costs generally follows guidance and industry standards related to the relevant accounting standards. For Newfoundland Power, its capitalization practices accord with guidance and standards applicable to US GAAP, and are broadly consistent with its historic use of Canadian GAAP.

As noted in Section 2.0 Accounting Standards, Newfoundland Power's adoption of US GAAP was principally based on the permitted recognition of regulatory assets and liabilities for financial reporting purposes. Until there is another available accounting standard in Canada that permits the appropriate recognition of these features of Newfoundland Power's financial circumstances, US GAAP is the only reasonable option.

²² Newfoundland Power's Application to Adopt US GAAP for Regulatory Purposes dated November 10, 2011, *Evidence of Newfoundland Power*, page 3, lines 1 – 11.

The Board's order approving Newfoundland Power's use of US GAAP for regulatory purposes outlined the benefits of that option.²³ Those benefits persist, and would be lost if Newfoundland Power were to adopt, for regulatory purposes, a different standard than it uses for financial reporting purposes.

In Newfoundland Power's view, the use of a consistent accounting standard for financial reporting and regulatory reporting is least-cost for customers. It minimizes accounting and record keeping costs while also being aligned with sound public utility practice.²⁴ Accordingly, the use of capitalization policies and practices that are consistent with both the US GAAP accounting standard and generally accepted Canadian public utility practice is also consistent with the provision of least-cost electrical service to Newfoundland Power's customers.

5.0 Conclusion

Newfoundland Power's adoption of US GAAP for financial reporting and regulatory purposes in 2011 and 2012 was consistent with sound Canadian public utility practice at that time, and consistent with the provision of least-cost electrical service to the Company's customers.

The Company's capitalization policies and practices comply with US GAAP and relevant orders of the Board. These practices are audited annually by the Company's independent auditor and reviewed by the Board's financial consultant.

The results of the survey of Canadian public utilities carried out at the direction of the Board confirms that the Company's capitalization policies and practices continue to be consistent with sound Canadian public utility practice.

In the absence of an alternative accounting standard that provides for reasonable recognition of Newfoundland Power's significant regulatory assets and liabilities, there does not appear to be any reasonable alternative to the Company's current capitalization policies and practices.

²³ See Section 2.2 Sound Public Utility Practice at page 2.

²⁴ See footnote 3.

Review of Capitalization Policies and Guidelines

Appendix A **Summary of Accounting Standards for Utilities**

Table A1 - Summary of Accounting Standards for Utilities

Entity	Ownership	2019 ¹
AltaGas Utilities Inc.	Investor	US GAAP
AltaLink Management Ltd.	Investor	IFRS
ATCO Electric Ltd.	Investor	IFRS
British Columbia Transmission Corporation	Investor	IFRS
Centra Gas Manitoba Inc.	Crown	IFRS
Enbridge Gas Distribution Inc.	Investor	US GAAP
Enbridge Gas New Brunswick	Investor	US GAAP
ENMAX Power Corporation	Crown	IFRS
EPCOR Utilities Inc.	Crown	IFRS
FortisAlberta Inc.	Investor	US GAAP
FortisBC Inc.	Investor	US GAAP
Gaz Métro Limited Partnership	Investor	US GAAP
Gazifère inc.	Investor	US GAAP
Heritage Gas Limited	Investor	US GAAP
Hydro One Networks Inc.	Investor	US GAAP
Hydro-Québec	Crown	US GAAP
Manitoba Hydro	Crown	IFRS
Maritime Electric Company Limited	Investor	ASPE
Newfoundland and Labrador Hydro	Crown	IFRS
Newfoundland Power Inc.	Investor	US GAAP
Nova Scotia Power Inc.	Investor	US GAAP
Pacific Northern Gas Ltd.	Investor	US GAAP
Saskatchewan Power Corporation	Crown	IFRS
SaskEnergy Inc.	Crown	IFRS
Toronto Hydro	Crown	IFRS
Union Gas Limited	Investor	US GAAP

¹ The accounting standards were identified through a review of December 31, 2019 financial statements, as filed with SEDAR, or by accessing publicly available information through the respective organizations' websites.

Review of Capitalization Policies and Guidelines

Appendix B Capitalization Policy

CAPITALIZATION POLICY

This Capitalization Policy provides guidelines for the allocation of costs to either Capital, Retirement or Operating Expense. These principles are intended to conform to accounting principles generally accepted in the United States (“US GAAP”), as well as industry best practices.

Newfoundland Power’s capital spending policy provides uniformity and consistency throughout the organization for the accounting of assets that are acquired, built, developed, installed, retired, removed or replaced. This policy should be used to complete both the operating and capital budgets.

