



*Newfoundland  
& Labrador*

BOARD OF COMMISSIONERS OF PUBLIC UTILITIES

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IN THE MATTER OF THE  
**2003 GENERAL RATE APPLICATION**  
FILED BY  
**NEWFOUNDLAND POWER INC.**

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**DECISION AND ORDER**  
**OF THE BOARD**

**ORDER No. P.U. 19 (2003)**

---

**BEFORE:**

**Mr. Robert Noseworthy**  
**Chair and Chief Executive Officer**

**Ms. Darlene Whalen, P.Eng.**  
**Vice-Chair**

**Mr. John William Finn, Q.C.**  
**Commissioner**

**P.U. 19(2003)**

**IN THE MATTER OF** the *Public Utilities Act*  
R.S.N. 1990, Chapter P-47 (the "*Act*");

**AND IN THE MATTER OF** a General Rate  
Application by Newfoundland Power Inc., filed  
pursuant to Order No. P.U. 22(2002-2003)

**BEFORE:**

**Robert Noseworthy**  
**Chair and Chief Executive Officer**

**Darlene Whalen, P.Eng.**  
**Vice-Chair**

**John William Finn, Q.C.**  
**Commissioner**

**DATE: June 20, 2003**

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## PART ONE. BACKGROUND

### I. THE APPLICATION

#### 1. Filing

Newfoundland Power (NP), pursuant to Order No. P.U. 22(2002-2003) filed an Application (the "*Application*") with the Board of Commissioners of Public Utilities (the "Board") on October 11, 2002 for an Order or Orders of the Board approving, among other things, the proposed rates for the various customers of NP, to be effective May 1, 2003. (See Appendix A)

On February 10, 2003 NP filed an amended Application to reflect 2002 actuals along with updated economic data. (See Appendix G) The Pre-filed Evidence, Exhibits and Studies filed as part of the original application were also updated and re-filed. In addition the evidence was revised to reflect the Board's decisions respecting NP's 2003 Capital Budget as contained in Order No. P.U. 36(2002-2003) issued on December 20, 2002. In the amended Application NP proposed revised rates to be effective August 1, 2003.

#### 2. Application Proposals

In the Application NP is proposing the Board approve the following:

1. *"accounting treatments and policies with effect from January 1, 2003 to:*
  - a) *amortize the recovery over a five year period, of an amount of \$5.6 million that has accumulated in the Weather Normalization Reserve;*
  - b) *adopt on a prospective basis, the market-related method of valuing pension assets for the purposes of determining pension expense;*
  - c) *amortize over a three year period, the estimated Board and Consumer Advocate's regulatory costs of \$1.2 million incurred with respect to this Application; and*
  - d) *credit one-half of the balance of \$944,000 in the Excess Revenue Account to Newfoundland Power's revenues in each of 2003 and 2004 to reduce revenue requirements from rates that would otherwise be recovered from customers in those years.*
2. *provision for customer recovery of the remaining balance of the 1992 and 1993 excess earnings by reducing revenue requirement to be recovered from rates by \$112,000 in 2003 and \$335,000 in 2004.*
3. *calculation of depreciation expense with effect from January 1, 2003 by:*
  - a) *use of the depreciation rates as recommended in the Depreciation Study filed with the Application; and*
  - b) *adjustment of depreciation expense to amortize over a 3 year period an accumulated reserve variance of \$17.2 million identified in the Depreciation Study filed with the Application.*

4. *rates, tolls and charges effective for service provided on and after August 1, 2003, to provide an average increase in electrical rates of 0.96 per cent, based upon:*
  - a. *a forecast average rate base for 2003 of \$599,245,000 and for 2004 of \$622,650,000;*
  - b. *a rate of return on average rate base of 10.55 per cent in the range of 10.30 to 10.80 per cent; and*
  - c. *a forecast revenue requirement to be recovered from electrical rates, following implementation of the proposals set out in paragraphs 9,10 and 11 of the Application, of \$378,327,000 for 2003 and \$385,490,000 for 2004.*
5. *continued use of the Formula with changes to:*
  - a. *adopt the method used by the National Energy Board and the British Columbia Utilities Commission to determine the risk free rate;*
  - b. *use an equity risk premium of 4.75 per cent at a risk free rate of 6 per cent for 2003; and*
  - c. *allow a range of return on rate base of 50 basis points.*
6. *amendments to the Rules and Regulations governing Newfoundland Power's provision of electrical service to its customers to:*
  - a. *eliminate the statement preparation fee;*
  - b. *reduce the fee applicable for customer name changes from \$14 to \$8; and*
  - c. *extend the application of the reconnection fee to circumstances where customers request reconnection of service following a landlord's request for disconnection of service.*
7. *defer dealing with outstanding issues related to revenue recognition and the Unbilled Revenue Increase Reserve Account pending resolution of an outstanding dispute with the Canada Customs and Revenue Agency.*
8. *additional capital expenditures for 2003 of \$425,000 to permit Newfoundland Power to undertake a load research program."*

## **II. THE HEARING**

### **1. Notice and Pre-Hearing Conference**

Notice of the Application and Pre-hearing Conference was published in newspapers throughout the province. The Pre-hearing Conference was held on October 30, 2002 and resulted in the Board issuing Procedural Order No. P.U. 27(2002-2003), which identified registered intervenors, set procedural rules for the conduct of the hearing, and set the schedule for the filing and service of documents, the motions days and the actual hearing. (See Appendix B)

NP was represented throughout the hearing by Ms. Gillian Butler, Q.C. and Mr. Peter Alteen, LL.B.

The registered intervenors for the hearing were the Government appointed Consumer Advocate, Mr. Dennis Browne, Q.C., represented by Mr. Stephen Fitzgerald, LL.B., and Newfoundland and Labrador Hydro (NLH), represented by Mr. Geoffrey Young, LL.B.

The Board was assisted at the hearing by Mr. Mark Kennedy, LL.B., who acted as Board Hearing Counsel; Ms. Dwanda Newman, Board Counsel; Ms. Cheryl Blundon, Board Secretary; and Ms. Barbara Thistle, Assistant Board Secretary.

### **2. Interim Order**

On December 16, 2002, NP filed an application with the Board for an interim order extending effective January 1, 2003 the current Schedule of Rates, Tolls and Charges approved in Order No. P.U. 22(2002-2003). The rates were to remain in place pending a further Order of the Board following the hearing of the general rate application. The Board subsequently issued Order No. P.U. 35(2002-2003) approving NP's proposal. (See Appendix E)

### **3. Motions and Procedural Order Amendments**

At the first scheduled motions day on December 4, 2002 the Board heard representations on a motion from the Consumer Advocate regarding the evidence of one of NP's proposed cost of capital experts, Ms. Kathleen McShane. The motion requested that either: a) the Board strike Ms. McShane's evidence from the record; or b) if Ms. McShane's evidence is allowed, that the cost related to Ms. McShane's evidence not be the responsibility of the ratepayers but be borne by NP's shareholders; and c) the Board provide direction to the parties as to the number of experts a party should be permitted to call on any particular issue. Following the hearing of the motion the Board issued Order No. P.U. 33 (2002-2003) denying the motion. (See Appendix C)

At the request of and with the agreement of the parties, on December 12, 2002 Procedural Order No. P.U. 34(2002-2003) was issued, amending the schedule of dates and order of witnesses. (See Appendix D)



A further motions day was held on January 10, 2003. NP filed a motion requesting amendment of the Procedural Order No. P.U. 34(2002-2003) to extend the filing date for NP's responses to information requests and to delay the start date of the hearing to March 3, 2003. After hearing the motion the Board rendered an oral decision extending the date for the filing of responses by NP to information requests but reserved its decision on NP's request to postpone the start date of the hearing. The Board subsequently issued Procedural Order No. P.U. 1(2003) which among other things amended the schedule of dates and set the start date of the hearing for March 3, 2003. (See Appendix F)

On February 17, 2003 NP filed an application with the Board objecting to certain issues as set out in the Consumer Advocate's Issues List, specifically those issues relating to the setting and fixing of a rate of return on common equity for NP. NP requested that the Board: (1) issue an Order determining that it has no jurisdiction with respect to certain issues; (2) limit consideration of related issues at the public hearing; and (3) strike those issues from the Consumer Advocate's Issues List. On February 21, 2003 the Board heard from the parties regarding the application and subsequently issued Order No. P.U. 5(2003) denying the application of NP excepting that it would not hear evidence on the setting and fixing of a rate of return on common equity to the extent that it is beyond the Board's jurisdiction. (See Appendix I)

At the hearing on February 21, 2003 Board Counsel presented for consideration a revised Rules of Procedure, as well as an order of witnesses for the hearing. There was a disagreement between NP and the Consumer Advocate concerning the Rules of Procedure, specifically the rules surrounding the calling of panels of witnesses and also the manner of presenting to witnesses documents which are not part of the hearing record. The Board, after considering the submissions of the parties issued Procedural Order No. P.U. 4(2003) which modified the rules for the conduct of the hearing and set out the order of witnesses. (See Appendix H)

During the hearing the Board also received a request from the Consumer Advocate to issue subpoenas to 5 witnesses. NP requested an opportunity to make submissions on this issue and the Board heard from the parties on April 1, 2003. As a result the Board issued Order No. P.U. 8(2003) wherein it consented to issue only one of the subpoenas requested. (See Appendix K)

#### **4. Technical Conference/Mediation**

In preparing for the hearing the Board proposed a number of days be set aside to allow for a technical conference. The purpose of the technical conference was to provide the parties with an opportunity to settle certain issues in advance of the hearing. With the assistance of a Board appointed mediator, Dr. J. W. Wilson, the parties focused on cost of service allocation, rate structure and tariff matters.

Agreement was reached on all issues set out for mediation with the exception of one item related to meter reading. The parties subsequently filed a Mediation Report with the Board detailing issues upon which settlement was reached. The parties also consented to the admission

of all pre-filed testimony and exhibits of witnesses pertaining to the settled issues without the calling of witnesses for the purpose of cross-examination.

The Board considered the Mediation Report and subsequently issued Order No. P.U. 7(2003) which accepted and adopted the Mediation Report and the proposed resolution of issues upon which the parties agreed. (See Appendix J) These proposals are incorporated into this Decision. Given the parties reached no agreement on meter reading, the Board has addressed the issue in this Decision based on evidence and cross-examination during the hearing.

The Board is of the view that the technical conference/mediation proved successful and contributed to a streamlining of the regulatory process. The Board believes this kind of dialogue between the parties provided a number of advantages including reduced regulatory costs, less time spent on expert testimony during the hearing, consensus decision making and reporting. Each of these enhance the quality of regulation in the public interest as well as to the benefit of the parties and the Board. The Board expresses its sincere desire to build on this initiative at future hearings and to incorporate technical conferences/mediation as a sound business practice aimed at addressing specific regulatory issues between hearings.

The Board wishes to thank Dr. Wilson and the parties for their support and cooperation in this very worthwhile initiative.

## **5. The Hearing**

The hearing commenced on March 3, 2003 and continued over a six-week period for 23 hearing days. Written submissions were filed on April 22, 2003 and the Board heard oral argument on April 25, 2003. The following witnesses were called by the parties and the Board:

### Witnesses called by NP:

Mr. Philip Hughes, CA	President and CEO, NP
Mr. Barry Perry, CA	Vice-President Finance and Chief Financial Officer, NP
Mr. Ron Crane	Director of Forecasting, NP
Mr. Earl Ludlow, P. Eng.	Vice President, Engineering and Operations, NP
Dr. Roger Morin	Professor of Finance, Robinson College of Business, and Professor of Finance for Regulated Industry, Centre for the Study of Regulated Industries, Georgia State University
Ms. Kathleen McShane	Senior Consultant and Vice-President, Foster and Associates, Bethesda, Maryland
Mr. John Browne	J.T. Browne Consulting, Toronto, Ontario
Mr. John F. Weidmayer	Gannet Fleming Valuation and Rate Consultants, Inc.
Mr. Bruce Chafe	Chair of the Board, NP

Witnesses called by the Consumer Advocate:

Dr. Basil Kalymon                                  Professor of Finance, Richard Ivey School of Business,  
University of Western Ontario

Witnesses called by Board Hearing Counsel:

Mr. William R. Brushett, CA                  Partner, Grant Thornton LLP, St. John's, NL  
(Board's Financial Consultant)

Public participation days were held in St. John's and Corner Brook. During this phase of the hearing interested persons and organizations were offered the opportunity to present their views on issues arising from the Application.

The Board heard from the following persons during the public participation days:

In St. John's on April 4, 2003:

Mr. Owen Crossan, Regency Management Ltd., St. John's, NL  
Mr. Greg Malone, Private Citizen, St. John's, NL  
Mr. Gary Milley, Executive Director, Newfoundland & Labrador Parks/Recreation  
Association, St. John's, NL  
Mr. Charlie Oliver, Martek Morgan-Finch, St. John's, NL  
Mr. Terry McNeil, Climate Change Action Coordinator, Conservation Corps of Newfoundland  
and Labrador, St. John's, NL  
Ms. Sara Peckford, Climate Change Action Coordinator, Conservation Corps of Newfoundland  
and Labrador, St. John's, NL  
Mr. Dennis O'Keefe, Chair, Consumer Group for Fair Gas Prices, St. John's, NL  
Mr. Bill Rossitor, Private Citizen, Mount Pearl, NL

In Corner Brook on April 11, 2003:

Ms. Priscilla Boutcher, Mayor, City of Corner Brook, NL  
Mr. Edward Buckle, Private Citizen, Corner Brook, NL  
Mr. Mark Baldwin, President, Corner Brook Chamber of Commerce, Corner Brook, NL  
Mr. Peter Blake, Private Citizen, Corner Brook, NL  
Mr. Michael J. Griffin, Q.C., Private Citizen, Grand Falls-Windsor, NL  
Mr. Walwin Blackmore, Mayor, Town of Grand Falls-Windsor, NL

The Board appreciates the time and effort of those who appeared before the Board to present their views on the Application. The presentations and comments were very helpful in providing the Board with both personal and community perspectives and the Board has considered this input in making its decisions.

Interested persons and organizations were also given the opportunity to submit a Letter of Comment, which also formed part of the record before the Board. Letters of Comment were submitted by:

Mr. Gerald Hounsell, Splash “N” Putt Cabins, Glovertown, NL  
Ms. Heide Pearce, Toulon Development Corporation, St. John’s, NL  
Mr. Wayne Richards and Ms. Janet Richards, Regency Towers, St. John’s, NL  
Ms. Catharine and Mr. Graham Bailey, Port Rexton, NL  
Mr. & Mrs. Gerald Hennifent, Norris Arm, NL  
Ms. Judy Tilley, Torbay Estates Limited, St. John’s, NL  
Mr. Mark Sexton, CEO, Corner Brook Economic Development Corporation,  
Corner Brook, NL

The Board also extends its appreciation to those persons and organizations submitting Letters of Comment.

In addition to the sworn evidence given at the hearing, which included evidence provided at the public participation days, additional evidence was entered by way of information requests, consent filings, and information filings. The Board has considered all the evidence before it in this proceeding and will refer directly to the evidence upon which it based its findings as set out in this Decision.

### III. REGULATION OF NP 1998-2002

NP is an investor owned, fully regulated electrical utility which operates an integrated generation, transmission and distribution system throughout the island portion of the Province. All the common shares of NP are owned by Fortis Inc., a diversified holding company headquartered in St. John's. NP services approximately 220,000 residential and general service customers, or approximately 85% of all electrical consumers in the Province. Newfoundland and Labrador Hydro ("NLH") serve the remainder. NP's total energy sales in 2002 were 4,765 GWh. NP purchases in excess of 90% of its energy requirements from NLH and supplies the rest itself using small hydro-electric generation.

NP's last rate review, in November 1998, was preceded by a full cost of capital hearing. Significant changes in market rates of return led to a preliminary investigation and a hearing was subsequently called by the Board in May 1998 under Section 88 of the *Act* into, *inter alia*, the matter of NP's rate of return and capital structure. The resulting Board Order No. P.U. 16(1998-99) used a maximum common equity ratio of 45% and return on equity ("ROE") of 9.25% to calculate a rate of return on rate base of 9.91%, which contributed to a decrease in rates effective January 1, 1998 of 2.1%. The concept of an automatic adjustment formula to set rates in upcoming years was also considered and the utility was ordered to address this issue in a general rate application with a hearing scheduled for the fall of 1998. This application also incorporated a number of other outstanding issues, including funding of pension liability and possible excess earnings in 1992 and 1993.

Following this hearing, the Board issued Order No. P.U. 36(1998-99) in January 1999. This Order set rates for 1999 and put in place an Automatic Adjustment Formula (the "Formula") to determine rates beyond the test year(s). The Formula was designed to annually adjust NP's rate of return on rate base based on changes in the forecast cost of common equity linked to changes in long-term Canada bond yields. The average weighted cost of capital was to be determined using this revised ROE and was then incorporated into the Formula on an annually adjusted basis along with the ratio of forecast average invested capital to average rate base in order to yield an allowed return on rate base and hence set rates in the following year. Additional details on the Formula are outlined on pg. 62 of this Decision. In addition to setting the Formula, Order No. P.U. 36(1998-99) also confirmed NP's maximum common equity ratio of 45% and determined for the 1999 test year a rate of return on rate base of 9.81%, based on an ROE of 9.25%. The result was a rate increase of 1% which became effective February 1, 1999.

Prior to the Board's issuing its cost of capital decision for NP in June 1998, the Court of Appeal rendered its opinion on a case stated before the Supreme Court of Newfoundland by the Board pursuant to Section 101 of the *Act*, (the "Stated Case") requesting an opinion on the jurisdiction of the Board. Among other matters, the Court of Appeal provided an opinion regarding the Board's jurisdiction to:

- set and fix the level of return on common equity;
- regulate the return on rate base;
- require a public utility to maintain ratios within its capital structure; and
- deal with excess earnings of the utilities being regulated.

In addition to the matters raised during the hearing the Board's Order No. P.U. 36(1998-99) also addressed its understanding of the Court's opinion and its effect on the regulation of NP.

Application of the Formula resulted in an increase in NP's rates of 0.7% in 2000, no change for 2001, and a decrease of 0.6% for 2002.

In June 2002 the Board issued Order No. P.U. 7(2002-2003) arising from NLH's general rate application. This decision and the subsequent rate Order No. P.U. 21(2002-2003) resulted in an increase in NP's purchased power costs of 6.5%. In August 2002, NP filed an application with the Board requesting new rates in order to pass through these increased costs. The Board issued Order No. P.U. 22(2002-2003) which approved an increase of 3.68% to NP's customers. This Order fixed NP's rates until December 31, 2002 and directed NP to file a general rate application for a full review of its 2003 costs, including cost of capital, no later than October 11, 2002. The general rate application was filed as required and is the subject of this Decision and Order.

Since the effect of Order No. P.U. 22(2002-2003) was that no approved Schedule of Rates, Tolls and Charges would be in place as of January 1, 2003, NP filed an application on December 16, 2002 for an interim Order under Section 75 of the *Act*. This application requested that the existing rates remain in effect until further Order of the Board following the hearing of NP's general rate application. The Board approved this application and issued Interim Rate Order No. P.U. 35(2002-2003). Rates for 2003 will be finalized in this Decision and Order.

During the period 1998-2002, the Board also dealt with a number of additional applications from NP, including a number of routine Contribution in Aid of Construction approvals, annual approval of balances in the Weather Normalization Account and the annual approval of rate stabilization and municipal tax adjustments. The Board also held public hearings in each year from 1999-2002 to consider NP's capital budget proposals. At these capital budget hearings, the Board dealt with approval of revised amounts for rate base and invested capital for use in the Formula in determining return on rate base for the subsequent year.

Other specific decisions issued by the Board in relation to NP during this regulatory period (1998-2002) included:

- i) Order No. P.U. 24(1999-2000) – Approval of amortization and funding of pension liability associated with an early retirement program.
- ii) Order No. P.U. 37(2000-2001) – Approval of a rebate to customers of \$6,733,000 plus HST credited to the Excess Revenue Account resulting from a tax reassessment.
- iii) Order No. P.U. 17(2001-2002) – Approval of NP's proposal to purchase poles jointly used with Aliant and the associated additional capital expenditures for 2003 of \$22,100,000.
- iv) Order No. P.U. 23(2002-2003) – Approval of issuance of Series AJ First Mortgage Bonds up to \$75,000,000 pursuant to Section 91 of the *Act*.

#### IV. STATUTORY POWERS AND RESPONSIBILITIES

The statutory powers and responsibilities described below are consistent with those set out in Order No. P.U. 7(2002-2003) for NLH and are intended to communicate to the utilities and other stakeholders the fundamental regulatory framework used by the Board in issuing its decisions, findings and subsequent Orders. This background may form a routine introduction to all future Board decisions involving a general rate application by a utility, although some variations in format and content may be evident from time to time.

The Board is an independent, quasi-judicial body established under Provincial legislation to regulate public utilities in the Province. Regulation is designed to ensure consumers receive safe and reliable electricity at rates that are reasonable while allowing the utility to earn a fair return on its investment in supplying the electrical service. Regulation strives to strike an equitable balance between the interests of consumers and the utility.

The regulatory framework of the Board consists of five cornerstones, as follows:

- i) BOARD AUTHORITY sets out the legislative and legal powers and responsibilities of the Board.
- ii) BOARD HEARING PROCEDURES govern the presentation of the evidentiary record on matters before the Board.
- iii) REGULATORY PRINCIPLES which are commonly accepted in guiding sound public utility regulation.
- iv) THE RATE SETTING PROCESS is founded in accounting, engineering and economic methodologies which are applied in combination with i), ii) and iii) and weighed by the Board in making decisions affecting rates.
- v) REPORTING/COMPLIANCE provides appropriate regulatory monitoring of the utility's ongoing activities and compliance with Board Orders.

##### 1. Board Authority

###### **Mandate**

The Board's authority is derived from its statutory powers and responsibilities as set out in the *Public Utilities Act* (the "Act") and the *Electrical Power Control Act 1994 (S.N. 1994, Chapter-E-5.1)* (the "EPCA").

The *Act* sets out the structure of the Board and defines its powers. The Board has responsibility for the general supervision of public utilities in the Province, which requires the Board to approve rates, capital expenditures and other aspects of the business of public utilities.

In addition to the provisions of the *Act*, the Board is also mandated through the *EPCA*, particularly Section 3, which states the power policy of the Province as follows:

- “3. *It is declared to be the policy of the province that*
- (a) *the rates to be charged, either generally or under specific contracts, for the supply of power within the province*
- (i) *should be reasonable and not unjustly discriminatory;*
  - (ii) *should be established, wherever practicable, based on forecast costs for that supply of power for 1 or more years;*
  - (iii) *should provide sufficient revenue to the producer or retailer of the power to enable it to earn a just and reasonable return as construed under the Public Utilities Act so that it is able to achieve and maintain a sound credit rating in the financial markets of the world; and*
  - (iv) *should be such that after December 31, 1999 industrial customers shall not be required to subsidize the cost of power provided to rural customers in the province, and those subsidies being paid by industrial customers on the date this Act comes into force shall be gradually reduced during the period prior to December 31, 1999;*
- (b) *all sources and facilities for the production, transmission and distribution of power in the province should be managed and operated in a manner*
- (i) *that would result in the most efficient production, transmission and distribution of power;*
  - (ii) *that would result in consumers in the province having equitable access to an adequate supply of power;*
  - (iii) *that would result in power being delivered to consumers in the province at the lowest possible cost consistent with reliable service...”*

Section 4 of the *EPCA* states:

- “4. *In carrying out its duties and exercising its powers under this Act or under the Public Utilities Act, the public utilities board shall implement the power policy declared in section 3, and in doing so shall apply tests which are consistent with generally accepted sound public utility practice.”*

In summary, the *EPCA* mandates the Board to make rate decisions that are reasonable and not unjustly discriminatory. Rates are to be based on forecast costs for the supply of power for one (1) or more years. This timeframe in practice is generally referred to as the “*test year(s)*”. The legislation also ensures that the utilities are permitted to earn a just and reasonable financial return while maintaining a sound credit rating in the financial markets of the world. The legislation calls for the most efficient production, transmission and distribution of power that will afford consumers the lowest possible cost electricity consistent with equitable, safe and reliable service.



## **Form of Regulation**

With regard to the form of regulation, Section 80(1) of the *Act* states:

*“80. (1) A public utility is entitled to earn annually a just and reasonable return as determined by the Board on the rate base, as fixed and determined by the Board for each type or kind of service supplied by the public utility...”*

This is commonly referred to as return on rate base regulation. Rate base consists largely of investment by the utility in plant and equipment and historically has constituted the statutory form of regulation used in the Province. Return on rate base regulation is more fully described in relation to the Rate Setting Process. Alternative forms of regulation in place elsewhere include Return on Equity (ROE) and/or an emerging trend toward Performance Based Regulation (PBR).

## **Statutory Limitations**

The legislative authority of the Board is, nonetheless, subject to two limitations (Sections 5.1 and 5.2) in the *EPCA* as follows:

*“5.1 Notwithstanding section 3 and section 4 of the Act and the provisions of the Public Utilities Act, the Lieutenant-Governor in Council may direct the public utilities board with respect to the policies and procedures to be implemented by the board with respect to the determination of rate structures of public utilities under the Public Utilities Act and, without limiting the generality of the foregoing, including direction on the setting and subsidization of rural rates, the fixing of a debt-equity ratio for Hydro and the phase in, over a period of years from the date of coming into force of this section, of a rate of return determination for Hydro and the board shall implement those policies and procedures.*

*5.2 The Lieutenant-Governor in Council may exempt a public utility from the application of all or a portion of this Act where the public utility is engaged in activities that in the opinion of the Lieutenant-Governor in Council as a matter of public convenience or general policy are in the best interest of the province, to the extent of its engagement in those activities.”*

To date, the Board has received no direction under either provision from the Lieutenant-Governor in Council in respect of NP.

## **Appeal Process**

Section 99. (1) of the *Act* states the statutory authority embodied in an Order of the Board as follows:

*“An appeal lies to the Court of Appeal from an order of the board upon a question as to its jurisdiction or upon a question of law, but the appeal can be taken only by leave of a judge of the court, given upon an application presented within 15 days after the making of the decision and upon the terms that the judge may determine.”*

An Order of the Board has the force of law and is binding on the parties and can only be appealed to the Court of Appeal on an issue of law or jurisdiction of the Board.

## Stated Case

The most comprehensive judicial consideration of the authority of the Board comes from the comments of Mr. Justice Green in Newfoundland (Board of Commissioners of Public Utilities)(Re)(1998), 64 NFLD. & PEI R.60 (NFLD.C.A.) In 1998 the Board stated a case for the consideration of the Court of Appeal pursuant to Section 101 of the *Act*. Mr. Justice Green set out some general principles that apply to all decisions of the Board, which may be summarized as:

1. The *Act* should be given a liberal interpretation respecting the purpose of the legislation and the power policy of the province;
2. The Board has discretion in how it approaches its mandate;
3. The Board has all appropriate and necessary powers;
4. The Board must balance the interests of public utilities and electrical consumers;
5. The Board sets rates prospectively, after a full consideration of all available evidence; and
6. The Board has discretion to choose the approach to setting rates as long as it observes the legislation and sound utility practices.

The Court was clear in setting out that the Board must balance two sets of interests - the utility's right to a fair return and the consumer's right to reasonable access to power. Mr. Justice Green notes that the Board must be careful to balance both interests, when he says, at para. 144:

*"It must always be remembered that, as has been emphasized throughout this opinion, the Board is charged with balancing the competing interests of the utility and the consumers of the service it provides. Neither set of interests can be emphasized in complete disregard of the interests of the other. Thus, in choosing to exercise a particular power within the Board's jurisdiction, the Board must always be mindful of whether, in so acting, it will be furthering the objectives and policies of the legislation and doing so in a manner that amounts to a reasonable balance between the competing interests involved."*

In conclusion, the Court found that the Board can be regulative and corrective but not managerial in its prospective regulation of a utility. The Board notes that the Court of Appeal suggested that the Board should observe a presumption of managerial good faith.

## 2. Board Procedures

The Board's procedures are governed by the relevant legislation and, as a quasi-judicial body, the principles of natural justice and procedural fairness apply. The *Act* and *Regulation 39/96* both set out procedures for the Board. In addition to prescribed regulations, Section 26 of the *Act* enables the Board to establish its own procedures. This permits the Board to exercise discretion to allow for a more informal and flexible treatment of issues.

The procedures of the Board address items such as the form of the application, public notice, submission by intervenors, information requests, document exchange along with rules and protocol surrounding public hearings. While the procedures in a hearing before the Board

are less formal than a court, the principles of natural justice are still observed. Sufficient notice is given to all interested persons who are provided with the opportunity to participate. Witnesses are sworn, and their testimony is heard by way of both direct and cross-examination. Evidence is entered and documented and the Board maintains a full and complete record.

All hearing documentation is filed in electronic format with a paper copy maintained as the official Board record. The Board provides public access to all information through the Board's web site ([www.pub.nf.ca](http://www.pub.nf.ca)). The web site is updated daily with transcripts and additional evidence filed during each day's proceedings posted in advance of the commencement of the hearing the following day. The evidence can also be viewed simultaneously by the Board, parties and witnesses on monitors located in the Hearings Room.

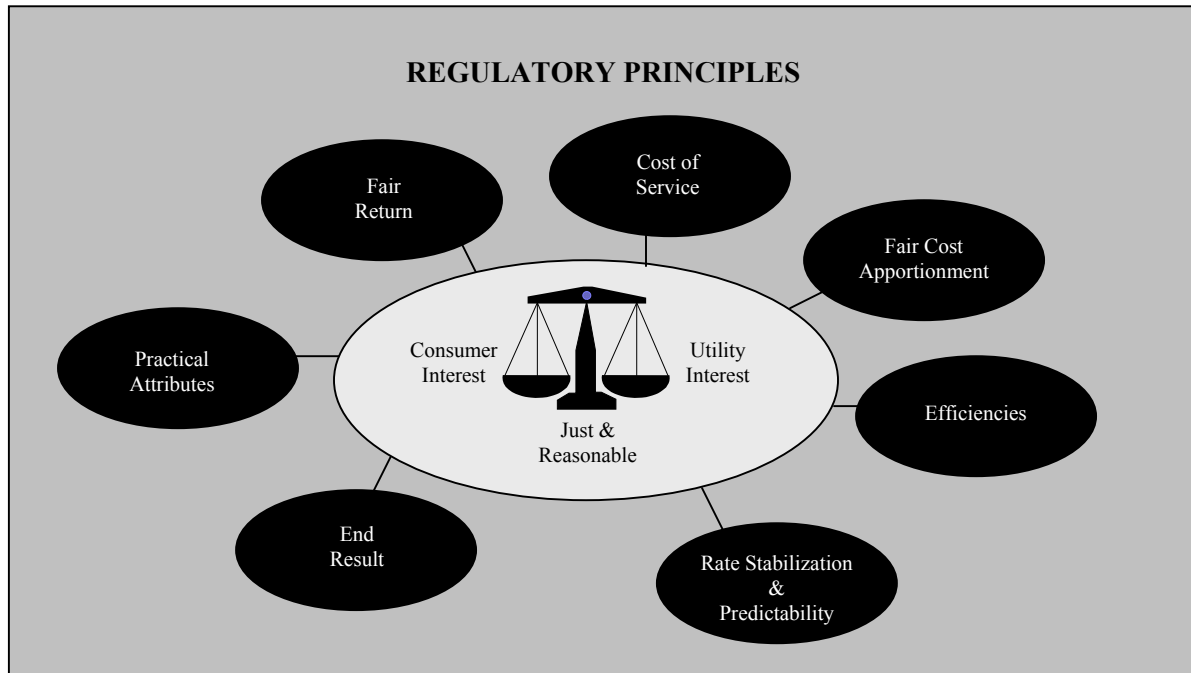
Through these procedures the Board ensures that the process is accessible and transparent for stakeholders, including the public. The Board may also travel throughout the province to hear from interested persons or organizations. Full and informed public debate and discussion on the issues is encouraged through the participation of the parties, the general public and, for major hearings, a government appointed consumer advocate.

After full consideration of all of the evidence the Board will issue a reasoned decision, usually in writing. Together with the Decision an Order of the Board will be issued and, as noted previously, can only be appealed to the Court of Appeal.

### **3. Regulatory Principles**

Sound regulatory practices encompass fundamental principles which are used by regulators as a guide or roadmap to rational decision-making. As stated in the Bonbright J. C., Danielsen A.L, Kamerscen D.R., Principles of Public Utility Rates (Arlington: Public Utilities Reports, Inc., 1988): "*We are simply trying to identify the desirable characteristics of utility performance that regulators should seek to compel through edict.*" These are commonly referred to as Bonbright's principles and are specifically outlined on pages 383-384 of his book.

Section 4 of the *EPCA* directs the Board to apply tests that are consistent with generally accepted sound public utility practice. The Board sets out the following principles for purposes of its regulatory framework:



1. Fair Return

Regulated utilities are given the opportunity to earn a fair rate of return. To be considered fair, the return must be:

- commensurate with return on investments of similar risk;
- sufficient to assure financial integrity; and
- sufficient to attract necessary capital.

The fair return principle is consistent with both Section 80(1) of the *Act* and Section 3(a)(iii) of the *EPCA*.

2. Cost of Service

Under this principle a utility is permitted to set rates that allow the recovery of costs for regulated operations, including a fair return on its investment devoted to regulated operations - no more, no less. Costs should be:

- prudent;
- used and useful in providing the service;
- assigned based on cause (causality);
- incurred and recovered (matching costs and benefits) during the same period; and
- reflective of private/social costs and benefits occasioned by the service.

3. Fair Cost Apportionment

Fairness of specific rates in the apportionment of total costs of service among the different ratepayers so as to avoid arbitrariness, capriciousness, inequities or discrimination. Under this principle, customers in similar situations should be treated equally (horizontal equity), while those in different situations should be treated differently (vertical equity). This principle would not deny cross-subsidization of rates among customers of equal circumstances but such subsidization should not cause undue discrimination. The principle of horizontal equity (i.e. equals treated equally) is set forth in Section 73(1) of the *Act* which requires that “*all tolls, rates and charges shall always, under substantially similar circumstances and conditions in respect of service of the same description, be charged equally to all persons and at the same rate, ...*”. Furthermore, the aspect of undue discrimination also has statutory reinforcement in Section 3(a)(i) of the *EPCA* which declares it to be “*...the policy of the province that the rates to be charged .....should be reasonable and not unjustly discriminatory.*”

4. Efficiencies

Rate classes and rate blocks should discourage wasteful use of service while promoting all types and amounts of use that are economically justified. Greater efficiency should also be employed in promoting innovation and responding economically to changing demand and supply patterns.

5. Rate Stability and Predictability

Rates and revenues should be stable and predictable from year to year with a minimum of unexpected changes seriously adverse to either ratepayers or utility companies. This principle may justify smoothing out increases to avoid sharp rate climbs or temporary fluctuations. The emphasis using this standard relates to the timing of rate implementation.

6. End Result

In compliance with the legislation, the end result must be fair, just and reasonable from the perspective of both the consumer and utility.

7. Practical Attributes

Rates should be simple, understandable and publicly acceptable with a minimum of controversy upon implementation.

While setting out these principles may be useful to ensure full consideration of all the issues, the Board notes that at times they may contain ambiguities, conflict with legislation, be inconsistent and/or hold different priorities. The real challenge for the Board, in keeping with its

legislative mandate, is to balance oftentimes competing objectives within the regulatory environment to ensure a set of sound and reasoned decisions serving the interests of both consumer and utility alike.

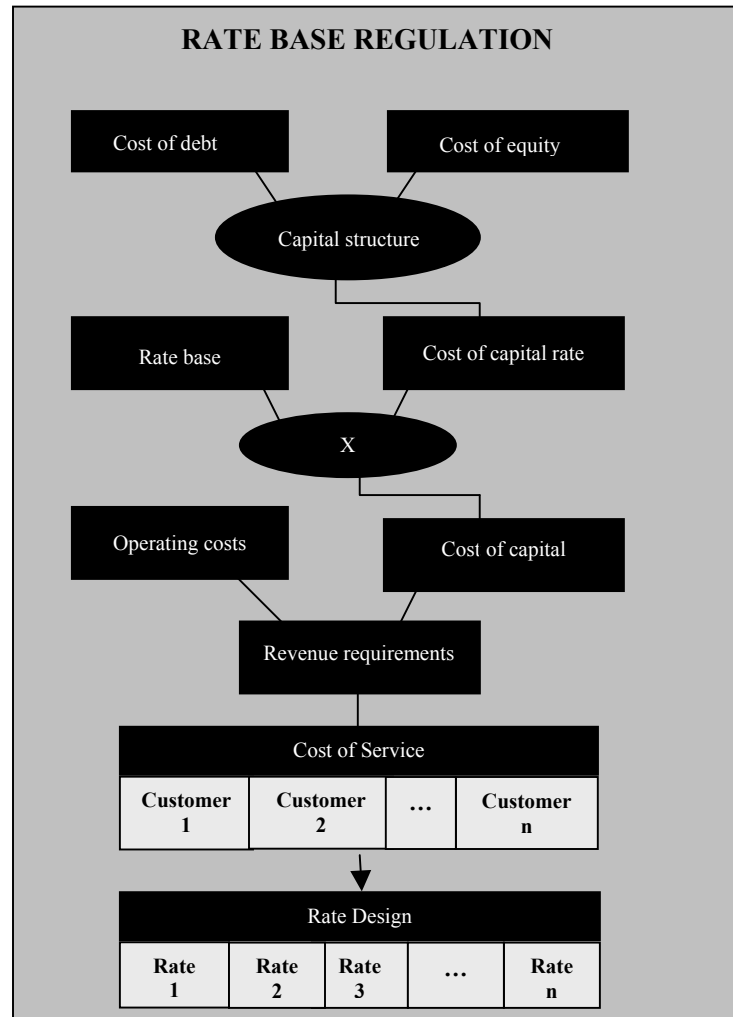
During rate proceedings the Board is often petitioned by intervenors and presenters to consider the customers' ability to pay when setting rates for various classes of customers and service. While cross subsidization of a group of customers contributing toward the cost of service assigned to another group of customers is a common regulatory practice, the ability of an individual customer to pay for the electrical service consumed is not considered by the Board in setting rates. Without compelling change in either legislation, public policy or structure of regulation, the Board will continue to pursue generally accepted regulatory principals as outlined above which does not incorporate ability to pay among its criteria for rate setting.

#### **4. The Rate Setting Process**

The rate setting process is founded in accounting, engineering and economic methodologies and is the proverbial glue that binds the regulatory framework. The Board's authority, the evidence and regulatory principles are combined by the Board through this process to make decisions affecting rates. The rate setting process is described below under the heading "*Rate Base Regulation*".

## Rate Base Regulation

As noted previously, pursuant to Section 80 of the *Act*, the regulatory framework of the Board is founded in rate base regulation. The elements of rate base regulation are illustrated as follows:



(As modified from "Basics of Canadian Rate Regulation", pg. 13)  
J. T. Browne and Charles Perron, Deloitte & Touche, 1997

The focus of return on rate base regulation is on earnings, in particular the allowed return per dollar of investment (rate base). Rates are set that give the regulated utility the opportunity to recover its revenue requirement consisting of its estimated operating costs and a fair return on its rate base. These costs are generally estimated for a test year(s) for which the rates are set.

### **Rate Base**

Rate base is the amount of investment on which a regulated utility is allowed to earn a fair return. Rate base comprises primarily depreciated investment in plant and equipment plus working capital as well as certain deferred assets/costs attributable to future operations. Regulators tend to focus on whether additions to the rate base, looking at the asset, are needed and if the cost is reasonable.

### **Capital Structure**

Capital structure is the relative amounts of equity and debt, commonly referred to as the debt to equity ratio, which comprises a company's total invested capital. The total invested capital represents the funds invested in the public utility by shareholders (equity) and by bondholders and other long-term debt holders (debt). The just and reasonable rate of return allowed on rate base is equivalent to the cost of capital representing the sum of the weighted costs of both debt and equity in the capital structure.

### **Revenue Requirement**

Revenue requirement is the amount of revenue required by a utility to cover the sum of operating costs including debt service, depreciation, taxes and allowed return on rate base (\$ rate base x cost of capital). The revenue requirement is the total amount of money a utility is eligible to collect from customers through rates:

$$\text{Revenue Requirement} = \text{Operating Costs} + (\text{Rate Base} \times \text{Rate of Return})$$

From a regulatory perspective, efficient operations, fully justified capital expenditures and a low cost capital structure all combine to minimize revenue requirement, and hence provide least cost electricity to ratepayers.

### **Cost of Service**

Cost of service constitutes the basis on which the utility's revenue requirement is allocated to each class of customer served. The utility normally submits a study of the costs incurred in purchasing, producing, transmitting and distributing electricity to its customers, by customer class.

### **Rate Design**

Once the cost of service or revenue requirement is allocated by customer class, specific rates are determined to recover the required costs/revenues from each customer within the class.



## 5. Reporting/Compliance

Reporting/Compliance is the mechanism used to monitor the ongoing activities of the utility from a regulatory perspective and is an important part of the regulatory framework. Section 16 of the *Act* states:

*“The board shall have the general supervision of all public utilities, and may make all necessary examinations and inquiries and keep itself informed as to the compliance by public utilities with the law and shall have the right to obtain from a public utility all information necessary to enable the board to fulfil its duties.”*

Consistent with the Court of Appeal’s findings, the role of the Board is not to exercise managerial influence but to ensure appropriate reporting/compliance mechanisms are in place such that regulatory objectives are met. The objective of the Board is to focus on regulatory accountability of the utility rather than engage in detailed reviews and costly controls. In keeping with this approach, some examples of the Board’s reporting/compliance requirements requested of the utilities include:

- Compliance with Board Orders;
- Annual financial review;
- Quarterly reports;
- Incident/Outage reports;
- Technical reports;
- Productivity, cost benefit and efficiency studies;
- CIAC audits; and
- Monitoring complaints.

## 6. Summary

The Board believes a consistent and equitable regulatory framework is in the interests of both the regulated utilities and consumers. The framework as described above has been in place in one form or another since the Board was established in 1949. This framework has evolved to date through a series of legislative amendments and case law and will continue to form the basis of the Board’s exercise of its regulatory authority under existing legislation, both in this Decision and Order and on a go forward basis.