Capitalization Principles

1. All expenditures are considered Operating Expense until it is proven that they meet the capital criteria.
2. In certain cases, US GAAP will not provide definitive rules that apply to every possible situation. In these cases, prior to approval of the expenditure, the Manager/Director of the department initiating the project should confirm with the Manager, Finance whether the project is capital or operating.
3. Costs include the amount to acquire, construct, develop or better an asset.
4. Capital assets include but are not limited to land, buildings, property, equipment, machinery, poles, wires, fittings, underground cable, furniture and fixtures, tools and instruments, computers, software, motor vehicles, reservoirs, dams and waterways, water wheels and turbines.
5. All capital assets will be shown at historical cost.
6. Capitalization of all costs will be based on effort (including all support functions) associated with the capital work being performed.
7. Staff will direct charge to projects, where possible.

Capital Expenditures are expenditures in excess of \$1,000 and that meet all of the following criteria

1. Provide substantial benefits for a period of more than one year.
2. Extend the useful life of an asset or increase the capacity of an asset or the quality of output efficiency and may reduce operating costs.
3. Are held for use to conduct business/generate income.

* Note that there are individual expenditure items less than \$1,000 that can be included in a capital project, such as capital inventory items or timesheet entries. These items contribute to the overall cost of the asset being constructed, and in aggregate would be well in excess of the \$1,000 capitalization limit described above.



Capital Expenditures include the following costs ¹

- internal labour costs directly charged
- contract work directly charged
- materials & supplies directly charged
- overhead recoveries as outlined below
- AFUDC (Allowance for Funds Used During Construction)

Additional Guidelines

Cost of Removal and Retirement

1. When an asset is retired from service, the asset account will be credited with the historical cost of the asset being removed.
2. If the asset being retired is a depreciable asset, the historical cost less any net salvage value and/or any insurance recovered will be charged to accumulated depreciation.
3. If any material is salvaged, the net salvage value is the salvage value less any removal costs.
4. Salvage value is, if the material is sold, the selling price, or if the material is retained for use by the Company, the original cost.
5. The labour charged to retirements should reflect the actual time associated with removal of the plant from service. Percentages have been developed for the following projects:

Project	Percentage of Internal Labour Charged to Retirements
Reconstruction	25%
3 rd Party Distribution	
Distribution Reliability Initiative	
Rebuild Distribution Lines	
Upgrades of Distribution Lines	
Transmission Line Rebuild	
Replacement of Services	50%
Meters	
Replacement of Street Lights	

¹ GEC guidance is detailed in the PP&E process narrative.

Staff Training & Development

1. Initial training to operate or maintain a new plant facility (e.g. substation) being constructed may be capitalized as a part of construction costs.
2. General training, once a plant facility is in service, must be treated as an operating expense.
3. Training and other ongoing support costs related to IT software projects must be treated as an operating expense.

Repairs and Improvements

Ordinary Repairs (Normally Operating Expenses)

Recurring or routine costs for parts, labour etc. that do not extend the useful life of the capital asset but are necessary to keep the asset in normal operating condition (preventative maintenance costs/high wear items) are to be expensed.

Extraordinary Repairs (Normally Capital Expenditures)

Large significant expenditures (relative to the total capital cost of the asset) for major repairs that extend the useful life of the capital asset and are not recurring in nature are generally to be capitalized.

Improvements (Normally Capital Expenditures)

Involves the installation of a new part that is a betterment to the old part and will provide benefit in the form of greater output or lower operating costs for many years.

Overhead Recoveries

1. Vehicle costs will be charged to capital through a labor overhead rate.
2. The cost of Stores and the purchasing function is charged to materials cost through a loading rate.

Questions

Should you have any questions pertaining to the above policy, please contact the Director, Finance.

Effective Date

This policy is dated and effective as of March 31, 2017.

Review of Capitalization Policies and Guidelines

Appendix C AFUDC Guidelines

AFUDC Guidelines

The following guidelines are used to determine whether a project will be charged AFUDC (Allowance for Funds Used During Construction):

- The project has incurred costs for greater than 3 months (AFUDC charges will begin in the fourth month).
- Project costs have to be >\$10,000 for all projects except distribution.
- Distribution projects have to have accumulated costs >\$50,000 before AFUDC will be charged to the project.
- Capital acquisitions which are immediately added to plant in service do not attract AFUDC (e.g. transformers, meters, vehicles, office equipment, etc.).
- AFUDC should not be charged on capital projects that are being financed by the customer through a CIAC.
- The interest rate used to calculate AFUDC is the rate of return on average rate base. For 2020, this rate is 7.04% as outlined in Order No. P.U. 2 (2019).
- The interest charges cease once a project is placed "in service" and no further costs remain to be recorded on the project.

Review of Capitalization Policies and Guidelines

Appendix D Summary of GEC Methodology

Summary of GEC Methodology

On August 11, 1995, Newfoundland Power filed an application requesting that the Board approve a change in the basis of the Company's allocation of costs to General Expenses Capitalized ("GEC"). The proposed change was from the full cost method to the incremental cost method of allocation.