## PART TWO. BOARD DECISIONS

### I. SUBMISSION OF CONSUMER ADVOCATE ON EXCESS EARNINGS

As part of the preliminary procedures set by the Board each party was required to file an Issues List to help focus and define the relevant issues contained in the Application. In the listing filed by the Consumer Advocate the following issues were identified, *inter alia*, as matters to be addressed during the hearing:

- “1. *Excess earnings by Newfoundland Power above the allowed Rate of Return on Equity since the implementation of the Automatic Adjustment Formula and since Board Orders in 1998 and subsequent Orders;*
2. *Rebate to consumers any excess earnings resulting from Newfoundland Power’s earnings above the allowed Rate of Return on Equity since the implementation of the Automatic Adjustment Formula and since Board Orders in 1998 and subsequent Orders;*
3. *A re-definition of Excess Earnings so that excess earnings will include excess earnings which are beyond the Allowed Rate of Return on rate base and include also Excess Earnings which are beyond the allowed Rate of Return on Equity.”*

Arising from the submission of these issues by the Consumer Advocate, NP filed an Interlocutory Application February 17, 2003, which sought an Order of the Board, *inter alia*, as follows:

- “(a) *pursuant to Section 11 of the Regulations, directing that insofar as the issues raised on the Consumer Advocate’s Issues List are premised upon the Board possessing jurisdiction to:*
  - (i) *set and fix the return that Newfoundland Power may earn on equity, or*
  - (ii) *determine the existence of excess revenues other than on the basis of Newfoundland Power’s return on rate base,*

*those issues shall not be considered at the public hearing of the Application.*
- (b) *pursuant to Section 26 of the Regulations, directing an amendment of the Consumer Advocate’s Issues List to strike out those matters contained in the Consumer Advocate’s Issues List that are premised upon the Board processing jurisdiction to:*
  - (i) *set and fix the return that Newfoundland Power may earn on equity, or*
  - (ii) *determine the existence of excess revenues other than on the basis of Newfoundland Power’s return on rate base.”*

The application was heard before the Board on February 21, 2003 following which the Board issued Order No. P.U. 5(2003), which declined to strike any issue from the Consumer Advocate’s list. The Board, however, confirmed that it would not hear evidence or submissions on the issue of the setting and fixing of the rate of return that NP may earn on equity to the extent that it is beyond the jurisdiction of the Board. The Board did not rule on whether it has the jurisdiction to determine excess earnings on any basis other than NP’s return on rate base.

This issue was raised during the hearing by the Consumer Advocate in cross-examination of both Mr. Hughes and Mr. Perry, and also in final written submission and oral argument. In final submission (pg. 16) the Consumer Advocate stated that NP has earned more than \$13 million over and above what the Board intended. In this respect NP earned an ROE greater than the 9.25% ROE used by the Board to set NP's return on rate base in Order No. P.U. 36(1998-99). The Consumer Advocate argued that no authority is found within the Stated Case to allow NP to retain these excess earnings. The Consumer Advocate further argued that the Board has jurisdiction to define excess revenue for the purposes of the operation of the Excess Revenue Account provided that definition meets the requirements as stated by the Court of Appeal. In support of his position the Consumer Advocate referenced the opinion of Justice Green as set out in paragraphs 111-114 of the Stated Case. The Consumer Advocate concluded:

*“Based on the foregoing, it is clear that the Board had jurisdiction to define excess revenue for the purposes of maintenance of a reserve account by incorporating in the definition the maximum level of return on common equity.”* (Final Submission, Consumer Advocate, pg. 18)

The Consumer Advocate further stated on page 19 of his final submission:

*“If the Board had jurisdiction to define excess revenue for the purposes of the establishment of the excess revenue account by reference to a level of return on common equity, then the Board has jurisdiction to retroactively revise a previous Order for the purpose of correctly stating the definition of excess revenue.”*

The Consumer Advocate requested the Board order these excess earnings to be either returned to consumers or treated similar to the disposition of excess earnings in Order No. P.U. 36(1998–99). (Final Submission, Consumer Advocate, pg. 22) In oral argument the Consumer Advocate further suggested that, if the Board was not prepared to rule on this issue, the matter could be referred back to the Court of Appeal for further clarification. Pending resolution of the issue, the Consumer Advocate requested that the Board consider whether or not NP should be required to segregate such earnings into an interest bearing account. (Transcript, April 25, 2003, pgs. 117-118)

NP disagreed with the Consumer Advocate's position and dealt with the issue extensively in its written submission. NP argues the Board's jurisdiction on this issue is limited as follows (Section G, pg. 17):

*“From a legal perspective NP submits that the Stated Case clearly indicates that the Board's jurisdiction to regulate a public utility's returns is limited to regulation of the return on rate base. This limitation was specifically indicated by the Court of Appeal to apply to the determination of excess revenues. While the Court of Appeal did refer in the Stated Case to the Board's ability to define a “reserve account” by reference to returns on equity, it specifically provided that the Board could not in so defining an account deprive a public utility of a level of return on rate base to which the Board had determined the utility to be entitled under s.80(1) of the Act. In fact, the Stated Case explicitly indicated how excess earnings were to be determined.”*

NP's position is that only where a utility's return on rate base exceeds the upper limit of the rate of return on rate base as prescribed by the Board does the Board have jurisdiction over the disposition of those earnings. (Transcript, April 25, 2003, pg. 52)

NP also raised concerns about the Consumer Advocate's suggestion that the Board has the "*jurisdiction to retroactively revise a previous order*" to allow a rebate to customers. NP submitted that this would amount to retroactive regulation, stating that:

*"Finally, on the issue of regulation of excess revenues, the Board has issued a series of orders specifically defining and redefining Newfoundland Power's Excess Revenue Account. Insofar as the issues raised in this proceeding constitute revisiting those orders, they raise serious issues of retroactive regulation that are contrary to both law and sound public utility practice."* (Written Submissions, NP, Section G, pg. 18)

NLH did not address the issue of NP's excess earnings in either written submissions or oral argument, though it did participate in the initial motion of the Consumer Advocate.

The Court of Appeal, in para. 57 of the Stated Case, specifically addressed the impact of any calculations by the Board of a rate of return on common equity, stating:

*"Subsection 80(1) makes no reference at all to determining, let alone setting and fixing, the rate of return on common equity. The calculation of an appropriate rate of return on common equity is truly a mere component in the overall process of determining a just and reasonable return on rate base"*.

The above comment of Justice Green was central to his conclusions outlined in para. 61 of the Stated Case where he states:

*"I therefore conclude that the power to determine a just and reasonable return on rate base, as contained in section 80(1) of the Act, does not include within it a power to set and fix a rate of return on common equity, but it obviously does contemplate that the analysis would be undertaken and factored into the conclusion as to what is a just and reasonable return on rate base."*

This conclusion is confirmed by Justice Green, where in para. 109, he states:

*"In light of the answer given to Question 1, the benchmark for determining excess revenue is the range of return on rate base determined by the Board to be just and reasonable"*.

The Board concluded it is appropriate and necessary that the Board consider the cost of common equity in deriving a just and reasonable return on rate base. It is the Board's view that the Stated Case confirms that the *Act* does not confer upon the Board a jurisdiction to fix and determine the returns of NP other than with reference to the utility's rate base. The cost of common equity is merely an input into the determination of a just and reasonable return.

The suggestion of the Consumer Advocate that the Board require NP to rebate to consumers any "*excess earnings above the allowed Rate of Return*" since 1998 requires that the

Board have the jurisdiction to first determine that there are excess earnings in relation to the return on equity and also that the Board has the jurisdiction to dispose of those excess earnings.

The following key paragraphs in the Stated Case guide the Board in making its final determination on the issues raised by the Consumer Advocate:

- “111. *As a result of the discussions at the hearing, however, it is apparent that there is a more fundamental issue at stake. The assumption appears to be that if the Board chooses to define excess revenue for the purpose of establishment of the excess revenue account in terms of revenue earned in excess of the maximum return on common equity, it is in effect saying that revenue earned below that maximum but which happens to be in excess of the just and reasonable return on rate base as determined by the Board under s-s. 80(1) is necessarily money which the utility can keep. This position is obvious from the arguments made by counsel for NLP since his position has been throughout that excess revenue has no meaning other than by reference to the definition used for the purposes of the excess revenue account. As indicated previously<sup>78</sup>, this is not a correct interpretation of the situation. The same assumption is also apparent from the position taken by the Consumer Advocate who argues that the decision of the Board to define excess revenue for the purpose of the excess revenue account in terms of exceeding the return on common equity, as opposed to rate base is ultra vires the Board because the Board must determine excess revenue by reference to revenues which are earned in excess of a just and reasonable return on rate base.*
112. *The assumption that the definition of excess revenue for the purpose of the operation of the reserve account is equivalent to the concept of excess revenue flowing from earnings in excess of a just and reasonable return on rate base as prescribed under s-s. 80-1, is false. I agree with the Consumer Advocate, for reasons already given<sup>79</sup>, that any revenues earned in excess of the maximum range of a just and reasonable return on rate base are revenues to which the utility is not automatically entitled. It does not follow, however, that for the purposes of regulating the accounts of the utility, the Board is prevented from requiring payment into an excess revenue account on a different basis (provided it does not deprive the utility of the level of return on rate base to which it has been determined to be entitled). The Board can and should deal with all revenue earned in excess of a just and reasonable return on rate base; however, it does not have to require that all of it be paid into an excess revenue account.*
113. *As indicated in the answers to Questions 3 and 4, the Board has a broad jurisdiction as to how to deal with the excess and it may well be that, in the circumstances obtaining, it will determine that only a portion (i.e. that portion above the maximum return on common equity) should be paid into a reserve account. It might determine that the rest should be rebated to consumers or used by the utility in furtherance of the objective of ensuring that it maintains a sound credit rating in the financial markets of the world. In short, there is nothing wrong in principle with the Board defining excess revenue for the purposes of a reserve account differently from the notion of excess revenue as determined by a comparison with a just and reasonable return on rate base as determined by s-s. 80(1). In so doing, however, the Board ought not to assume that any additional excess revenue ought necessarily to be returned to the utility to be used as it sees fit. The Board*

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<sup>78</sup> para. [73]

<sup>79</sup> paras. [31], [50]

*has jurisdiction, and in exercise of its legislative mandate it ought to exercise that jurisdiction, to make a determination as to how that remaining excess revenue, if any, should be dealt with consistent with the objectives and policies of the legislation.*

114 *Accordingly, the technical answer to Question 5 is “no” but so as to limit any confusion over the implications of the wording of the question, I would add that the Board has jurisdiction to define excess revenue for the purposes of maintenance of a reserve account by reference to the maximum level of return on common equity (or any other appropriate measure for that matter) but that does not mean that the Board may for all purposes define the level of excess revenue to which the utility is not entitled by reference to that measure; rather, the Board must determine, on the specific circumstances of the case, what is to be done with respect to any excess revenue measured against a just and reasonable return on rate base. If all or a portion of the excess revenue, measured against the return on rate base, is not ordered to be paid into a reserve account, it must nevertheless be dealt with in some other manner consistent with the objects and policies of the legislation. It should not be simply assumed that such excess revenue if not required to be paid into a reserve account belongs to the utility to be dealt with as it sees fit.”*

In para. 114 the Board’s jurisdiction to define excess revenue for the purposes of maintenance of a reserve account by reference to the maximum level of return on common equity is in the context of determining what earnings must be paid into a reserve account or, in the alternate, what funds not paid into a reserve account may be otherwise appropriately disposed of by the Board. However, the Court of Appeal is clear in para. 112 that any definition of excess earnings is subject to the ultimate proviso that the utility can not be deprived of the level of return on rate base which was allowed.

The Board finds that the Consumer Advocate is incorrectly equating measures which the Court has indicated are appropriate to the Board for purpose of defining and establishing a reserve account with measures which the Board may use to determine the existence of excess earnings to which NP is not entitled. The Consumer Advocate does not distinguish whether or not the measure encroaches upon earnings to which the utility is entitled as of right; in particular, earnings which are within the range of the return on rate base as ordered by the Board but may be in excess of the component rate of return on equity.

Following the rendering of the majority opinion in the Stated Case, through Order Nos. P.U. 36(1998-99) and P.U. 37(1998-99), the Board effectively revised the definition of the Excess Revenue Account such that the account to this date has been maintained with reference to the upper limit of the allowed range of return on rate base as set and fixed by the Board. This change for purpose of maintenance of this account was a recognition by the Board that, while it could continue to maintain an excess earnings account with reference to the rate of return on common equity, it appears to be of little practical consequence to do so when the only jurisdiction the Board has to dispose of these earnings is when they exceed the range of return on rate base.

The Board therefore concludes that the only jurisdiction it can exercise is over excess earnings which exceed the allowed range of return on rate base as set by the Board. In respect of these earnings the Board can order that they be utilized for the benefit of ratepayers in a manner

the Board deems appropriate and in accordance with the objectives and policies of the legislation. The Board in future will continue to exercise its discretion in this manner to the benefit of ratepayers, specifically as set forth in Order Nos. P.U. 36(1998-99) and P.U. 37(2000-2001), but it cannot go further and exceed its jurisdiction by depriving NP of earnings to which it is otherwise entitled under the *Act*.

**The Board finds that it has no jurisdiction under the *Act* to require payment by NP into a reserve account or otherwise deprive NP of any amount which is within the allowed return on rate base as fixed and determined by the Board pursuant to Section 80(1) of the *Act*.**

## II. FORECASTING ISSUES

Mr. Ron Crane, NP's Director of Forecasting, provided evidence on NP's customer and energy sales forecasts for 2003 and 2004. These forecasts form the basis of the test year projections for both revenue from electrical sales and for purchased power expense, NP's largest single expenditure. Exhibit BVP-27 (1<sup>st</sup> Revision) provides details on NP's customer and energy sales forecasts, along with the economic and financial assumptions used.

### 1. Economic Assumptions

The economic assumptions used by NP in preparing the customer and energy sales forecasts are based on the Conference Board of Canada's *Provincial Outlook, Long Term Forecast 2003 Edition*, dated December 6, 2002. According to Mr. Crane, Gross Domestic Product (GDP) is forecast to grow by 3.2% in 2003 and 1.5% in 2004. In 2003 the economy will benefit significantly from the development of both the White Rose and Voisey's Bay projects and continued increases in oil production. This compares to an average annual growth in excess of 5% since 1997, largely as a result of large resource based projects such as Hibernia and Terra Nova. The low growth in 2004 reflects a deceleration in oil production from 2003 levels and a decline in construction expenditure. The fishing industry is forecast to grow modestly over the forecast period with landings expected to increase marginally. As a result, the goods-producing sector is forecast to grow by 4.1% in 2003 and 0.9% in 2004. [Exhibit BVP-27, (1<sup>st</sup> Revision), pg. 5] The Conference Board of Canada's *Provincial Outlook, Winter 2003*, February 24, 2003 revised the GDP forecast for the goods producing sector to show an increase of 8.9% for 2003 and a decrease for 2004 of 1.5%. (U #17)

NP's electrical energy sales growth is primarily influenced by growth in the service sector of the economy as opposed to GDP. More specifically, changes in employment levels, personal income, energy prices and population demographics in NP's service territory are more determinative of sales growth than resource industry production levels. The service sector is expected to grow by 2.7% in 2003 and 1.8% in 2004. [Exhibit BVP-27, (1<sup>st</sup> Revision), pg. 5] Economic growth will not be uniform across NP's service territory. In the Northeast Avalon, growth will continue to be robust principally due to the offshore oil industry. With the exception of the impact of the development of the White Rose Project on the Burin area, much of rural Newfoundland is expected to continue the trend of economic stagnation.

### 2. Customer Growth and Energy Sales Forecast

Domestic customer growth is largely influenced by the number of housing starts in each year. Mr. Crane states that, even though 2001 and 2002 have shown significant improvements in housing starts, this level is not sustainable with the demographic changes occurring in the province. The Conference Board of Canada forecasts housing starts of 1,695 units in 2003 and 1,493 in 2004. Based on this projection the number of domestic customers is forecast to grow by 0.9% in 2003 and 0.8% in 2004. [Exhibit BVP-27, (1<sup>st</sup> Revision), pg. 7]

Average domestic electricity consumption is forecast to increase by 0.7% in 2003 and remain at that level in 2004. The combined impact of customer growth and changes in average



electricity use will result in growth in the volume of domestic energy sales under proposed rates of 1.6% in 2003 and 0.8% in 2004. [Exhibit BVP-27, (1<sup>st</sup> Revision) pg. 7]

The number of General Service customers is forecast to grow by 0.5% in 2003 and 2004. Under proposed rates the volume of General Service energy sales is forecast to grow by 2.2% in 2003 and 2.4% in 2004. The increased level of growth in the General Service forecast reflects activity related to construction for the White Rose project at Marystown which started in the fourth quarter of 2002. [Exhibit BVP-27, (1<sup>st</sup> Revision), pg. 8]

In Street and Area lighting class the number of customers is forecast to grow on average by 0.5% during 2003-2004, while the volume of energy sales is forecast to grow on average by 0.1%. [Exhibit BVP-27, (1<sup>st</sup> Revision), pg. 8]

Exhibit BVP-27 (1<sup>st</sup> Revision), (pg. 11 of 13) shows the customer and energy sales forecasts for the 2003 to 2004 period under both existing and proposed rates. Under both scenarios the number of customers is forecast to increase by 0.8% in 2003 and 0.7% in 2004. Energy sales under existing rates are forecast to increase by 1.8% in 2003 and 1.5% in 2004. Energy sales under proposed rates are forecast to increase by 1.8% in 2003 and 1.4% in 2004. NP has incorporated the impact of elasticity into its energy sales forecast as required by Order No. P.U. 7(1996-97).

### **3. Forecasting Accuracy**

During the hearing and in written submissions the Consumer Advocate raised the issue of NP's forecasting accuracy and the impact on revenue of "*under forecasting*" of energy sales in any given year. The Consumer Advocate argued that "*there is a disincentive for NP to accurately forecast its energy sales since if NP receives more revenue than anticipated in its forecast in any one year, NP suffers no consequence unless and until these revenues cause NP to overearn on its rate base.*" (Final Submission, Consumer Advocate, pg. 14)

The Consumer Advocate has taken specific issue with NP's forecast of housing starts, stating that this input has been understated by NP in its forecasting for 2003.

In U #18 NP prepared an analysis of the effects on the forecast of energy sales of the different housing forecasts that were put before the Board during the hearing, as well as the effect of the negotiated settlement. The results of this analysis show an overall variance of approximately 0.1% on energy sales for the scenarios considered. Mr. Crane also testified that a new forecast incorporating recent events in the Province such as the flood in Badger, the potential closure of the cod fishery, and the recent announcements of a paper mill shut down would indicate approximately the same, or perhaps slightly lower, energy sales than the forecast contained in Exhibit BVP-27 (1<sup>st</sup> Revision). (Transcript, March 18, 2003, pg. 56/5; pg. 57/9)

The Consumer Advocate submitted that "*NP's growth in sales volume from year to year should be more closely monitored on an annual basis, since in 2001 and 2002 NP's forecasting has been significantly inaccurate...*" (Final Submission, Consumer Advocate, pg. 15)

Grant Thornton also reviewed NP's forecasting methodology and reasonableness of assumptions and raised no concerns. (Grant Thornton Report-NP-2003 GRA, pgs. 33-34)

A comparison of forecast energy sales to weather adjusted actual sales shows a variance of -0.4% for 1999, which is the test year used by the Board in NP's 1998 GRA hearing. Overall variances for the period 1992 to 2003 range from -2.9% in 1992 to +2.4% in 2002, with over half the variances being less than 0.5%. The Board is satisfied these variances are indicative of very good forecasting accuracy. The Board also notes that the forecasting methodology is continually tested against actual observed data using "back casting" techniques to ensure that the methodology remains sound. (Transcript, March 18, 2003, pg. 92/3; pg. 94/12)

The Board agrees with the Consumer Advocate that NP's growth in sales volume from year to year should be monitored. In Order No. P.U. 36(1998-99) the Board made the following Order:

*"2(g) The Board will continue its practice of undertaking annual reviews of the company expenses and other financial and operating information of interest to the Board. Factors such as growth and sales volume will be monitored and a hearing will be convened by the Board on its own motion to consider revision in the company's revenue requirement if there is reason to believe that the adjustment mechanism has led or would lead to a level of earnings above what the Board believes to be just and reasonable."*

Since the 1998 hearing the Board has monitored growth and energy sales volumes through quarterly regulatory reports from NP and as part of its annual financial reviews. The Board has not found it necessary to make any adjustments to the forecasts for growth and energy sales as presented for the test year 1999 and upon which existing rates are based.

**The Board will accept NP's customer and energy sales forecasts for the test year period 2003-2004.**

### III. RISK ASSESSMENT

An assessment of risks including business, regulatory and financial risks is a key determinant in NP's ability to maintain and achieve the financial targets and objectives contained in its application. The Board has assessed the evidence pertaining to each of these risks in setting NP's appropriate capital structure and return on equity (ROE) for ratemaking purposes.

#### 1. Defining Risks

During the hearing, the Board heard a considerable amount of evidence regarding the exposure of NP to varying risks. These risks were described using a number of terms including business risk, regulatory risk, financial risk, investment risk and general utility risk without necessarily a clear evidentiary distinction being made when referring to these differing types of risk. For example, in its oral argument NP stated: *"Without exception, all three cost of capital experts agree that overall Newfoundland Power's business risks have not changed materially since 1998, and Newfoundland Power is of average business risk overall."* (Transcript, April 25, 2003, pg.22/15-20) Consistent with this position, NP cited evidentiary references from the three cost of capital experts in stating *"All experts agreed that Newfoundland Power has an approximately average utility risk."* (Written Submissions, NP, Section C, pg. 10/9-12)

Two of these references, Ms. McShane and Dr. Morin, referred to investment risk as opposed to business risk with Dr. Morin actually following up the specific reference to investment risk with the fact that NP's business risk actually exceeds that of other utilities. The third reference by Dr. Kalymon includes business risk along with capital structure risk and overall volatility in arriving at his conclusion on NP's risk profile.

Because of the lack of clarity, the Board feels compelled to distinguish between these various risks before attempting to assess them. With this in mind, the Board found Dr. Morin's pre-filed evidence helpful [Pre-filed Evidence, Dr. R.A. Morin, pgs. 18-25] along with definitions of Drs. Winters and Waters in 1998. [P.U. 16(1998-99), pgs. 20-21] The latter is particularly appropriate since it was the relative risks in each category comparing the current evidence with that of 1998 which became a primary focus of experts during the hearing. Described below are an explanation of the relevant definitions for each category of risk to be explored by the Board.

<u>Dr. Morin</u>	<u>Drs. Winters and Waters (1998)</u>
<b><u>Business Risk</u></b>	
Refers to the relative variability of operating profits induced by the external forces of demand for and supply of the firm's products, by the presence of fixed costs, by the extent of diversification or lack thereof of services, and by the character of regulation.	The basic risk that the utility's operating income may not be sufficient to service all its obligations, including the provision of the return on equity the investor regards as fair and expects to receive, in one or more future periods.
<b><u>Regulatory Risk</u></b>	
Normally included with business risk and refers to the quality and consistency of regulation applied to a given utility and to the fairness and reasonableness of regulatory decisions.	Similarly included with business risk as the risk that rates will not be set at a level sufficient to provide a fair rate or return on total capital invested.
<b><u>Financial Risk</u></b>	
Refers to the additional variability of earnings induced by the employment of fixed cost financing, that is, debt and capital stock.	Risks that arise through the corporation's financing and capital structure.

The Board feels the above definitions are consistent and reasonable. The Board accepts these definitions and sees no particular conflict in terms of the evidence presented during the hearing.

## **2. Business Risk**

NP started the hearing by indicating that its overall business risks were relatively high compared to other Canadian electric and gas utilities. This is borne out in CA-599 and Mr. Perry's evidence. [Pre-filed Evidence, B.V. Perry, (1<sup>st</sup> Revision) pg. 24/21-22] In oral argument, however, NP concluded: "*Without exception, all three cost of capital experts agree that overall Newfoundland Power's business risks have not changed materially since 1998, and Newfoundland Power is of average business risk overall*". (Transcript, April 25, 2003, pg. 22/15-19)

As noted earlier, while this is not strictly accurate in terms of the evidence before the Board, there was a good deal of consensus around this particular issue. Ms. McShane testified there have been no material changes in NP's business risk profile since 1998. [Pre-filed Evidence, Ms. K. McShane, pg. 4/22-23] While noting NP operates in a highly favourable regulatory environment, Dr. Kalymon concurred in his overall assessment that the business risks of NP have not changed substantially since the last hearing. Dr. Kalymon qualified this by observing NP's business risk may now indeed be lower than certain other Canadian utilities but,

at most, is comparable to the average levels for regulated Canadian companies. (Pre-filed Evidence, Dr. B. Kalymon, pg.11/19-20; pg. 12/15-19). Dr. Morin indicated that business risk for NP is principally forecasting risk and following a review of several related factors concluded that NP's business risks exceeded that of other utilities. [Pre-filed Evidence, Dr. R. Morin, pg. 22/11-12]

In addition, the Board was presented with evidence on factors influencing business risk including economic forecasts, demographic trends, regulation, competitive forces and various cost considerations highlighted by NP. Based on the level of consensus reached on this issue the Board will not belabour the evidence on these factors but will comment generally on each.

In the short to medium term aligning itself closest with the period covered by this application, the Conference Board of Canada is projecting strong economic performance in the Province though at a decelerating rate. This projection is mitigated somewhat by continuing out-migration, particularly affecting rural areas. The Board acknowledges that an aging demographic profile coupled with proportionately higher population losses in rural areas will continue to have a negative impact on NP's business risk in the longer term.

Unlike some other provincial jurisdictions, there is no evidence before the Board to suggest the regulatory environment in this Province will change. Those experts commenting on regulatory risk viewed the quality and consistency of the Board's decisions in a positive light with Dr. Morin rating the risk as slightly above average by Canadian standards. Dr. Morin attributed this to the company's low allowed ROE for 2002 and structural deficiencies in the automatic adjustment formula. (Pre-filed Evidence, Dr. R. Morin, pg. 23/26-30)

During the hearing, a regulatory caution was raised in relation to Standard and Poors' ("S & P's") research report dated March 5, 2003, indicating Canadian utility regulation would be reassessed in terms of a credit rating factor. This reassessment stems from S & P's concerns regarding the reliability of the generally positive influence of regulatory factors, particularly business risk, used in its analysis of Canadian utilities. S & P plans to seek the views of Canadian regulators.

The Board acknowledges S & P's intention to reassess Canadian utility regulation as a credit rating factor but believes it is premature to speculate on the outcome of this review and even more inappropriate to apply such speculation to the decisions affecting this Order. The Board will, however, be cognizant of the relevant issues in making its decisions and it does note some recent prospectives that reflect positively on the regulatory environment affecting NP in the Province. S & P's October, 2002 research report granting an "A" rating to NP C\$75,000,000 first mortgage bonds offered the following observation:

*"Newfoundland Power's relatively low business risk profile is supported by cost of service/rate of return regulation; the ability to flow through all power costs; a weather normalization mechanism; and no exposure to cyclical industrial customers, which are serviced directly by the provincial government-owned utility, Newfoundland and Labrador Hydro."*

Also, the Dominion Bond Rating Service (DBRS) in its January 31, 2003 report ranks the regulation of NP as a strength in its credit rating considerations.

The competitive prospects facing NP remain relatively stable. CA-601 reveals NP will continue to face competition from traditional sources such as furnace oil, propane and wood with the degree of competition dependent on the relative economics between electricity and competitive fuels. In CA-602, while noting the spectre of the Electricity Policy Review, NP responds it possesses no specific evidence that its role in the provision of electricity will be challenged by competition in the next five years.

With a view to the arguments presented by Mr. Perry on fixed and variable costs as well as interest rates [Pre-filed Evidence, B.V. Perry, (1<sup>st</sup> Revision), pgs. 22-24], the Board is not persuaded that either of these items will significantly affect the business risk of NP.

Following this assessment, the Board agrees that the business risk profile of NP has not changed appreciably since 1998.

**The Board does not anticipate a change in the business risk of NP in the foreseeable future and concurs with the assessment of NP and the cost of capital experts that NP is of average business risk compared to other utilities.**

### **3. Financial Risk**

#### **i) Market Conditions**

Fluctuating conditions in the capital markets were presented by NP as an important consideration in contributing to its cost of capital. NP pointed to the changes which have occurred in the capital markets since 1998; in particular, the spread between the company's first mortgage bonds and long-term Canada bond yields. These spreads have trended from 68 basis point in 1996 to 130 in November 1998 to 185 in October 2002. In 2002, the spread between NP's bonds and long-term Canada bonds was 2.7 times greater than in 1996. This increased volatility, NP argued, contributed to greater risk and a higher cost of capital, affecting both the rate at which NP can borrow and the return to which its investors are entitled. (Written Submissions, NP, pg. 10/14-26; pg. 11/1-15; Transcript, April 25, 2003, pg. 25/1-10).

Ms. McShane described numerous factors which have contributed to changes in both the bond and equity markets since 1998. A combination of investors scurrying to safer government securities combined with decreased government borrowing has resulted in thin markets, especially for 30-year maturities. A negative spread which existed between 10-year and 30-year Canada bond yields has corrected itself. Canadian corporate bonds, however, have maintained a normal positive yield slope. Ms. McShane suggests the growing spreads between utility bonds and long term Canadas can be traced to a number of events since 1998 – a scarcity premium related to decreased government borrowing, flights to quality investments in the face of the global market crisis of 1998, and the subsequent crisis of confidence in corporate America, as well as a widespread economic downturn from which global recovery is not yet assured, particularly in the U.S. In terms of the equity market, Ms. McShane reviewed multiple factors which, in her judgement, warrant expanding the Board's analysis of the market risk premium beyond historic Canadian risk premiums and more in line with the U.S. equity markets. In an exhibit duplicated below, Ms. McShane shows the deterioration in relative average allowed

ROEs between Canadian and U.S. utilities along with a corresponding widening gap in risk premiums while observing average long-term government bond yields have remained similar. (Pre-filed Evidence, Ms. K. McShane, pgs. 23-36)

<b>Year</b>	<b>Average Allowed ROE Canadian Utilities</b>	<b>Average 30-Year Canada Yield</b>	<b>Risk Premium</b>	<b>Average Allowed ROE U.S. Utilities</b>	<b>Average 30-Year/Long Term Treasury Yield</b>	<b>Risk Premium</b>
1994	11.6%	8.7%	2.9%	11.3%	7.4%	4.0%
1995	12.1%	8.4%	3.7%	11.5%	6.9%	4.6%
1996	11.4%	7.8%	3.6%	11.3%	6.7%	4.6%
1997	10.9%	6.7%	4.2%	11.3%	6.6%	4.8%
1998	10.3%	5.6%	4.7%	11.6%	5.5%	6.0%
1999	9.5%	5.7%	3.8%	10.7%	5.9%	4.8%
2000	9.8%	5.7%	4.1%	11.4%	5.9%	5.5%
2001	9.6%	5.8%	3.9%	11.0%	5.5%	5.6%
2002	9.5 %	5.8%	3.7 %	11.2%	5.7%	5.5%

This evidence, Ms. McShane concluded, calls into question the validity of the current levels of allowed returns as determined by automatic adjustment formulas, which were first introduced in Canada in 1994. (Pre-filed Evidence, Ms. K. McShane, pgs. 15-38)

In his assessment of market conditions, Dr. Kalymon pointed to budgetary surpluses, particularly citing the Government of Canada, as providing major relief to borrowing pressure on the capital markets, resulting in lower yield expectations by investors. Long-term bond rates can be seen as relatively stable and parallel the development of more stable and low levels of inflation in the economy. Dr. Kalymon further indicated equity markets have been exceptionally volatile in the past two years. After double digit gains from 1996 through to 2000, investor confidence has been shaken in 2001 and 2002 with significant declines in price/earnings ratios, overall returns and dividend yields. Dr. Kalymon concluded volatility has led to investor expectations reflecting low inflation levels and lower effective inflation risk premiums. (Pre-filed Evidence, Dr. B. Kalymon, pgs. 6-9)

The Board believes that, while experts agreed that substantive changes have occurred in the capital markets since 1998, they presented contradictory interpretations as to how these changes may impact NP's cost of capital. NP relied on market volatility as being central to its argument for a higher ROE. Dr. Kalymon explained that, when economic conditions and market conditions change, especially under volatile circumstances, one has to be very careful in interpreting the results of various tests to determine the cost of capital. (Transcript, March 26, 2003, pg. 19/11-15)

The Board concurs that dramatic changes have occurred in the capital markets since 1998. This market volatility has impacted cost of capital in a number of ways. The Board agrees

that expectations of equity investors have been dampened in recent years by events occurring in the capital markets and this has resulted in moderating the historic levels of ROEs. This trend is reflected in Ms. McShane's evidence where allowed average ROEs for Canadian utilities have declined from 11.6% in 1994 to 10.3% in 1998 and 9.5% in 2002. In addition, as demonstrated by NP's October, 2002 bond issue, spreads between corporate borrowing and long-term government bonds are widening to reflect market volatility and the higher risk associated with corporate bonds. This gap is wider still in relation to the equity market, reflecting the even higher risk associated with equity investments.

Apart from the more universal impacts on the capital markets arising from volatile market conditions, there was no evidence presented to the Board which would signify any greater financial risk to NP than other comparable Canadian utilities resulting from these same conditions.

**The Board finds that capital market conditions, in particular affecting the equity market, have changed substantially since 1998. This volatility has contributed to an overall reduction in investor expectations in the equity market from historic levels. In addition, volatility has contributed to greater spreads being demanded by corporate bondholders and equity investors to account for added risk as compared to long-term government securities. The Board finds these trends will similarly influence NP but present no greater financial risk to NP than will be experienced by other comparable Canadian utilities.**

## ii) Creditworthiness & Credit Rating

The *EPCA* mandates that rates charged by NP provide sufficient revenue to enable the company to earn a just and reasonable return, as provided in the *Act*, in order for it to achieve and maintain a sound credit rating in the financial markets of the world.

Along with an assessment of business risk, the creditworthiness and ultimately the credit rating of an enterprise is determined following a thorough evaluation by the various credit rating agencies of the company's financial performance while paying particular attention to its capital structure.

In reviewing NP's corporate performance for the period 1994 to 2004, Mr. Hughes highlighted a number of factors impacting financial performance. [Pre-filed Evidence, P. Hughes, (1<sup>st</sup> Revision), pg. 3/6-12] These include:

- Gross operating expenses are forecast to decrease by approximately 9% on a historical basis (23% inflation adjusted);
- The workforce is forecast to decrease by approximately 25%;
- The number of customers served is forecast to increase by approximately 9%; and
- The volume of energy sales is forecast to increase by approximately 13%.

In reviewing NP's actual financial results for 1998-2002, [Exhibit BVP-1, (1<sup>st</sup> Revision); EAL-2, (1<sup>st</sup> Revision); Grant Thornton Report-NP 2003 GRA] the Board noted the following:



- Energy sales have increased from \$333,000,000 to \$363,000,000, an increase of 9.0%;
- Other revenue accumulated during this period amounted to \$28,000,000, primarily derived from pole attachment sources;
- Total assets have grown from \$586,000,000 to \$705,000,000, an increase of 20.3%, primarily attributable to upgrading and replacement of property, plant and equipment; and the purchase of joint use poles;
- Gross operating expenditures remained relatively stable over the period with 1998 at \$55,400,000 and 2001 at \$55,100,000 and showing a 4.2% decrease in 2002 to \$52,800,000. Grant Thornton attributes this to savings in early retirement allowances (\$963,000), deferred regulatory costs for the 1998 hearing (\$384,000), other operating expenses including travel, tools/clothing and computing equipment/ software offset by increased insurance costs (net \$960,000); and
- Net income increased from \$22,200,000 to \$29,400,000, an increase of 32.4%.

As shown below, the average capital structure for NP denoting relative proportions of debt and equity remained relatively stable for the period 1998-2002 with interest coverage increasing from 2.41x to 2.61x. [Exhibit BVP-1, (1<sup>st</sup> Revision), pg. 12]

<b>Regulated Average Capital Structure</b>		
	<b>1998</b>	<b>2002</b>
<b>Debt</b>	53.80%	54.63%
<b>Preferred Equity</b>	1.88%	1.54%
<b>Common Equity</b>	44.32%	43.83%
<b>Interest Coverage (x-times)</b>	2.41 x	2.61 x

According to NP, it is this improved interest coverage resulting from increased revenue from extraordinary events, primarily the tax reassessment and the Aliant pole purchase, that contributed to S & P's reinstatement in 2001 of NP's first mortgage bonds to an "A" rating. (Written Submissions, NP, Section C, pg. 34/11-15)

With the exception of the period 1998-2001, NP has been historically able to sustain an "A" credit rating on its first mortgage bonds. In its October 16, 2002 Report, S & P assigned an "A" rating to NP's C\$75,000,000 first mortgage bonds issued at that time. In January 31, 2003, DBRS released its credit rating report confirming its long standing "A" rating for NP's first mortgage bonds. DBRS concluded for a regulated utility NP's financial profile is relatively strong with low leverage and favourable coverage ratios.

No cost of capital expert disputed the current creditworthiness or credit rating associated with NP. Ms. McShane noted the cost of debt to be borne by NP's ratepayers reflects a single "A" credit rating and there has been no impact to date resulting from S & P's announcements referred to earlier. (Supplementary Evidence, Ms. K. McShane, pg. 2/15-24) Dr. Morin indicated that relative to other Canadian utilities, NP's financial risks remain below average. (Pre-filed Evidence, Dr. R. Morin, pg. 25/3-4) Dr. Kalymon provided a comparative analysis of NP's bond rating with other utilities and concluded the financial viability of NP is well established based on both the credit ratings assigned the company and its demonstrated ability to

access capital markets. Dr. Kalymon further observed that this is accomplished despite the smaller size and riskier market within which NP operates and indicates several other utilities operate with a lower credit rating. (Pre-filed Evidence, Dr. B. Kalymon, pg. 16/21-24)

The Board believes that the financial integrity and performance of NP is sound. Both the management and employees of NP can take pride in this accomplishment. This achievement is acknowledged by the credit rating agencies and is demonstrated by the continuing success of NP in accessing the capital markets. The Board will explore in the following section the issue of the credit linkage involving Fortis and NP and its potential impact on NP's future creditworthiness.

**The Board finds that based on its financial performance NP continues to sustain a sound credit rating which is providing appropriate and cost efficient access to the financial markets.**

### iii) S & P's Credit Linkage NP to Fortis

Considerable evidence was heard throughout the hearing regarding the relationship between Fortis, the parent company, and NP, its subsidiary, and the impact or effect of this relationship on the regulated entity NP. The evidence referred to inter-corporate transactions, reciprocal staffing arrangements, linkage of credit ratings, financial cross-subsidization, and comparisons of financial targets including capital structure. These issues are dealt with in this Decision, on pgs. 55-61. The purpose of this assessment is to review the potential impact on NP's financial risk of S & P's credit linkage between NP and Fortis.

The comparative credit ratings between Fortis and NP summarized from evidence are as follows:

Credit Rating	Fortis	NP
Bonds	BBB (S&P) BBB+ (DBRS)	A (S&P) A (DBRS)
Corporate	A- (S&P)	A- (S&P)

During the hearing considerable attention was focused on information contained in two S & P research reports.

S & P's October 16, 2002 publication stated:

*“Although Newfoundland Power's key debt-related ratios are expected to remain relatively stable, with a debt-to-capital ratio of about 55% and funds from operations (FFO) to interest coverage in the 2.8 times (x) to 3.0x range, it is the consolidated financial profile of Fortis that will influence ratings actions on Newfoundland Power in the future. Fortis' financial profile has remained relatively stable over the past six years with consolidated debt to capital in the 60%-65% range and FFO to interest coverage in the 2.25x-2.50x range. Nevertheless, key financial ratios are presently outside the acceptable range for the current rating and consolidated business risk profile.*

*Future ratings actions on Newfoundland Power will be directly determined by ratings actions on Fortis. The negative outlook on Fortis reflects a financial profile that inadequately supports the company's growing business risk and the current ratings. The ratings outcome on Fortis is expected to be resolved within the next year as part of Standard and Poor's ongoing assessment of global utility ratings criteria in light of some uniquely Canadian characteristics, including low deemed equity allowances and comparatively low ROEs that largely dictate a Canadian utility's financial profile. Nevertheless, adverse ratings actions are highly likely if there is no reduction in Fortis' consolidated business risk or improvement in key debt-related ratios."*

The March 5, 2003 research report explained S & P would meet with Canadian regulators among others as part of its planned assessment. The report also listed Fortis as one of several Canadian companies S & P has placed on negative credit watch pending the outcome of this review. S & P noted selective downgrades in credit ratings may result from amongst this list based on the assessment, but some or all of the ratings could indeed remain unchanged.

NP indicated this linkage by S & P of parent and subsidiary is new and NP, like other utilities who are impacted, is seeking clarification from S & P in order to assess the implications. NP emphasized the other credit rating agencies (DBRS and Moody's) continue to treat NP as a stand-alone utility. (Transcript, March 7, 2003, pg. 40/8-19)

In written submissions, NP distinguishes, correctly in the Board's judgement, between the two separate issues raised in S & P's research reports. These include: (1) the assessment of Canadian utility regulators as a rating factor; and (2) the credit linkage between Fortis and NP. On the first issue, as outlined when dealing with the question of NP's regulatory risk, the Board believes it is premature to speculate on the outcome of this review in making decisions affecting this Order. With respect to the second issue, NP points out that Fortis is not subject to regulation and its capital structure requirements are based upon different considerations and will not mirror NP's. Fortis' debt is unsecured and non-recoverable to the assets of NP. It is these assets that allow NP to fulfil its obligation to serve its customers and serves as security for NP's outstanding long-term debt. The long-term debt is comprised entirely of first mortgage bonds which are rated "A" by both DBRS and S & P and ratepayers benefit from this rating. NP confirmed the uncertainty surrounding S & P's ratings and pronouncements but concluded a weakening of NP's balance sheet resulting from the Board's decisions would only increase the current level of risk. (Written Submissions, NP, Section C, pgs. 35-40)

Both Dr. Morin and Ms. McShane echoed support for NP's position, stating the Board should continue to evaluate the utility on a stand-alone basis in consideration of its "A" first mortgage bond rating. (Supplementary Evidence, Dr. Morin, pg. 3 and Ms. McShane, pgs. 2-4)

Dr. Kalymon referred to S & P's notice suggesting that the high leverage of Fortis is potentially damaging to the credit rating of NP and may cost ratepayers money. Dr. Kalymon suggests that, if NP was so concerned about coverage ratios, appropriate adjustments could be started at the parent (Fortis). Dr. Kalymon argues this only adds to the justification to revisit NP's capital structure and ROE consistent with his recommendations. (Transcript, March 27, 2003, pgs. 55/18-25; 56/1-9)

Following a review of a number of financial indicators comparing NP and Fortis, the Consumer Advocate submitted that the consequences of this relationship, insofar as it impacts on the Board's assessment of NP's allowed ROE or capital structure, should be borne solely by NP and not its ratepayers. (Final Submission, Consumer Advocate, pgs. 49-54)

Board Hearing Counsel observed it is reasonable to conclude that, if Fortis' corporate rating is lowered and by linkage NP's, there will be pressure placed on the debt ratings of NP as well. Using some examples, Board Hearing Counsel suggested the subsidiary can mitigate the potential impact of any "*linkage*" by maintaining operational and financial distance from the parent, referred to in the ratings industry as "*ring fencing*". Conversely, closely integrated subsidiaries are more exposed to the risk of their parents; the more the parent and affiliate share resources and personnel, the greater the risk the subsidiary will lose its financial independence and status as a stand-alone utility. In any event, Board Hearing Counsel concludes the linkage between Fortis and NP is a significant and potentially troubling change in the ratings game with implications for how NP is to be regulated in the future. (Final Brief, Board Hearing Counsel, pg. 9/9-25)

The Board takes particular note that, for the first time in NP's history, a link has been made by a credit rating agency (S & P) assigning it the same corporate credit rating as Fortis, which has now been placed on a negative credit watch, citing the parent's unacceptable financial ratios. The Board agrees the outcome of this review by S & P remains uncertain but could conceivably result in a downgrade to NP's corporate rating and in turn affect its "A" bond rating. A downgrade in its bond rating will translate into higher debt costs to NP and potentially higher rates to its customers, a situation the utility has stridently argued against throughout the course of the hearing. This prospect is unacceptable and the Board will require NP to take all steps possible to mitigate against this outcome.