The resulting Order No. P.U. 3 (1995-96) sets forth the basis for the methodology approved by the Board. The Order stated that:

*"Overhead costs will be considered to be incremental costs of capital projects to the extent that they vary with the level of construction as compared to no capital projects whatsoever. Otherwise the overhead costs are expenses of the period in which they are incurred."*¹

In the Order, the Board further noted that:

*"The Board had accepted in the past the merits of full costs, however, in light of low sales growth and diminished capital program, full cost appears to be excessive. This does not mean the Board wishes to minimize capitalization, since to do so would burden today's customers with the costs associated with delivering services long into the future."*²

The Order stated that this change was to be phased in over the period January 1, 1995 to December 31, 1999.

The GEC methodology was further considered by the Board during the phase-in period. In Order No. P.U. 36 (1998-99), the Board stated that:

*"In P.U. 3 (1995-96), the Board recognized that the company would have to determine how specific general expense cost ratios may have to be adjusted over the period of the five year phase-in from a full cost basis to an incremental cost basis and, thereafter, any adjustments to the ratios was intended to be at the discretion of NP."*³

The Order also stated that:

*"The Board agrees that there is no reason to revise or modify the accounting methodology regarding GEC and, therefore, concludes that its previous order adequately addresses the situation."*⁴

These general expense cost ratios have been consistently applied by the Company since the conclusion of the phase-in period in 1999.

¹ Order No. P.U. 3 (1995-96), page 28.

² Order No. P.U. 3 (1995-96), page 14.

³ Order No. P.U. 36 (1998-99), page 26.

⁴ Order No. P.U. 36 (1998-99), page 27.

In Newfoundland Power's 2019/2020 *General Rate Application*, a change was proposed to update the capitalization percentage from 11% to the current capital labour split of 46%. The change was as a result of Accounting Standards Update 2017-07, which indicated that only the current service cost component and other post-employment benefits expense be eligible for capitalization and it should be capitalized at the overall labour splits. This change was approved in Order No. P.U. 2 (2019).

Within GEC, there are two primary components: Direct and Indirect.

- Direct – These are employees that are deemed incremental as a result of the capital program. These are primarily employees whose focus is on capital planning and standards as it does not relate to a specific asset.
- Indirect – These are allocations that are considered incremental as a result of the capital program. These are comprised of construction activities, non-construction activities and pension.

Table D1 outlines the current general expense cost ratios that have been applied by the Company.

Table D1 – GEC Cost Ratios & Amount

Function	Allocation	2019 Amount (\$000's)
Direct GEC	N/A	\$1,290
Construction Activities		
<i>Operating Supervision & Misc.</i>	15.0%	\$547
<i>Tools, Equip., Safety Clothing</i>	48.0%	\$794
Non-Construction Activities		
<i>Accounting</i>	13.0%	\$238
<i>Human Resources & Admin</i>	13.0%	\$326
<i>Printing Services</i>	13.0%	\$39
<i>Employees' Welfare</i>	31.0%	\$77
Pension Plan	46.0%	\$2,892
Total GEC		\$6,203

Review of Capitalization Policies and Guidelines

Appendix E **Survey of Capitalization Practices of Canadian Utilities**

Review of Capitalization Policies and Guidelines
Survey of Capitalization Practices of Canadian Utilities
August 14, 2020

1.0 Overview

On February 21, 2020, the Board of Commissioners of Public Utilities of Newfoundland and Labrador (the “Board”) issued Order No. P.U. 5 (2020) approving Newfoundland Power Inc.’s (“Newfoundland Power”) *2020 Capital Budget Application*. In that order, the Board stated it would establish a process to review the capitalization practices of both Newfoundland Power and Newfoundland and Labrador Hydro (“Hydro”) (collectively, the “Utilities”) to ensure consistency with sound public utility practice and the provision of least-cost service to customers.

On April 30, 2020, the Board requested each utility complete a report for the Board describing its capitalization practices relating to capital asset additions. The report was expected to address:

1. the particular accounting standards being followed by the utility;
2. 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
3. any other alternatives that may be available to be used by the utility in the development of capitalization practices.

The Board also requested that the Utilities conduct a jurisdictional scan of capitalization practices used by other utilities across Canada.

The Utilities, in consultation with Board staff, developed 11 questions to be included as part of the jurisdictional survey. In total, the survey was sent to 18 Canadian utilities. Eleven utilities responded, for a response rate of 61%.

The survey responses are summarized herein, and comparable information for Newfoundland Power is included. The ownership and responses to questions 1 through 3 for Utility 9 have been redacted for anonymity.

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
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

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
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 due, 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% ¹

¹ 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:
- What is included in the labour loader (i.e. benefits, vacation, pension, etc.)?
 - 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
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	25.0%	N/A	No
Newfoundland Power	Health Benefits, Payroll, Vacation, Leave	Time Entry	35.0% ²	43.0% ³	Inventory

² Adjusting Newfoundland Power's capitalized internal labour to account for Pension increases the percentage to 37.5%.

³ Adjusting Newfoundland Power's capitalized total labour to account for Pension increases the percentage to 44.8%.