The Board acknowledges that its jurisdiction over the relationship between NP and Fortis is limited to regulating NP. The Board's responsibility is to set fair and reasonable financial targets for NP while ensuring least cost electricity to consumers. As reflected on pg. 46 of this Decision the Board has concurred with NP's proposal to maintain a capital structure of 45% common equity. Despite this decision taken by the Board to preserve a bond rating compatible with least cost electricity, NP could potentially experience a lower bond rating resulting in higher incremental costs for electricity by virtue of its association with its parent Fortis. The Board believes this condition is not in the interest of either consumers or the utility. The Board recognizes this situation is not a reality at this time but such an outcome presents a distinct and troubling consequence. The Board is not prepared to simply presume a stand-alone utility in the future and has an obligation to ensure the financial integrity and independence of NP is fully protected on behalf of those it serves.

**The Board concludes that in the interest of both the utility and its customers. NP should continue to be treated as a stand-alone utility. Therefore, the Board will require NP to take all appropriate steps necessary to preserve the financial integrity and independence of the utility. As a first step, NP will be required to file a report by June 30, 2004 addressing how it can ensure stand-alone status in respect of its corporate credit linkage by S & P to Fortis. This report should: 1) document discussions with the credit rating**

agencies and Fortis on this issue; 2) explain how other regulated Canadian utilities are facing similar challenges; 3) provide a list of possible mitigating actions; and 4) provide a plan of implementation of recommended actions.

#### 4. Summary of Risks

The Board concurs with the consensus among the experts in finding that the business risks associated with NP were average compared to other Canadian utilities. The regulatory risk of NP is subject to the review proposed by S & P to determine the quality of regulation as a credit ratings factor. The Board points to evidence indicating a generally positive regulatory environment in which NP operates. The Board concludes it is inappropriate to speculate on the outcome of this review by S & P in its decisions relating to this Order.

As demonstrated by NP's most recent bond issue (October 2002) the utility has been able to maintain a sound credit rating and cost efficient access to the financial markets. The financial performance and capital structure of NP is quite favourable relative to other Canadian utilities. Market conditions, while particularly volatile in the equity market, are not viewed by the Board to have any greater impact on the financial risk of NP in comparison to other utilities.

While experts agreed NP's current financial risk was below average, respective positions were complicated by other related issues. In this respect, the Board expresses serious concerns regarding S & P's pronouncements linking the credit rating of NP with that of Fortis, which has been placed on negative credit watch by S & P. The Board has directed NP to take all steps necessary to protect its status as a stand-alone utility and so preserve its financial integrity and independence.

With a view to overall investment risk, Dr. Morin concluded the net result of his medley of risk factors is that NP possesses average total investment risk to possibly slightly above average. (Pre-filed Evidence, Dr. R. Morin, pg. 25/8-9) Ms. McShane indicates that, with a common equity ratio close to 45%, NP would be viewed by investors as approximately average investment risk relative to the spectrum of investor-owned electric and gas-utilities in Canada. (Pre-filed Evidence, Ms. K. McShane, pg.11/11-13) Based on his assessment of business risk, capital structure risk and volatility risk, Dr. Kalymon observed that NP would be considered by investors to be, at most, comparable in risk to the average regulated utility company in Canada. (Pre-filed Evidence, Dr. B. Kalymon, pg. 16/8-10). NP concurred with the three experts in concluding it had an approximately average utility risk. (Written Submissions, NP, Section C, pg.10/9)

**Despite the change in circumstances since 1998, the Board finds that the overall investment risk of NP is average when compared to other Canadian utilities. This finding will be the basis on which the Board will consider a commensurate capital structure and ROE for the utility.**

## **IV. FINANCIAL TARGETS AND OBJECTIVES**

### **1. Introduction**

The Board acknowledges the fundamental distinction between the challenges faced by management in managing the capital structure and ROE of a utility and the Board's responsibility in balancing the interests of both the utility and consumers. Before examining the evidence relating to the capital structure of NP, the Board believes it would prove useful to the process to examine this distinction more closely.

#### **i) Management Perspective**

The challenge of the company's management is to maintain an efficient capital structure which will seek to balance the risks and costs associated with each source of funds, both debt and equity, in an effort to secure least cost capital. Given that debt is generally less risky than equity and hence is available at lower cost, in practice this management challenge reduces to establishing financial parameters, including a capital structure, that when managed in concert with the various business, regulatory and financial risks facing the company will ensure its creditworthiness in the financial markets so as to attract least cost debt. On the other hand, common shareholders are a company's primary risk takers because they receive a return on their investment only after payment of interest on bonds and other debt and dividends on preferred stock. For a regulated enterprise, the fundamental challenge for management concerning return on equity is to maximize the company's net income or earnings in order to provide the highest return possible to the shareholder within the rules laid down by the regulator. The realization of this challenge will in turn provide a stream of dividends and/or enhanced share value to the shareholder which will attract future investment as required.

#### **ii) Board Perspective**

Prior to 1996, the Board accepted capital structure objectives of NP believed necessary to maintain the company's "A" rating. During its 1996 general rate application, however, NP proposed modifications to its capital structure which were not supported in the Board's resulting order. This situation in part prompted the Stated Case referral whereby the Supreme Court of Newfoundland, Court of Appeal, provided an opinion regarding the Board's jurisdiction in a number of areas, including whether the Board can require a public utility to maintain ratios within its capital structure.

The Stated Case describes the process of establishing rates of return on each component of capital structure and the rate of return on rate base. In para. 28, Mr. Justice Green states:

*"The costs associated with long term debt and preference shares are generally static over the period covered by a particular rate hearing. Accordingly, they are often described as 'embedded costs'. The rate of return necessary to be earned on rate base to cover the cost of debt and preference shares can therefore usually be easily determined based on the interest rates or dividend rates applicable to such instruments. In the case of common equity, however, the cost of the utility of this source of funds depends upon a number of factors, especially current market conditions which, by nature, can be volatile."*

In para 56, Mr. Justice Green continues:

*“All of these considerations favour an approach that, in principle, should limit the degree of intrusion by the Board into the managerial control by the utility over financial decision-making. As emphasized earlier the powers of the Board should be generally regulatory and corrective, not managerial.”*

In para 57, Mr. Justice Green concludes:

*“An alternative to actual intrusion into the utility’s financial affairs in the form of a direction as to how the enterprise should be structured is for the regulator, for the purpose of setting rates, to base its estimates of the cost of capital on a hypothetical appropriate capital structure, thereby disregarding the utility’s actual capitalization.”*

It is clear the Board’s role is not to second-guess management on its financial decisions regarding the utility’s actual capitalization. The Board’s approach, however, will be to consider an appropriate capital structure upon which to estimate the cost of capital for ratemaking purposes. The Board used this approach in its 1998 hearing and will consistently follow this methodology in this Decision and Order. Clearly management has the prerogative to set a capital structure different from that ordered by the Board.

A fair ROE will be calculated by the Board, based primarily on a review of the various methodological tests and other evidence presented by the cost of capital experts.

### **iii) Relationship between Capital Structure, Return on Equity and Interest Coverage**

Capital structure is the mix of debt and equity invested in a company with debt representing the investment of bondholders or other long-term debt holders and equity representing the investment of shareholders, in either common or preferred stock.

The relationship between capital structure, return on equity and interest coverage is a key element in any cost of capital determination.

Interest coverage represents the ability of a company to meet its debt obligations and is derived as a ratio of earnings before interest and taxes to annual interest charges. Interest coverage is a prime ratio used by credit rating agencies in measuring the creditworthiness of a company since it reflects both the earnings capacity of the company and how well its capital structure or indebtedness is managed.

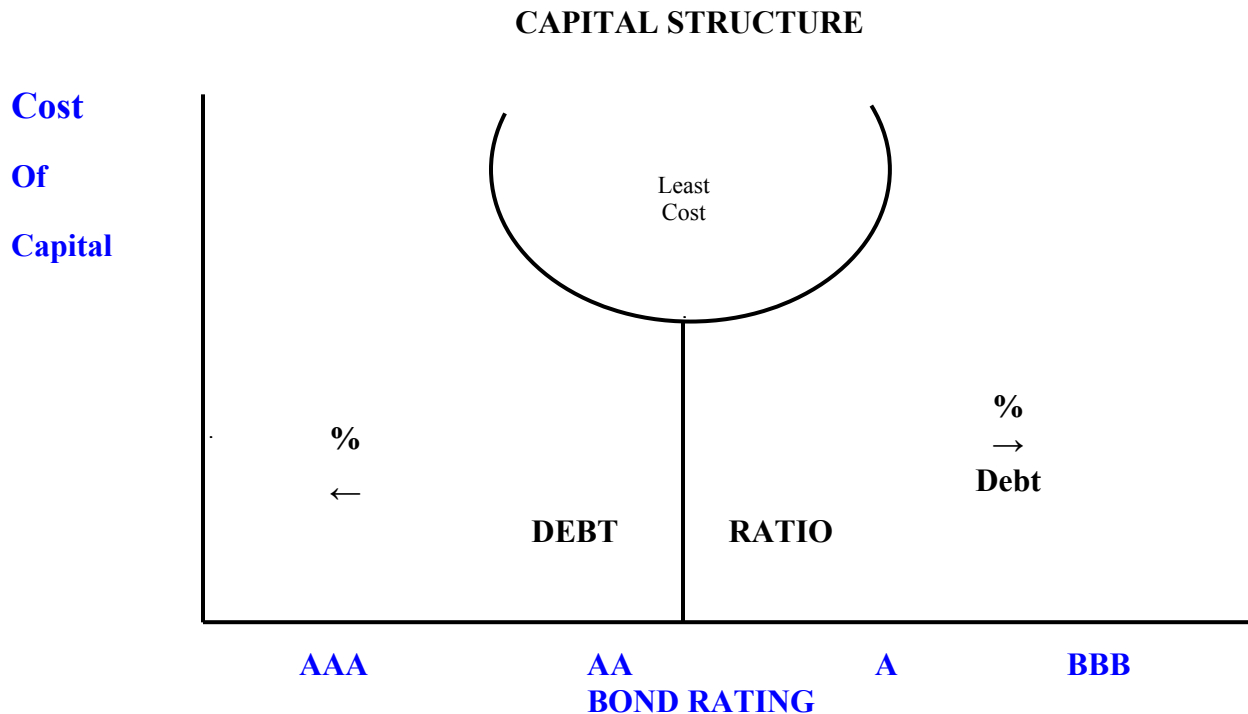
Return on equity (ROE) is a ratio of a company’s net income or earnings (less any preferred dividends paid) to the shareholders’ common stock equity or investment. ROE essentially is the measure of earnings available to common shareholders compared to their investment.

Exhibit BVP-6 (2<sup>nd</sup> Revision) demonstrates the sensitivity in the relationship between capital structure, return on equity and interest coverage. As debt increases and hence, common

equity decreases combined with a decreasing ROE (all elements potentially reflecting higher risk), the interest coverage and creditworthiness of the company decreases. Higher ROEs, less debt and more common equity translates into a higher interest coverage and improved creditworthiness.

Dr. Morin explained all these things are circularly or logically linked together in a balanced system. The ROE will determine a company's profitability and interest coverage on its interest charge. The level of debt or common equity will determine how much interest a company will have to cover and that will influence ROE because lower common equity and higher risk means higher ROE. (Transcript, March 24, 2003, pg. 5/20)

The following illustration presented by Dr. Morin (Exhibit RAM-11, pg. 7) proved a useful conceptual model for the Board:



The horizontal axis displays the quality or bond rating along with the capital structure or debt to equity ratio. Moving in the direction AAA - AA - A - BBB signifies deteriorating bond ratings and increasing proportions of debt to equity. With regard to the curve, as the weight of debt increases the cost of capital reduces because of the increased use of low cost, tax deductible capital. As debt continues to increase, however, the benefit associated with low cost, tax deductible capital is more than offset by the rising cost of equity or return demanded by the investor and by the debt holder to assume the higher levels of risk associated with this increased debt. The U-shape function delineates the least cost capital structure reflecting the optimal trade-off between risk on the one hand and return on the other. The Board acknowledges the cost of capital experts may disagree on where this function falls on the horizontal axis.



## 2. Capital Structure

A summary of the historical and proposed capital structure of NP is as follows: [P.U. 16(1998-99), pg. 45 and CA-200, Attachment A (1<sup>st</sup> Revision), pgs. 5-6]

<b>Capital Structure Historical and Proposed</b>			
<b>Order No.</b>	<b>Debt</b>	<b>Preferred Equity</b>	<b>Common Equity</b>
P.U. 1(1990)	45-50%	6-9%	42-47%
P.U. 6(1991)	45-50%	5-10%	40-45%
P.U. 7(1996-97)	47-55%	3-6%	40-45% <sup>1</sup>
P.U. 16(1998-99)	Average for test year until adjusted by Board	Average for test year	< 45% <sup>2</sup>
<b>Year</b>			
2002 (actual)	54.63%	1.54%	43.83%
2003 (proposed)	54.28%	1.45%	44.27%
2004 (proposed)	54.06%	1.39%	44.55%

For the purpose of setting electricity rates, NP has proposed a forecast regulated average capital structure composed of 44.27% common equity in 2003 and 44.55% common equity in 2004.

NP referenced prior decisions of the Board in support of its position and notes the current capital structure has been maintained through appropriately managing dividend payouts to its shareholder. NP referred to Ms. McShane's evidence describing NP as a relatively small, stand alone utility which requires more conservative capital structures than larger utilities (i.e. a larger common equity ratio) in order to achieve an equivalent credit rating. NP further recited Ms. McShane's evidence indicating that the financial guidelines established by S & P for an "A" rated company with business risk similar to NP requires common equity 47.0 - 52.5% placing NP at the lower end of the compatible range. NP concluded that, since it has experienced no material change in risk since 1998, there is little reason to reduce the protection accorded to debt holders. (Written Submissions, NP, Section C, pg. 5 12-14)

Dr. Morin indicated he has always been supportive of the past attitude displayed by the Board regarding capital structure. He stated in respect of a possible meeting between the Board and S & P over its regulatory concerns: *"just tell our story, there we have the highest common equity ratio in Canada here. We have first mortgage bonds here, unlike any other utility in Canada."* Dr. Morin suggested, however, now is not the time to weaken NP's capital structure. (Transcript March 24, 2003, pgs. 86/8-10; 88/2-8).

<sup>1</sup> Common equity exceeding 45% deemed preferred with ROE of 6.33% assigned for rate setting.

<sup>2</sup> For purposes of setting rates through the automatic adjustment formula, lesser of 45% or projected average common equity in test year.

ROE of 6.33% applied to preferred equity as well as common equity > 45%.

Dr. Kalymon on the other hand observed high levels of equity imply expensive costs of capital and this is very relevant to customers of the utility because lowering the cost of capital means lowering their rates. Dr. Kalymon also pointed out that Fortis is clearly functioning with leverage structures that are substantially higher than NP and it is troublesome that consumers cannot enjoy the same efficiency that a more leveraged capital structure would imply. Dr. Kalymon concluded from his analysis that the capital structure risk of NP is well below that of comparable Canadian utilities and recommends a reduction in the common equity ratio to 40% which still places NP at the top end for regulated utilities in Canada. Dr. Kalymon suggested the differential between the approved 45% and the 40% could be substituted with preferred shares as a desirable way to hold interest coverage. (Transcript, March 26, 2003, pgs. 17/14-17; 18/1-14; Pre-filed Evidence, Dr. B. Kalymon, pgs. 13-15)

The Consumer Advocate supported the recommendations of Dr. Kalymon indicating a fairer capital structure for NP should be adopted and implemented by the Board. (Final Submission, Consumer Advocate, pg. 51)

Board Hearing Counsel explained that, as a consequence of both double leverage financing at the parent corporate level and substantial debt financing of its non-utility enterprises, Fortis' consolidated capital structure has more debt and less equity (and, therefore is correspondingly riskier) than the capital structure NP recommends for ratemaking purposes in this application. Board Hearing Counsel noted the argument of the Consumer Advocate that maintaining an "A" rating in view of Fortis' own choice of a much thinner consolidated common equity ratio may be both futile and exceedingly costly to NP's ratepayers, especially if little or no additional long-term bond financing is required by NP in the near future. (Final Brief, Board Hearing Counsel, pgs. 14-15)

The capital structure of NP has been maintained through the ongoing decisions of the Board as contained in its respective Orders and also NP's actions in managing the level of common equity accordingly. Generally in the past it has been determined by the Board that a strong equity component is needed to mitigate the impact of NP's relatively small size and low growth potential. The Board reiterates its earlier finding that NP has an average business risk which incorporates these elements into this assessment. The Board also notes that NP retained an "A" credit rating in its October 2002 bond issue with an actual capital structure of 44% equity despite having an ROE characterized by NP as the lowest in Canada. Based on this recent experience and the Board's findings relating to NP's risk profile, the Board is not convinced at this time to change what has proven a sound and successful capital structure for NP. The Board is not satisfied that the common equity component could be notably reduced without significantly compromising interest coverage. Dr. Kalymon's proposal to substitute preferred shares for equity is not seen as an acceptable solution in the judgement of the Board. The Board notes this same proposal by Dr. Kalymon was rejected in Order No. P.U. 16(1998-99). In reaching this decision of a maximum 45% common equity component, the Board recognizes NP will continue to retain one of the most favourable capital structures among Canadian utilities of comparable risk. The Board acknowledges the sensitivity in the relationship between capital structure and ROE and the importance of maintaining an appropriate balance to ensure both efficient access to the capital markets by NP and least cost electricity for consumers. The

challenge for the Board now is to set an appropriate ROE which will preserve this necessary balance.

**Having reviewed the evidence the Board is of the opinion that it is reasonable and prudent to maintain the capital structure deemed appropriate in Order No. P.U. 16(1998-99). The proportion of regulated common equity in the capital structure should not exceed 45%. Any regulated common equity in excess of 45% will only be entitled to a rate of return equal to the rate of return on preferred equity. For the purpose of determining the weighted average cost of capital (WACC), the Board accepts NP's proposed forecast average capital structure for the 2003 and 2004 test years.**

### **3. Return on Equity (ROE)**

NP has proposed that the Board allow a return on regulated common equity of 10.75% for ratemaking purposes. This ROE compares to 9.25% found by the Board in 1998, and 9.05% which is currently in place based on the Formula.

#### **i) ROE Tests**

The three standard methodological tests for determining ROE were applied by the experts in varying ways. The three tests can be generally described as follows:

- Equity Risk Premium Test - A forward looking test which measures ROE in terms of a risk-free rate, normally determined in relation to government guaranteed long-term bond yields plus a premium to reflect the added risk associated with investing in the common equity of an enterprise. The Capital Asset Pricing Model (CAPM) is a variation of this test weighted more toward measuring the market price of risk to account for such factors as interest rate change and economic growth.
- Discounted Cash Flow (DCF) Test – Measures ROE in terms of the present value of projected returns to the investor, both dividends and expected growth, discounted at an appropriate rate to reflect the risk associated with these returns.
- Comparable Earnings Test - Measures ROE in relation to the past earnings of comparable companies which are then used as a proxy for future returns of the utility being considered.

#### **ii) Application of Tests**

The following summary highlights the evidence of each expert witness in applying these cost of equity tests.

## Summary of Expert Evidence of Cost of Equity

### Ms. McShane (@ 45% Common Equity)

Test	Description of Evidence	Rate %
<b>Equity Risk Premium</b>		<b>10.5-11.25%</b>
(i) Risk-Free Rate	<ul style="list-style-type: none"> <li>30 year yield based on Consensus Forecasts using 10-year Canadas plus spread (est.) to account for yield differential.</li> </ul>	<ul style="list-style-type: none"> <li>6.0%</li> </ul>
(ii) Risk Premium	<ul style="list-style-type: none"> <li>3 tests conducted (incl. CAPM). Results (1) 4.0% @ beta 0.60-0.65%, (2) 4.75-5.0%; and (3) 4.6% - Updated 4.7%.</li> <li>Canadian and U.S. data used "Bare bones" cost of equity (i) + (ii)</li> </ul>	<ul style="list-style-type: none"> <li>4.0-4.75%</li> </ul>
(iii) Total ERP	<ul style="list-style-type: none"> <li>Add 50 basis points to reflect financing costs associated with other risk variables.</li> </ul>	<ul style="list-style-type: none"> <li>10.0-10.75%</li> </ul>
(iv) Other		<ul style="list-style-type: none"> <li>0.5%</li> </ul>
<b>Discounted Cash Flow</b>		<b>11.5%</b>
(i) DCF Rate	<ul style="list-style-type: none"> <li>2 DCF tests conducted with Results (1) 11.0 - 11.1% &amp; (2) 11.1% - Updated 11.5%.</li> <li>U.S. data used as proxy for NP.</li> </ul>	<ul style="list-style-type: none"> <li>11.0%</li> </ul>
(ii) Other	<ul style="list-style-type: none"> <li>Add 50 basis points for financing cost as above.</li> </ul>	<ul style="list-style-type: none"> <li>0.5%</li> </ul>
<b>Comparable Earnings</b>		<b>12.75-13.25%</b>
	<ul style="list-style-type: none"> <li>2 tests conducted using (1) Canadian industrials and (2) U.S. low risk industrials with emphasis on (1). Results as follows: (1) 12.75-13.25% and (2) 14%.</li> </ul>	
<b>Recommended ROE</b>		<b>11.5-11.75%</b>

### Dr. Morin (@ 45% Common Equity)

Test	Description of Evidence	Rate %
<b>Equity Risk Premium</b>		<b>10.5-11.0%</b>
(i) Risk-Free Rate	<ul style="list-style-type: none"> <li>Same as Ms. McShane above.</li> </ul>	<ul style="list-style-type: none"> <li>6.0%</li> </ul>
(ii) Risk Premium	<ul style="list-style-type: none"> <li>6 studies conducted (incl. CAPM) @ beta 0.67%. Results ranging from 4.4% - 6.1% and average 5.1%.</li> <li>Studies involve 2 aggregate stock market, 2 utilities and 2 regulators allowed risk premiums.</li> <li>Primarily U.S. data weighted toward Canada.</li> </ul>	<ul style="list-style-type: none"> <li>4.5 - 5.0%</li> </ul>
<b>Discounted Cash Flow</b>		<b>10.5 - 11.0%</b>
	<ul style="list-style-type: none"> <li>DCF used only to confirm ERP Results</li> </ul>	
<b>Recommended ROE</b>		<b>10.5-11.0%</b>

### Dr. Kalymon (@ 40% Common Equity)

Test	Description of Evidence	Rate %
<b>Equity Risk Premium</b>		<b>7.54-8.04%</b>
(i) Risk-Free Rate	<ul style="list-style-type: none"> <li>Spot bond yields for 10-year Canadas on December 17, 2002 coinciding with the date of his pre-filed evidence submission.</li> </ul>	<ul style="list-style-type: none"> <li>5.04%</li> </ul>
(ii) Risk Premium	<ul style="list-style-type: none"> <li>For 1981-2001 negative risk premium of equities on TSX index. Incompatible with risk theory. Reversed to positive by removing capital gains on 10 year Canada. Real rate of bond interest adjusted upward to reflect increased risk of average company on TSX.</li> </ul>	<ul style="list-style-type: none"> <li>2.5 - 3.0%</li> </ul>
<b>Discounted Cash Flow</b>		<b>7.10-9.85%</b>
	<ul style="list-style-type: none"> <li>Alternative DCF based on growth in dividend yield and earnings/book value.</li> <li>2 tests conducted. Results (1) utility 7.10 - 8.60% and (2) industrials 8.41 - 9.85%.</li> </ul>	
<b>Comparable Earnings</b>		<b>7.72-9.84%</b>
	<ul style="list-style-type: none"> <li>2 tests conducted with adjustments for market to book ratios Results (1) industrials 7.72-8.82% and utilities 7.93 - 9.84%.</li> </ul>	
<b>Recommended ROE</b>		<b>8.5- 9.0%</b>

### iii) Reliance on Tests

In Order No. P.U. 16(1998-99), the Board relied principally on the equity risk premium in establishing the appropriate return on regulated common equity and ordered its use in the Formula.

All three cost of capital experts presented evidence on the equity risk premium test.

Ms. McShane completed all three tests, including the DCF and comparable earnings tests and assigned some weight to each test in making her recommendation. (Pre-filed Evidence, Ms. K. McShane, pg. 64/18-20)

Dr. Morin concentrated primarily on the equity risk premium test while using the DCF test only in support of his equity risk premium recommendation. Dr. Morin noted in his evidence the DCF and comparable earnings methodologies are particularly difficult to implement in practice when you are dealing with the fast-changing and fluid circumstances of the Canadian utility industry and the scarcity of reliable capital market data on comparable companies. In addition, Dr. Morin pointed to other conceptual and methodological difficulties in applying the comparable earnings method. (Pre-filed Evidence, Dr. R. Morin, pg. 14/23-26; pg. 17/13-28)

Dr. Kalymon conducted all three tests while applying variations to the traditional DCF and comparable earnings tests. Dr. Kalymon observed the outcomes of different tests provide a wide range of results reflecting extreme volatility in the general equity markets in recent years. For this reason and given the experience of stable bond yields, Dr. Kalymon placed greater reliance on the equity risk premium test and the results of the utility sample in presenting his ROE recommendation. (Pre-filed Evidence, Dr. B. Kalymon, pg. 41/24-25; pg. 42/1-6) Dr. Kalymon did indicate, however, that other test results lead to an upward push to his primary equity risk premium outcomes in reaching his recommended ROE. (Transcript, March 26, 2003, pg. 159/1-15)

The equity risk premium test received primary weighting by the expert witnesses, with other tests demonstrating certain difficulties either with their methodology, application or outcomes. The Board notes that Ms. McShane's DCF and comparable earnings tests were both higher than the upper range of the equity risk premium test and, when applying all three tests, produced a bias in her recommended ROE beyond that sought by NP. The Board is also persuaded by the fact that the equity risk premium test is anchored in the bond market which has demonstrated significantly greater stability in recent years as compared to the equity market. The Board believes, in the absence of evidence which would warrant change, consistent decision making conforming to existing practices promotes a more reliable and stable regulatory environment with less risk. The continuity of the equity risk premium test also has added relevance to the automatic adjustment formula which is considered later in this Decision

**The Board will continue to rely principally on the equity risk premium test and will determine a return on regulated common equity primarily with a view to establishing a risk-free rate based on long-term Government of Canada bond yields plus an appropriate risk premium.**

#### iv) **Equity Risk Premium Test**

##### Risk-Free Rate

In relying on the equity risk premium test in 1998, the Board established the risk-free rate with reference to the yield on long-term 30-year Government of Canada bonds. The Board determined that 5.75% was an appropriate forecast of the long-term bond rate to be used in setting the risk-free rate. In concert with this decision, the Board similarly ordered that long-term (30-year) Government of Canada bonds be used as the basis for setting the risk-free rate to be applied to the equity risk premium model in introducing the automatic adjustment formula.

Dr. Morin and Ms. McShane based their risk-free rate on a forecast of 30-year bond yields derived from the Consensus Forecast of 10-year Canada bonds plus an allowance for an observed spread between 10-year and 30-year Canada bonds. Both experts used August 2002 Consensus Forecasts which anticipates that the 10-year yield 3-months and 12-months hence will be 5.3% and 6.0% respectively, for an average of 5.65%. Dr. Morin and Ms. McShane concurred on an estimate of 35 basis points as reflecting the recent and historic spread between 10-year and 30-year Canadas which, when added to the 5.65%, provides a 6.0% long-term yield and represents a reasonable forecast on the risk-free rate for the 2003 test year. (Pre-filed Evidence, Dr. R. Morin, pg. 44/5-15; Ms. K. McShane, pg. 44/15-23)

Ms. McShane indicated Consensus Forecasts would bring to bear the judgment of forecasters in predicting future long-term bond rates as opposed to actual which are subject to greater cyclical variation. (Transcript, March 25, 2003, pg. 81/7-25)

Dr. Morin suggested stability is enhanced by substituting Consensus Forecast on long-term Canada bonds instead of actual. (Transcript, March 24, 2003, pg. 81/5-8)

Dr. Kalymon selected a risk-free rate of 5.04% which equates with the spot bond yields for 10-year Canada bond rates coincident with the date of his pre-filed evidence. (Pre-filed Evidence, Dr. B. Kalymon, pg. 25/6-7)

NP indicated the recommended risk-free rate proposed by Dr. Morin and Ms. McShane is the method used by the National Energy Board (NEB) and the British Columbia Utilities Commission (BCUC). (Written Submissions, NP, Section C, pg. 29/5-8)

The Consumer Advocate indicates Ms. McShane and Dr. Morin overstate long-term Canada bond rates at a forecast 6%, when actual 30-year rates are only 5.55%. (Final Submission, Consumer Advocate, pg. 45)

In accepting the 6.0% risk-free rate and Consensus Forecast method proposed by NP, the Board would be effectively abandoning its present automatic adjustment formula in favour of the NEB or BCUC model or some variation thereof. Based on the comparison shown in BVP-17, pg. 5 and the evidence during the hearing assessing the performance of each formula, the Board is not convinced that either the NEB or the BCUC model demonstrates sufficiently superior operating characteristics to warrant a change in formula methodology. Depending on the

assumptions, it could be argued that the existing Formula methodology actually out-performed either or both of these proposed alternatives. The Board also expresses concern with the notable spread which would have to be factored into the formula between Consensus Forecast and actual long-term Canada Bond yields. The Board believes that greater regulatory stability and consistency is encouraged by retaining the existing methodology and linking the risk-free rate to actual 30-year bond yields.

For additional guidance in determining the appropriate risk-free rate using actual long-term 30-year Canada Bond yields, the Board turned to various references, as follows:

	References	Description	Rate
1.	Pre-filed Evidence, Ms. K. McShane, Schedule 4	Average long-term Canada yield 1999-2002	5.75%
2.	Final Argument, Consumer Advocate, pgs. 30-31	Spot yield	5.55%
3.	Transcript, March 24, 2003, pg. 137/22	Spot yield	5.62%

The Board determines a risk-free rate of 5.60% is fair and reasonable.

**The Board will utilize 5.60% as the forecast of the risk-free rate to be applied in the equity risk premium test for the test years 2003 and 2004.**

#### Equity Risk Premium

In 1998, in applying the equity risk premium test, the Board determined a risk premium of 3.00%, based on a market risk premium of 5.00% and a relative risk factor of 0.6.

Ms. McShane conducted three equity risk premium tests using a combination of U.S. and Canadian data. The Capital Asset Pricing Model (CAPM) resulted in a market risk of 6.0% - 6.5% and a relative risk factor or beta of 0.6 - 0.65 for a risk premium of an average Canadian utility similar to NP of 4.0%. The remaining tests produced risk premiums of 4.75% - 5.0% and 4.6% (updated to 4.7%). Ms. McShane's risk premium recommendation was 4.0% - 4.75%.

Ms. McShane added 50 basis points to what she refers to as the "bare-bones" cost of equity to cover financing flexibility. This adjustment according to Ms. McShane is designed to allow for 3 distinct elements: (1) flotation costs relating to costs upon sale of the new equity; (2) a cushion for unanticipated capital market conditions; and (3) a recognition of the fairness principle between book and market value of stock when comparing regulated utilities with sample industrials. Ms. McShane suggested that to ignore these principles in setting an appropriate financing flexibility adjustment is to ignore the basic premise of regulation. (Pre-filed Evidence, Ms. K. McShane, pgs. 53-54)

Dr. Morin performed six tests which also included a CAPM and an empirical CAPM. Applying a beta of 0.67 to a market risk of 6.7% resulted in risk premiums of 4.5% and 5.0% respectively. These multiple tests used primarily U.S. data and resulted in a risk premium ranging from 4.4% - 6.1% with an average of 5.1%. Weighing this average in favour of the

Canadian data, Dr. Morin concluded a risk premium for NP of 4.5% - 5.0% was reasonable. Dr. Morin made no adjustment to account for financing flexibility.

Dr. Kalymon's risk premium is predicated on his analysis that during 1981-2001 the TSX had realized negative risk premium when compared to long-term Canada bonds. This result, Dr. Kalymon commented, is inconsistent with conventional risk theory but can occur in highly fluctuating markets. Dr. Kalymon reversed to a positive risk premium of the TSX Index by removing the capital gain of bondholders. Following a calculation of the real rate of interest on 10-year Canada bonds at 2.74% (5.04% risk-free rate less 2.3% inflation) and, given equity investment is more risky than bonds, Dr. Kalymon anticipates an average company trading on the TSX should expect a risk premium of 2.50% - 3.00%. Dr. Kalymon concluded no relative risk or beta adjustment is necessary for NP. (Pre-filed Evidence, Dr. B. Kalymon, pgs. 22-28) Dr. Kalymon made no adjustment to his risk premium test but did make a downward revision of 50-100 basis points to both his other tests, DCF and comparable earnings, to account for the lower risk of the regulated versus his industrials sample. (Pre-filed Evidence, Dr. B. Kalymon, pgs. 32/6-7; 34/17-18; 38/11-12)

NP argued the risk premiums derived by Dr. Morin and Ms. McShane are based on long-term economic studies of the differences in actual returns on equity compared to yields on long-term government bonds. NP suggested Dr. Kalymon's equity risk premium approach exercises more subjective judgment than economic theory. (Written Submissions, NP, Section C, pg. 29/13-22; pg. 30/1-5)

The Consumer Advocate submitted both Dr. Morin's and Ms. McShane's recommendations should be rejected as their tests contain primarily U.S. data and their recommendations are considerably higher when compared to regulatory awards in Canada. The Consumer Advocate disputed the subjective characterization of Dr. Kalymon's evidence, citing a 100-year study as a satisfactory alternative determination of the risk premium test. (Final Submission, Consumer Advocate, pgs. 41-45; Transcript, April 25, 2003, pg. 79/5-11)

### Financing Costs

Before making a determination on the equity risk premium, the Board is of the view that consideration of the issue of financing flexibility is necessary. The Board notes only Ms. McShane recommended a 50 basis point adjustment for financing flexibility. Despite NP's contention in its written submissions (Section C, pg.17), as indicated above Dr. Kalymon did not make an allowance for financing but adjusted the DCF and comparable earnings test downward by 50-100 basis points to reflect the lower risk of a regulated utility versus his industrials sample. The Board acknowledges that financing costs were incorporated in Order No. P.U. 16(1998-99). The Board believes this regulatory practice varies depending on jurisdiction and notes the Ontario Energy Board in CA-535 (Attachment B) provided for flotation costs whereas in its recent decision 2002 NSUARB 59, the Nova Scotia Utility and Review Board did not make such a provision. (Final Submission, Consumer Advocate, Appendix 2) While limited evidence was brought before the Board concerning financial flexibility, the Board observes 2 of the 3 cost of capital experts made no such allowance. The Board is of the opinion its application introduces a further measure of subjectivity in setting ROE. The Board believes the issue of financing costs are best considered within the context of the equity risk premium.



**The Board will make no adjustment to the equity risk premium test for financing costs.**

Equity Risk Premium

From an empirical standpoint, Dr. Morin explained that allowed risk premiums expand when interest rates go down and shrink when interest rates go up. This relationship he noted is indicative of the capital market response which is built into the testing process of examining allowed returns. (Transcript, March 24, 2003, pg. 119/13-19) In addition, the Board observes that this relationship has been reflected in historical trends between long-term interest rates and risk premiums in both Canada and the U.S. This trend is also consistent with the findings of the Board following its review of the impact of market conditions on pg. 35 of this Decision.

In considering the appropriate risk premium, the Board highlights the following:

- The investment risk of NP is average overall;
- Long-term bond rates and inflation are anticipated to remain relatively stable;
- A capital structure of 45% equity and 55% debt has been supported by the Board;
- Higher risk premiums allowed in the U.S. bear no discernable relationship to NP and the focus of the Board will be on allowed risk premiums of comparable Canadian utilities; and
- No separate financing costs are being considered.

In light of the above, the Board is of the view that the recommendation of Dr. Kalymon for an equity risk premium of 2.50% - 3.00% is too low. Dr. Morin recommended a risk premium of 4.5% - 5.0% while Ms. McShane recommended a risk premium of 4.0 - 4.75% while later adjusting for financing flexibility of 50 basis points. The Board concludes these are somewhat high.

The Board deems an equity risk premium of 4.15% to be fair and reasonable.

**The Board will incorporate a risk premium of 4.15% in the equity risk premium test in calculating the cost of common equity.**

v) **ROE Summary**

The Board summarizes its findings in respect of the equity risk premium test as follows:

Risk-Free Rate	5.60%
Risk Premium	<u>4.15%</u>
	9.75%

**The Board will utilize a return on regulated common equity of 9.75% for the purposes of determining the WACC for both 2003 and 2004.**

#### 4. Interest Coverage

As previously detailed on pg. 42 of this Decision, interest coverage represents essentially an arithmetic determination which is a function of the capital structure, in particular its debt level, and the ROE reflecting the ability of the company's earnings to cover or meet these debt obligations.

NP noted interest coverage is the principal ratio used by credit rating agencies to assess the creditworthiness of the Company. Exhibit BVP-6 (2<sup>nd</sup> Revision) demonstrates the nature of this relationship with lower interest coverage depicting greater risk through a combination of higher debt and lower earnings and vice-versa. Exhibit BVP-5 (1<sup>st</sup> Revision) proposes an interest coverage of 2.50x for 2003 and 2.53x for 2004, assuming a 45% common equity capital structure and an ROE of 10.75% and 10.72% respectively. NP explained it had prepared this application with a target interest coverage at the mid-point in the range of 2.4x to 2.7x identified as suitable in Order No. P.U. 16(1998-99). [Pre-filed Evidence (1<sup>st</sup> Revision), B. V. Perry, pgs. 15/23;16/1-2]

NP argued the only time in its history that the utility received a downgrade in its bond rating was by S & P following the issuance of P.U. 16(1998-99) when interest coverage was in the lower end of this range. But for the additional revenue generated by the extraordinary events, NP concluded its bond rating would not have been reinstated to "A" and a rate hearing would have been necessary to restore NP's financial integrity. (Written Submissions, NP, Section C, pgs. 5; 32; 34; 35)

Given the dispersion of recommended ROEs, not unexpectedly cost of capital experts were divided in their opinion on interest coverage. Dr. Kalymon confirmed he had no difficulty maintaining a recommended 40% capital structure and a return of 8.75% yielding interest coverage in the range of 2x. (Transcript, March 27, 2003, pg. 60/15-21). Dr. Kalymon compared interest coverage for a number of regulated Canadian utilities which showed a mean of 2.65x and a range from 1.80x to 3.56x. Dr. Kalymon concluded NP with a highly stable and very protected market should be able to operate with an interest coverage at the lower end of this range. (Pre-filed Evidence, Dr. B. Kalymon, pg. 14/8-16)

Both Dr. Morin and Ms. McShane disagreed with Dr. Kalymon. Dr. Morin noted S & P's pretax interest coverage benchmark for a single "A" utility with a "very strong" business risk position is 2.9x. (Supplementary Evidence, Dr. R. Morin, pg. 4/10-11). He indicated his own recommended 45% common equity ratio and ROE translated into interest coverage of 2.5x or 2.6x. (Transcript, March 24, 2003, pg. 22/11-13) Ms. McShane pointed to S & P's guidelines requiring interest coverage of 2.8x-3.4x for a company of comparable business risk to NP. (Pre-filed Evidence, Ms. K. McShane, pg. 10). Ms. McShane observed NP's ability to maintain an "A" rating for its recent bond issue at interest coverage considerably less than the lower end of this range may be attributable to S & P placing weight on the fact that NP's bonds are secured by its assets. (Transcript, March 26, 2003, pg. 10/18-20)

The Consumer Advocate argued NP failed to provide any evidence from a bond-rating agency to suggest that the level of interest coverage requested by NP is required for an "A" bond

rating. The Consumer Advocate suggested that, if S & P has stated that for an "A" rating the range is 2.0 - 3.2x and given that agency's reviews of Fortis Inc., the Board should not attempt to over-compensate NP by providing for interest coverage over and above the requirement of the bond rating agency. (Final Submission, Consumer Advocate, pg. 55)

The Board is fully cognizant of the relationship between capital structure and ROE and the measure of risk it attaches to NP as a consequence of its decisions regarding financial targets. As indicated previously, maintaining an appropriate balance between these factors in the interests of both NP and consumers is one of the key challenges faced by the Board in this Application. The Board does not regulate interest coverage but notes the resulting coverage is 2.4x from BVP-6 (2<sup>nd</sup> Revision) when applied to its findings of maintaining a capital structure of 45% common equity and an ROE of 9.75%. The Board notes a 2.4x interest coverage remains within the range previously accepted by the Board in Order No. P.U. 16(1998-99), though admittedly at its lower end. Given the average risk assigned to NP, the Board believes that this interest coverage serves a realistic and compatible balance between NP and its customers. NP indicated it will not be going to the bond market again until 2006. (Transcript, March 7, 2003, pg. 134/11-15) The Board does not accept that an ROE of 75 - 100 basis points higher than the 9.75% deemed fair and reasonable by the Board is warranted in order to sustain a 2.5x interest coverage based on a capital structure that ranks amongst the most favourable when compared to utilities of equivalent risk.

**The Board finds an interest coverage in the order of 2.4x is acceptable given NP's level of risk and the Board's findings in this Decision with respect to NP's capital structure and return on regulated equity.**

## V. INTER-CORPORATE RELATIONSHIPS AND CHARGES

### 1. Background

The issue of inter-corporate transactions between NP, its shareholder Fortis, and with affiliated companies has been considered and addressed in previous Orders of the Board. In Order No. P.U. 6(1991) the Board directed the following: (i) a quarterly reporting mechanism be put in place; (ii) NP's code of accounts be modified to identify all inter-corporate transactions; and (iii) NP conduct a study into the financial policies of regulated Canadian utilities with respect to mark up percentages on related party transactions. This study, completed for NP by Deloitte and Touche, was filed with the Board in March 1996. In Order No. P.U. 7(1996-97) the Board: (i) set a deadline for the filing of inter-corporate quarterly transaction reports; (ii) set the basis for allocation of specific charges from Fortis to NP; and (iii) provided direction to NP on the treatment of certain costs as non-regulated or regulated expenses. The Board also accepted the principles presented in the Deloitte and Touche Study ordering that:

- i) inter-corporate services obtained from a competitive market be valued at market;
- ii) in acquiring a competitive service from an affiliate, the allowed regulated expense shall be the lowest cost bid or tariff;
- iii) in cost allocations from affiliates and the parent, transactions must be supported by documentation;
- iv) the markup on the cost must also be supported by reasonable documentation;
- v) a markup may include return on capital only where assets were used to deliver service or good;
- vi) inter-corporate loans involving NP must be valued at their opportunity cost and documentation to support the rate shall be kept;
- vii) pole attachment charges to Unitel shall be valued at the same rate offered to Newtel or CATV operators; and
- viii) postage and courier charges must include labour and the standard overhead charge.

Inter-corporate issues were also raised at NP's 1998 general rate hearing. In Order No. P.U. 36(1998-99) the Board found that the directives set by Order No. P.U. 7(1996-97) and NP's treatment of non-regulated expenses continued to be appropriate and no changes were ordered.

At this hearing issues concerning NP's relationship with its shareholder Fortis and also with other Fortis subsidiaries were raised by the Consumer Advocate. The Consumer Advocate argued that:

*“the level and complexity of NP's inter-company transactions with Fortis Inc., and all of its related subsidiaries is exposing NP, and therefore ratepayers, to unnecessary financial and insurance risks; reveals that NP may be operating with too many employees; indicates an improper use of regulated funds; and shows that NP is charging preferential interest amounts on outstanding balances due from Fortis related companies, contrary to Section 107 of the Act.”*  
(Final Submission, Consumer Advocate, pgs. 63-64)

The Board has dealt with the financial risks of NP's relationship with its shareholder Fortis on pgs. 38-40 of this Decision. The other issues raised by the Consumer Advocate are addressed separately below.

## **2. Level of Inter-Corporate Transactions**

Board Hearing Counsel observed that Fortis now comprises some nine subsidiaries, eight of which are utilities. (Final Brief, Board Hearing Counsel, pg. 4/4-5) By contrast, there were three utilities referred to in Fortis' 1998 Annual Report. A comparison of Fortis' operating revenues shows NP contributing an estimated 71% in 1998, declining to 57% in 2001. In describing its vision Fortis' 2002 Annual Report states:

*“The principal business of Fortis will remain the ownership and operation of electric distribution utilities. We will be proactive and innovative in responding to the challenges and opportunities presented by changes in the electricity industry. While the continued profitable expansion of the electric utilities in the Fortis family is our first priority we will also pursue opportunity to acquire other utilities in Canada, the Caribbean and the NorthEastern United States.”*

The Board believes the relationship between Fortis, its affiliated companies and NP has become much more complex and integrated since 1998. This relationship extends beyond corporate governance issues between shareholder and subsidiary and has escalated to where NP supplies an increasing level of services to Fortis and its affiliated companies, in particular, insurance and staff, including executive and professional support. NP's regulated and unregulated inter-corporate transactions with Fortis and its sister companies have multiplied several times since 1998 and involve the flow of significant services and charges between affiliates. (Grant Thornton Report-NP 2003 GRA, Schedule 6C) Furthermore, in the case of Central Newfoundland Energy (CNE), Board Hearing Counsel notes professional staff are provided by NP to a sister company, 50% owned by Fortis, which may arguably be viewed as a competitor of NP since it produces energy and sells it in the Province. The Board believes there is no reason to anticipate these transactions between NP and its affiliates will stabilize and the evidence appears to support a continuing escalation, particularly as additional utilities are acquired by Fortis as outlined in its vision. NP argues these inter-corporate arrangements benefit customers of the utility since they generate additional revenues which serve to reduce rates as well as enhance employee development and provide exposure to outside business practices and ideas.

The Board places considerable stock in the advice given by Board Hearing Counsel:

There is a down side to the Board's openly encouraging Newfoundland Power to pursue this strategy further in that it would further integrate Newfoundland Power possibly into Fortis and the sister companies. And this has implications for the ratings of Newfoundland Power, vis-a-vis it's own stand alone status. So, it's a thorny issue, it's not one that's simply resolvable by addressing it--it's not simply resolvable by suggesting to Newfoundland Power that they just unbridled, go ahead with providing professional services at market rates. But it is something that needs to be monitored and there needs to be a concerted policy put in place so that we can measure this going forward.

(Transcript, April 25, 2003, pg. 157/12-25; pg. 158/1-3)

With regard to the provision of staff and other services to its affiliates, the Board agrees NP may indeed be deriving benefits on behalf of ratepayers. The Board believes, however, such benefits should be transparent, demonstrable and maximized to the advantage of ratepayers. In the absence of these stated objectives, the customers of NP may pay incrementally more for their electricity with either Fortis and/or its other subsidiaries sharing in these benefits. As previously indicated the Board's singular focus in its regulatory responsibility is NP and it is the Board's mandate to ensure electric consumers in the Province enjoy least cost electricity. The Board recognizes it may be several years before NP's next general rate application and, given the ever increasing complexity and number of inter-corporate transactions, it is incumbent upon the Board to ensure the interests of ratepayers are protected.

The Board acknowledges the Deloitte Touche guidelines covering inter-corporate transactions of NP which were put in place in Order No. P.U. 7(1996-97) and went unchanged by the Board in Order No. P.U. 36(1998-99). While these guidelines have generally proven adequate to date, the Board is persuaded in light of the corporate growth of the Fortis family that explicit regulatory policy direction is required to govern NP's inter-corporate transactions into the future. Therefore, in addition to the existing guidelines, NP will be required to observe certain principles in all of its inter-corporate transactions.

The overriding principal that should govern NP is that all inter-corporate transactions between affiliates shall be fully transparent and subject to scrutiny by the Board.

The Board acknowledges the general presumption of managerial good faith but notes that transactions between the utility and its affiliates present unique challenges, as they are non-arms-length transactions. Therefore, the onus will be placed on the utility to establish, to the satisfaction of the Board, that the transaction is prudent and that any corresponding costs reflect "*fair market value*" or "*cost based pricing*", including a return on invested capital, as appropriate.

The Board has no desire to "*micromanage*" the operations of the utility and places the responsibility with NP to demonstrate to the Board that it has operated in the best interests of the utility and its customers. The Board expects directors and officers of NP to act in a manner which does not prejudice the interests of ratepayers in transactions with affiliates. Inter-corporate transactions between the utility and its affiliates should provide benefit to the electrical consumer and should not be implemented so as to disadvantage the consumer.

**NP will be required to observe the following principles in all inter-corporate transactions:**

- (i) All inter-corporate transactions between a utility and its affiliates shall be fully transparent and are subject to scrutiny by the Board.**
- (ii) A utility shall have the right to manage its affairs but it must demonstrate to the satisfaction of the Board that all affiliate transactions are prudent.**
- (iii) A utility shall ensure that inter-corporate transactions will not disadvantage the interests of ratepayers and furthermore that ratepayers and the utility will derive some demonstrable benefit from such transactions.**
- (iv) The onus is on the utility to show that it is in compliance with the guidelines and principles with respect to inter-corporate transactions.**

**These principles may be amended by the Board from time to time. Given the implications of these principles on both NP and its affiliates, NP will be required to undertake a review and update of its operating practices and procedures relating to any and all inter-corporate transactions to ensure that the principles as set out above are reflected. The results of such a review shall be reported to the Board no later than March 31, 2004.**

### **3. Centralized Insurance Administration**

NP currently handles the insurance administration for Fortis and its subsidiaries. All insurance billings, claims, etc. for the Fortis Group of Companies are coordinated and paid through an employee of NP. NP charges the related companies through inter-corporate billings. The Consumer Advocate argued that *“this is an unusual function for a subsidiary to perform for its parent, and can lead to the exposure of NP to increased insurance costs as a result of its linkage with the insurance risks of other companies over which NP has no control.”* The Consumer Advocate further argued that NP has not demonstrated any compelling reasons why it should bear the risk of paying out all of Fortis companies’ insurance premiums or why it should remain risk-linked with other Fortis companies. The additional labour and accounting costs associated with performing this function were also questioned. (Final Submission, Consumer Advocate, pgs. 65-66)

In an undertaking to the Consumer Advocate, NP provided information on the relationship of NP’s annual insurance premium to the claims experience of other Fortis companies. (U #1) This information included a comparison of loss ratios (ratios of the total claims under a policy of issuance to the total premiums paid for coverage under the policy) for the Fortis Group of Companies and NP. The loss ratios for Fortis and NP for auto and liability policies are comparable; loss ratios for property are 208% for Fortis and 147% for NP; and loss ratios for all coverages is 149% for NP compared to 152% for Fortis. Total insurance premiums for 1997-2003 for the Fortis Group were \$5,912,915 with \$3,071,518 (51%) allocated to NP. In U #1 NP also identified the following benefits of participating in a group insurance program:

1. diversity of claims experience among a group of insured parties can benefit participants who experience higher incidence of claims in a given period;
2. volume discounts on premiums available as a result of the spreading of risk and economies of scale;
3. savings resulting from sharing of broker services; and
4. improved access to leading specialty insurance markets, such as those specializing in insuring utility risk.

In written submission (Section D, pg. 16) NP argued that its centralized insurance management is more cost effective than if it were to purchase insurance on its own as a small electric utility.

It is unusual, in the Board’s view, for a subsidiary company to perform a centralized function such as insurance administration for the parent company and its affiliates. The Board’s primary concern in this matter is that ratepayers are not subsidizing or contributing to the

insurance expenses of Fortis and related companies and also that there is no additional cost to NP (and hence ratepayers) of NP's participation in a group insurance program. NP has argued that there is a benefit to maintaining the insurance expertise in-house rather than having to out-source. Based on the evidence the Board is satisfied that the insurance costs are tracked and billed to the related companies as required. The labour charges for NP's staff persons associated with the activity are billed as well, including the appropriate markups. Inter-corporate charges are reported to the Board quarterly and reviewed by the Board's Financial Consultants as part of their annual financial reviews.

A more difficult issue for the Board is the determination of whether there is actually a benefit accruing to NP and its ratepayers as a result of this activity. Mr. Perry indicated that NP had not gone to market for a stand-alone quote for insurance coverage based on NP's risks alone. While the benefits listed by NP above relate primarily to cost savings, these savings have not been quantified and the Board has no information before it to satisfy itself on this question. On this issue the Board agrees with the Consumer Advocate's submission that NP should be directed to demonstrate that there is a real, quantifiable benefit to ratepayers for NP to remain as the central insurance administrator for Fortis and its subsidiaries and that there is a real benefit to ratepayers for NP to continue to participate in the group insurance plan rather than to be insured on a stand-alone basis.

**NP will be directed to prepare a report which should compare and quantify the benefits to NP and ratepayers of its administration of and participation in a centralized insurance program for the Fortis Group of Companies, rather than be insured on a stand-alone basis. This report should be filed with the Board no later than March 31, 2004.**

**NP will be required to modify its quarterly reports on inter-corporate charges to show separately associated labour and other staff and expense charges billed in relation to NP's insurance administration on behalf of Fortis and related companies.**

#### **4. Inter-Corporate Staff Exchanges and Associated Charges**

The Consumer Advocate raised the issue of the number of NP's employees working for affiliated companies and the charge for these transactions. Specific concerns raised include the charge rate for Mr. Hughes, NP's President and CEO, for doing work for Fortis companies, and the increasing level of staff charges billed to Fortis for NP's employees working on behalf of Fortis or related companies. The Consumer Advocate submits that "*NP has excessive staff if it is able to operate without the staff that generated the \$1,600,000 in staff charges to Fortis companies in 2002.*" (Final Submission, Consumer Advocate, pg. 67)

The Board has already addressed the issue of the level of inter-corporate transactions and has identified the principles that should govern inter-corporate activity between NP and affiliated companies. The Board's responsibility in this area is to ensure that ratepayers are only paying for those costs necessarily incurred by NP in the provision of electrical service.

NP bills Fortis and its related companies for time spent by NP employees working with these companies based on timesheets and the individual specific rate of pay plus a loading factor to recover related overheads. It also bills affiliated companies all out-of-pocket expenses, which



are passed on at cost. Certain engineers and technicians are charged at market rates where market rates are ascertainable. The Board's Financial Consultants review inter-corporate charges each year and report to the Board. A review of Schedule 6A of Grant Thornton's report filed in this proceeding indicates that the level of staff charges to Fortis has increased since 1999. (Grant Thornton Report-NP-2003 GRA) As well it is apparent that the increase in Fortis' interests in other electrical utilities such as Fortis US Energy Corp., Belize Electricity Limited, Belize Electric Company Limited and CNE, has resulted in additional inter-corporate staff charges since 1999.

According to CA-666 the percentage of Mr. Hughes' total compensation charged to Fortis and related companies has been in the range of 18% each year since 1999, with the exception of 2001 when 25% of Mr. Hughes' total compensation was charged. In addition to this direct compensation charge NP also bills for associated overhead costs on an hourly basis. CA-667 provided similar information for other NP executives. This information indicates that a portion of the total compensation for other executives is also billed to Fortis and related companies but that the percentages are much lower than that charged for Mr. Hughes. Of the remaining executive Mr. Perry, NP's Vice President Finance and CFO, has the most significant charge, with 21% of his total compensation charged in 2001 and 17% charged in 2002.

In addressing this issue in cross-examination the Consumer Advocate suggested that the charge out rate for Mr. Hughes is in the order of \$170 per hour, based on the evidence filed in the hearing. (Transcript, March 3, 2003, pg. 158/21-9) In response, Mr. Hughes could not confirm the rate nor whether that rate is in his opinion a market rate for a CEO since he does not have a benchmark.

Q. Is your answer then that that would be a market rate?

A. I don't know. I mean, obviously what a CEO gets paid for is to produce far more value and make more changes and set the direction than what they're getting paid. To be honest, I can't think of an example where a CEO is charged out to a non-related company. So I haven't got a benchmark, so I suppose, Mr. Fitzgerald, I'm neither agreeing or disagreeing, I just don't—I can't think of a comparative.

Based on the evidence the Board is satisfied that the time for NP's employees, other than executive and management, is being recorded and charged out to Fortis and affiliated companies at market rates or other appropriate rates. In the Board's view this should also be the case for executive and management, rather than using a cost plus overhead basis. This approach in the Board's view recognizes the value of the service being provided by NP. If a market rate is not ascertainable (as seems to be the case), NP should add an appropriate premium to its cost-based rates as a proxy.

**As part of the review of operating practices and procedures relating to inter-corporate transactions NP will be required to investigate the utilization of market rates for executive and management time charges. In lieu of market rates, NP shall propose an appropriate markup on its cost-based rates as a proxy for market in the event that utilization of market rates is not practical.**

## 5. Billing Practices and Interest Arising from Inter-Corporate Transactions

The Consumer Advocate also raised the issue of billing practices to related companies for inter-corporate transactions, specifically the timing of billings and interest charges on overdue accounts. It was submitted by the Consumer Advocate that *“the billing out of NP staff charges on a quarterly basis, where the cost to pay the staff and provide travel funds are incurred on a monthly, if not weekly, basis by NP, reveals a significant benefit that Fortis and its affiliates receive from NP.”* (Final Submission, Consumer Advocate, pg. 68) The Consumer Advocate also argued that NP’s practice of not charging these companies interest for overdue accounts is unfair to consumers and is in contravention of Section 107 of the *Act*, which essentially prohibits preferential billing.

During the hearing, in response to questioning from the Consumer Advocate regarding timing of insurance billings and subsequent payments, Mr. Perry acknowledged that NP has incurred a cost associated with receivables over 30 days from related companies. In an undertaking NP provided a pro-forma calculation of interest that would have accrued in each of years 2000-2002 on inter-corporate receivables over 30 days if interest had been charged based on NP’s average short-term borrowing rate for that year. This information showed that the interest charges would have totalled approximately \$12,400. (U #16) Mr. Perry also testified that this issue of billing practices to Fortis and related companies has been addressed and corrected. (Transcript, March 13, 2003, pg. 120/9-19)

The Board is satisfied that the time and expenses relating to inter-corporate transactions are being tracked and recorded as required, and that NP is billing and recovering those costs from related companies. The Board expects, however, that the billings for these services performed by NP on behalf of related companies be treated in the same manner as any billings for amounts owing that NP would issue to a non-related company as part of its normal trade or business practice. The Board’s finds that this is one of the ways that it can assure itself that NP is not treating its billings and receivables to Fortis and affiliates differently than it would any other unrelated party to which it provides service. It follows that billings to Fortis and related companies should be issued on the same terms and conditions, and be assessed appropriate interest charges and penalties in the case of late payments, as for non-related parties. It is not clear from the evidence that this is the case. For example, NP calculated the pro-forma interest in U #16 using its average short-term borrowing rate, which the Board estimates to be approximately 4% - 4.5%. This interest rate appears to be much lower than the interest rate or penalty that would normally be applied to outstanding bills, which is typically calculated on a prime rate plus basis. The Board also expects billings to Fortis and related companies to be undertaken within 30 days of the service and/or expenses being charged for recovery.

**NP will be required to apply billing and collection practices with respect to inter-corporate transactions which are consistent with those applied to unrelated parties. Billings to Fortis and related companies should also be undertaken within 30 days of the service and/or expenses being charged for recovery.**

## VI. AUTOMATIC ADJUSTMENT FORMULA

In Order No. P.U. 16(1998-99) and P.U. 36(1998-99) the Board ordered the use of an automatic adjustment formula (the “*Formula*”) to set an appropriate rate of return on rate base for NP on an annual basis. The Board also determined that after NP’s rate of return on rate base had been set for three consecutive years using the Formula, and without a hearing, then a hearing will be convened in the following year to consider the cost of capital, including a full review of forward looking test year projections.

The Formula put in place by the Board in 1998 is as follows:

$$\text{Rate of Return} = \frac{\text{Invested Capital}}{\text{Rate Base}} \times \text{Weighted Average Cost of Capital} + \frac{Z}{\text{Rate Base}}$$

Where Z represents amounts which are recognized in the calculation of either weighted average cost of capital or rate of return on rate base, but not both. These amounts include:

- (A) Amortization of Capital Stock Issue Expenses;
- (B) Interest on Customer Deposits; and
- (C) Interest Charges to Construction.

The Formula adjusts NP’s rate of return annually based on changes in the forecast cost of common equity. This forecast change is based on changes in long term Government of Canada Bond yields. By use of an equity risk premium approach the Board determined that the appropriate return on regulated equity for NP was the sum of the risk free cost of capital (i.e. the average of long term Government of Canada bond yields) and an adjusted risk premium which varies based upon the changes to the risk free cost of capital. The resulting rate of return on common equity, along with the appropriate rate of return on preferred equity and the embedded cost of debt are then used to calculate the Weighted Average Cost of Capital (WACC). The appropriate rate of return on rate base is calculated by multiplying this WACC by the ratio of forecast average invested capital to forecast average rate base plus a Z factor as shown above. The Formula also adjusts on an annual basis the ROE, forecast average invested capital and average rate base. All other components of the Formula are based on 1999 test year data.

### 1. Existing Formula Performance

The Formula has been used in each of 1999, 2000 and 2001 to set the rate of return on rate base (and hence rates) for NP for the years 2000, 2001 and 2002. In Order No. P.U. 28(2001-2002) the Board ordered, among other things, that NP undertake a review of the performance of the Formula. The results of this review were filed as part of the evidence in this proceeding. (Exhibit BVP-17)

The following table shows the allowed range of return on rate base as set by the Board for 1997-1999 and as derived by the Formula for 2000-2002 and, for comparison purposes, the actual returns achieved by NP:

<b>Returns on Rate Base: 1997 to 2002</b>			
<b>Year</b>	<b>Allowed Rate of Return</b>	<b>Allowed Range (%)<sup>1</sup></b>	<b>Actual Return (%)<sup>2</sup></b>
1997	10.65	10.50- 10.80	10.71
1998	9.81	9.63 - 9.99	9.86
1999	9.98	9.80- 10.16	10.04
2000	10.28	10.10- 10.46	10.46
2001	10.28	10.10- 10.46	10.46
2002	10.06	9.88- 10.24	9.94

<sup>1</sup> As set out in various Board Orders.

<sup>2</sup> As reported by NP in its annual returns.

Consumer electricity rates were set each year based on the rate of return on rate base, which is the midpoint of the allowed range of return set by the Board, using a 36 basis point spread. The operation of the Formula resulted in adjustments to rates for 2000 and 2002 of less than 1% with rates remaining unchanged in 2001.

One of the conclusions of the Formula review contained in BVP-17 is that the Formula yielded a low return on common equity when compared to similar mechanisms adopted by the NEB and the BCUC.

A significant issue raised during the hearing was the increasing spread between the actual rate of return on rate base and the actual rate of return on regulated equity. This issue was highlighted by Grant Thornton as part of their annual reviews of the operation of the Formula for 2000 and 2001. The following comparison of the actual return on average regulated common equity with the actual return on average rate base for 1998 to forecast 2002 was provided by Grant Thornton (Grant Thornton Report-NP 2003 GRA, pgs. 19-20):

<b>Comparison of Actual Returns on Rate Base and Regulated Common Equity</b>					
	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>Forecast 2002</b>
Return on Average Common Equity	9.58%	9.81%	10.80%	11.35%	10.32%
Return on Average Rate Base	9.86%	10.04%	10.46%	10.46%	9.79%
Spread between actual returns	(0.28%)	(0.23%)	0.34%	0.89%	0.53%
Spread based on formula returns	-	(0.73%)	(0.69%)	(0.69%)	(1.01%)

In its evidence NP describes two events which have affected the returns for 2000 and 2001 i.e. the treatment of GEC for income tax purposes and the Aliant pole purchase. Grant Thornton adjusted the returns for the effect of these two events as shown below:

<b>Returns Adjusted for Extraordinary Events per Exhibit BVP-2</b>					
	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>Forecast 2002</b>
Return on Average Common Equity	9.58%	9.81%	9.92%	8.50%	9.43%
Return on Average Rate Base	9.86%	10.04%	10.07%	9.23%	9.47%

Grant Thornton also prepared an analysis of the impact of changes in the individual components of the Formula. As a result of this analysis two additional areas were identified for further consideration by the Board: (i) changes in forecast versus actual embedded cost of debt; and (ii) changes in forecast versus actual ratio of average invested capital to average rate base.

Before considering the evidence put forward in the hearing regarding proposed changes to the Formula the Board wishes to provide its opinion and findings regarding the effectiveness of the Formula since 1998 and on the continued use of the Formula for setting rates beyond this Decision.

## **2. Board's View on Continued Use of the Formula**

The appropriateness of implementing an automatic adjustment mechanism for resetting the rate of return in years subsequent to a test year to reflect changes in financial benchmarks was considered by the Board in NP's 1998 cost of capital hearing. In Order No. P.U. 16(1998-99) the Board stated the following (pg. 103):

*"The Board is of the view that there is merit to a formula, in light of the cost of a full cost of capital hearing and the potential savings to consumers which could be realized. The Board also believes that the adoption of an automatic adjustment mechanism will create greater predictability, which will thereby reduce the risk of regulatory uncertainty. In the opinion of the Board, a mechanism to facilitate an annual review at modest costs will be of benefit to the ratepayer and the Company."*

The Board also stated in Order No. P.U. 16(1998-99) that it would call a hearing if circumstances change, so as to render the use of an automatic adjustment formula to be inappropriate, citing specific examples on pg. 104 as follows:

- a) deterioration in the financial strength of the Company, resulting in an inappropriately low interest coverage;
- b) changes in financial market conditions which would suggest that the formula is not accurately reflecting the appropriate return on equity; and
- c) fundamental changes in the business risk of the Company.

The Board has monitored the operation of the Formula as part of its ongoing supervisory role in regulating the utility. Revised values for rate base and invested capital for use in the Formula for each year were reviewed and approved by the Board as part of that year's capital budget hearing. The Board's financial consultants reviewed the operation of the Formula as part

of their annual financial reviews of NP. As well NP was required to file quarterly reports with the Board which, in addition to the required annual report, provided information on actual financial performance, both regulated and non-regulated. In Order No. P.U. 36(1998-99) the Board also specified the time period for the setting of rates using the Formula to three consecutive years, after which a full cost of capital hearing would be convened.

As stated in Order No. P.U. 16(1998-99) one of the primary motivations for adopting the Formula was the potential savings to be realized from a regulatory process that does not require frequent cost of capital hearings, which are time consuming and expensive. It was also recognized that the use of a formula may reduce regulatory risk due to the certainty associated with an automatic adjustment mechanism in reflecting changing financial conditions. In the Board's view the use of the Formula has contributed to stable rates for consumers and lower regulatory costs since 1998. Rate changes due to the operation of the Formula have been +0.71% in January 2000, no change in January 2001 and a decrease of 0.56% in 2002. Many of the issues raised during this hearing relating to NP's earnings and the impact of extraordinary events on those earnings do not relate to the operation of the Formula and are discussed elsewhere in this Decision. None of the parties advocated abandoning the Formula but rather proposed specific changes to the Formula on a go forward basis.

In the Board's view there is merit in continued use of a formula for the same reasons as set out in Order No. P.U. 36(1998-99) and stated above. This was the Board's first experience with an automatic adjustment mechanism and, based on the evidence in this hearing, the Board believes that adjustments to the Formula itself and implementation of specific triggers leading to a review of the Formula's components will improve its operation and effectiveness.

### **3. Changes as Proposed by NP**

In this Application NP is proposing three changes to the Formula: 1) change the manner of determining the risk free rate by adopting the method utilized by the National Energy Board (NEB) and the British Columbia Utilities Commission (BCUC); 2) adopt an equity risk premium of 4.75% at a risk free rate of 6%; and 3) expand the range of return on rate base to 50 basis points. These proposals are discussed in detail in the following sections.

#### **i) Risk-Free Rate**

NP stated that the calculation of the risk-free rate in the Formula as put in place by the Board is out of step with similar mechanisms currently in use in Canada and that, as a result, "*NP's returns are established by means outside of the mainstream for such mechanisms in use for Canadian utilities*" [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pg. 47/1-2]. Mr. Perry goes on to state that the short observation period for setting the risk-free rate exposes NP's investors to additional risk.

The risk-free rate used in the existing Formula is based on the actual yields of two series of long-term Government of Canada bonds. The observed average of the daily closing yields for the last five trading days of October and the first five trading days of November for Government of Canada 8% Issue, maturing June 1, 2027 and the 5.75% Issue, maturing June 1, 2029 is used to forecast the risk-free rate for the upcoming year.

NP proposes that the Formula be amended to adopt the NEB and BCUC approach to determining the risk-free rate. The NEB's formula uses a forecast 10-year bond yield as calculated by taking the average of the 3-month and 12-month-out forecasts of 10-year Government of Canada bond yields as set out in the November issue of *Consensus Forecasts* (published by Consensus Economics Inc., London, England). This forecast 10-year bond yield is added to the observed spread between the 10-year and 30-year Government of Canada bond yields for the current year, calculated by averaging the yields published daily in the National Post throughout October of the current year, to provide a forecast risk-free rate for the next year. The BCUC uses the same calculation for the forecast risk-free rate.

NP provided a comparison of the risk-free rate forecasts and actual 30-year Government of Canada bond yields for 1999 to 2002 as outlined below (Written Submissions, NP, Section G, pg. 8):

<b>Comparison of Risk Free Rate Forecasts and Actual 30-Year Government of Canada Bond Yields: 1999-2002</b>				
(%)				
<b>Forecasts:</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Newfoundland	5.49	6.18	5.75	5.50
NEB	5.69	6.12	5.73	5.63
BCUC <sup>1</sup>	5.47	6.04	5.73	5.63
<b>Actual Yields<sup>2</sup></b>	<b>5.72</b>	<b>5.71</b>	<b>5.76</b>	<b>5.68</b>

<sup>1</sup>In 2000 the BCUC adopted a longer observation period to establish the forecast spread between 10 and 30-year bond yields.

<sup>2</sup>Actual yields are the average of Bank of Canada published month end yields for 30-year Government of Canada Bonds for each year.

NP submitted that the table above provides conclusive evidence that the NEB formula has greater predictive accuracy and lower volatility in predicting the risk-free rate than the existing methodology contained in the Formula. Dr. Morin and Ms. McShane agreed with this proposed change, principally because of its relative stability as compared to spot observations of long-term Canada bond yields.

The Consumer Advocate does not support this proposed change, and stated that "*if the Board is to continue with a formula it should continue with the ten trading days' methodology as provided for in P.U. 16 (1998-99)...*" (Final Submission, Consumer Advocate, pg. 28). Dr. Kalymon suggested that the existing formula methodology for calculating the risk-free rate has been more accurate than the NEB's methodology.

As stated previously in this Decision the Board is not convinced that either the NEB or the BCUC model demonstrates sufficiently superior operating characteristics to warrant a change in formula methodology. The Board believes that greater regulatory stability and consistency is encouraged by retaining the existing Formula.

**The Board will continue to use the existing methodology in the Formula for calculating the risk-free rate. However, the risk-free rate will now be calculated based on the actual yields of the three most recent series of long-term Government of Canada bonds**

during the 10 trading days being monitored as reported in The Globe and Mail under the heading “Ask Yields”. The observed average of the daily ask yields for the last five trading days of October and the first five trading days of November for these three most recent issues will be used to forecast the risk-free rate for the upcoming year, in each year of operation of the Formula.

## ii) Equity Risk Premium

NP is also proposing that the Formula be amended by establishing, at a risk-free rate of 6.0%, an equity risk premium of 4.75%.

In Order No. P.U. 16(1998-99) the Board determined that the total risk premium (including an allowance of 50 basis points to cover underwriting costs, the risk of dilution of share value and unforeseen circumstances) to be used in the Formula with a risk-free rate of 5.75% was 350 basis points, or 3.50%, to give an ROE of 9.25%.

**The Board has determined that a total risk premium of 415 basis points, or 4.15%, is reasonable. This is the value that will be used and adjusted on the same basis as was ordered in Order No. P.U. 36(1998-99) in the application of the Formula.**

## 4. Embedded Cost of Debt

The issue of the variance between the embedded forecast cost of debt used in the Formula and the actual cost of debt was raised by Grant Thornton (Grant Thornton Report-NP 2003 GRA, February 4, 2003, pg. 22). In Order No. P.U. 36(1998-99) the Board fixed the embedded cost of debt for purposes of the Formula at 9.18%. This cost of debt remains constant from year to year. Actual embedded cost of debt for 1999 to 2001 has been below that used in the Formula, ranging from 9.01% in 1999 to 7.79% in 2002. According to Grant Thornton:

*“The decrease in the embedded cost of debt means that actual interest costs are lower than anticipated in the Formula. Generally speaking, assuming other items are constant, as interest costs decrease earnings increase and vice versa. What this means in terms of the operation of the Formula is that because the cost of debt is set at a higher level than actual, the Company has the opportunity to increase the return on equity while still staying within the limits of rate of return on rate base.”*

Grant Thornton suggested the Board consider the significance of variations in the embedded cost of debt and whether the Board should consider modifying the Formula to adjust for forecast changes in the embedded cost of debt annually. In supplementary evidence Grant Thornton suggested that, as an alternative to modifying the cost of debt annually in the Formula, the Board may establish criteria which would trigger a review of the Formula and the cost of capital. This review would be triggered whenever certain variables or returns generated by operation of the Formula vary significantly from expectations. (Supplementary Evidence, Grant Thornton, pg. 3)

The Consumer Advocate submitted that the operation of the Formula unadjusted for the true cost of embedded debt has resulted in additional income of approximately \$7,500,000 for NP for the years 2000, 2001 and 2002. This extra income, according to the Consumer Advocate,



contributed to NP's over-earning on its equity in each year since the implementation of the Formula. The Consumer Advocate supports the annual adjustment of the forecast embedded cost of debt. (Final Submission, Consumer Advocate, pgs. 36-39)

The Board agrees that the changes in the embedded cost of debt from that set by the Formula for the 1999 test year have contributed in part to the earnings above the ROE used in the Formula. These changes in debt costs are caused by a number of factors, however, including use of more short-term debt by NP to finance its operations, and changes in interest rates. In addressing this issue in the context of the Formula the Board does not wish to put mechanisms in place that would restrict the ability of NP's management to lower costs, including debt costs, between cost of capital hearings. The real issue for the Board is how the benefit of these lower costs is passed on to consumers.

In the Board's view it would be contrary to the purpose of having an automatic adjustment mechanism if, once a formula has been established, the Board were to use variances from forecasts of requirements to adjust various formula components as they change. In implementing a formula the Board must select reasonable and justified test year values based on the evidence. In the Board's view this is consistent with the prospective nature of setting rates. Changes in test year values are expected. The primary concern for the Board is to ensure that the components in the Formula remain appropriate. This was recognized by the Board in Order No. P.U. 36(1998-99).

The Board concludes that a triggering mechanism tied to the overall cost of capital would be more appropriate. This will provide the Board with the opportunity to review not only the components of the Formula but also to examine the reasons for the variances from test year values. If the variances are related to changing financial and market conditions that the Board or parties could not have foreseen or anticipated, an adjustment to the Formula may be appropriate. The Board does not want, however, to discourage NP from continuing to seek efficiencies to lower costs and will focus primarily on those components that remain outside the control of the utility. As an added monitoring mechanism the Board will require NP to provide additional information on changes in the embedded cost of debt as part of its annual returns.

**NP will be required to modify the schedule filed as part of its annual return that calculates the embedded cost of debt to identify specifically the causes of variations in the actual embedded cost of debt from the cost forecast for the test year period.**

## **5. Trigger Mechanism for Early Review**

From the Board's perspective, a significant indicator that the Formula may not be operating as intended in setting the rate of return on rate base is when NP's actual earned return on regulated equity in a given year is significantly higher than the expected return or cost of equity determined for that year. In this context it is logical that the triggering mechanism for an early review of the Formula be some pre-defined threshold for the observed rate of return on regulated equity. The Board finds that a good reference point for the threshold is the upper limit of the range of return on rate base. The threshold should be higher than the upper limit otherwise a review would be triggered even though the utility did not earn outside the allowed range.

The Board feels that an appropriate trigger point would be when the actual rate of return on regulated equity for any given year is greater than 50 basis points above the cost of equity as determined by the Formula. Where in any year this threshold trigger is exceeded, the Board will require NP to file a report, as part of its annual return, which details the variations in all components of the cost of capital and explains the circumstances or facts leading to such variations. The Board will undertake an immediate review of this information and make an assessment as to the most appropriate course of action which may involve calling for a hearing on cost of capital.

**The Board will establish a mechanism tied to the observed rate of return on regulated common equity which may trigger an early review of the Formula and cost of capital. Where the actual rate of return on regulated equity in any intervening year exceeds the cost of equity determined by the Formula by more than 50 basis points, then NP will be required to file a report with the Board in its annual return setting out the circumstances and facts contributing to the difference.**

## **6. Period of Operation**

NP set out its position on the period of operation of the Formula in its response to CA-343. NP has proposed that the Formula be used for a further three year period, stating that customer rates should be set for 2003 and 2004 by Order arising from this hearing and the Formula be used to set rates for 2005, 2006 and 2007. This would mean, presumably, that NP would come before the Board no earlier than late 2007 or early 2008 for a cost of capital hearing unless circumstances change such that an earlier hearing is required by the Board or requested by NP.

It is evident from the record that there are several events that will occur in the next 2-3 years that may impact NP's financial position. These were summarized in the final brief of Board Hearing Counsel (pg. 24). The specific impacts of these events on NP cannot be determined at this time, especially those events outside NP's control, such as the outstanding CCRA issue and the outcome of S & P's ratings review. If either of these events has a negative or material impact on NP's financial position the Board anticipates that NP will request an earlier hearing to review its cost of capital. However, the Board is of the opinion that the proposed period of operation of the Formula for a three-year period starting in 2004 (i.e. to set rates for 2005, 2006 and 2007) is reasonable and meets the intended objective of regulatory efficiency and stability. The Board has put in place with this Decision a triggering mechanism which, along with the Board's ongoing monitoring, will provide the opportunity for the Board to convene an early review if deemed necessary.

**The Board will approve the use of the Formula, as modified by this Decision, for a further three-year period. Customer rates will be set for 2003 and 2004 by this Decision and Order. The Formula will be used to set the rate of return on rate base, and hence customer rates, for 2005, 2006 and 2007.**

## **7. Ratio of Average Invested Capital to Average Rate Base and Inclusion of Deferred Charges in Rate Base**

### Deferred Charges

In its review of the Formula Grant Thornton observed, as inputs are updated annually, the resulting calculation adds both complexity and variability to the operation of the Formula. For example, deferred charges such as pension costs which may fluctuate substantially from year to year are included in invested capital but not in rate base. Grant Thornton suggests that if the Board wishes to improve the operation of the Formula one alternative the Board may wish to consider is the Asset Rate Base method, where all regulated assets of the utility are included in rate base. The Asset Rate Base method is applied to NLH and is an equally acceptable regulatory practice which would more closely equate rate base and total required invested capital. Grant Thornton points out, however, that even with the inclusion of deferred charges in rate base a difference still remains between NP's average rate base and average invested capital. Grant Thornton reconciles this difference as \$3,799,000 in 2003 and \$2,858,000 in 2004. (Supplementary Evidence, Grant Thornton, pgs. 3-4) Grant Thornton acknowledges these remaining differences should eventually be absorbed into the Asset Rate Base model but this will require further analysis and is best left to NP's next general rate application. (Transcript, April 8, 2003, pg. 13/16-25)

Grant Thornton explained including deferred charges into NP's rate base under the Asset Rate Base method will add approximately \$77,000,000 to the rate base in 2003 but will not increase revenue requirement as NP is also recovering these costs through the current Invested Capital approach. Grant Thornton noted that deferred charges are forecast to increase significantly over the next five years and suggested that the Board apply a prudence test each year to deferred charges in conjunction with its hearing of the company's capital budget application. (Supplementary Evidence, Grant Thornton, pgs. 3-4; Exhibit II)

NP indicated that Grant Thornton's alternative does not appear to affect the balance between the interests of the utility and its customers and that the Board is free to make choices between reasonable regulatory alternatives. (Written Submissions, NP, Section G, pg. 5/1-7) The Board Hearing Counsel indicated that if the Board were to adopt the Asset Rate Base method as recommended, it will need to establish a reporting process and review guidelines for testing the prudence of pension related expense, as their determination involves expert actuarial evidence and the exercise of considerable management discretion. (Final Brief, Board Hearing Counsel, pg. 22/22-30)

The only expert commenting on the issue, Mr. J.T. Browne, appeared indifferent to either option as long as the cost of financing the investment is recovered and regulatory accounting principles are followed. Mr. Browne commented that in his experience there is generally a presumption of prudence unless there is evidence to the contrary. (Transcript, March 31, 2003, pg. 71/15-25; pg. 78/11-14)

The Board finds that changing the Formula and adopting the Asset Rate Base method will result in a consistent approach to determining rate base for both NP and NLH. Furthermore, the

Formula will also be simplified and the results more stable year over year. The Board will require NP to observe appropriate guidelines to ensure proper annual monitoring of these deferred charges. The Board acknowledges NP's understanding that this change has no impact on the utility but notes in the reconciliation of the remaining differences based on the Asset Rate Base method more work is required. Whether or not these subsequent adjustments will be revenue neutral for NP is uncertain. The Board indicates, however, these issues will be a subject of the NP's next general rate hearing, at which time the evidence of all parties will be heard.

#### Regulated verses Book Equity

In its written submission, NLH addressed the issue of utilizing return on "*regulated common equity*" versus return on "*book value*" in measuring NP's return on equity. The difference between regulated equity and book equity is one of the reconciling items noted by Grant Thornton in their reconciliation of Average Invested Capital and Average Rate Base (including deferred charges). (Supplementary Evidence, Grant Thornton, Exhibit II) NLH submitted that, in moving to the Asset Rate Base method for NP, the Board may consider discontinuing the use of regulated common equity in favour of book equity.

The Board believes that the arguments put forward by NLH with respect to using book equity have considerable merit, however, the Board is not prepared to make such a change in regulatory practice at this time. As noted above, this is one of the remaining reconciling items between Invested Capital, as currently calculated, and Rate Base. The Board will direct NP to address all reconciling items, including this issue, no later than its next general rate application.

**The Board finds that the Asset Rate Base method should replace the Invested Capital approach currently used to calculate NP's rate base. The move to the Asset Rate Base method will begin in 2003 by incorporating deferred charges in rate base. The Board will direct NP to implement the following guidelines in switching to the Asset Rate Base method:**

- (i) Average deferred charges based on BVP-11 to be added to the average rate base for the 2003 and 2004 test years and all subsequent fiscal years.**
- (ii) Evidence relating to changes in deferred charges, in particular deferred pension costs, to be filed annually at the capital budget hearing.**
- (iii) NP will provide a reconciliation of average Rate Base to average Invested Capital annually at the capital budget hearing.**
- (iv) NP will review no later than its next general rate application, the appropriateness and approach to including the remaining reconciling items in the Rate Base. This review will address the issue of discontinuing the use of regulated common equity in favour of book equity.**

## VII. RATE BASE

### 1. Average Rate Base and Return on Rate Base

NP's average rate base comprises investment in plant and equipment less accumulated depreciation to which is added an amount owed to NP by its customers in the Weather Normalization Reserve and allowances for inventory and cash working capital and from which is deducted amounts for Contribution in Aid of Construction ("CIAC"). The return on rate base comprises the cost of debt, rate of return on preferred equity and rate of return on regulated common equity.

The average rate base, return on rate base and rate of return on rate base is calculated on pg. 8 of Exhibit BVP-1 (1<sup>st</sup> Revision) for 1998 through to 2002 and forecast for 2003 and 2004. A summary of the relevant rate base figures presented by NP is as follows:

<b>Financial Results and Forecasts Rate of Return on Rate Base (000's)</b>							
	<b>Historical Data</b>					<b>Proposed</b>	
	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
Return on Regulated Common Equity	\$ 22,299	\$ 23,639	\$ 27,237	\$ 29,699	\$ 29,518	\$ 31,822	\$ 33,429
Return on Preferred Equity	626	626	626	623	613	613	613
Finance Charges	25,233	26,488	26,641	26,700	26,853	30,774	31,626
Return on Rate Base	48,158	50,753	54,494 <sup>1</sup>	57,024 <sup>1</sup>	56,984	63,209	65,668
Average Rate Base	488,204	505,688	520,979	545,162	573,337	599,245	622,650
Rate of Return on Rate Base	9.86%	10.04%	10.46%	10.46%	9.94%	10.55%	10.55%

<sup>1</sup> Subject to rounding

NP's proposed rate of return on average rate base for 2003 and 2004 is 10.55% arrived at by dividing a forecast return on rate base of \$63,209,000 (2003) and \$65,668,000 (2004), by an average rate base of \$599,245,000 and \$622,650,000 respectively.

Grant Thornton conducted a review of the pre-filed evidence comparable to these revised figures and concluded that the results were calculated in accordance with established practice and contained no discrepancies. (Grant Thornton Report – NP 2003 GRA, pgs. 21; 26)

The Board heard no evidence contesting NP's proposed rate base calculations for 2003 and 2004 but notes these specific numbers will change based on other findings of the Board as contained in this Decision.

Specifically, the Board has determined that effective in 2003 the Asset Rate Base method will replace the Invested Capital approach currently used to calculate NP's rate base and as a result deferred charges will now be incorporated in this rate base.

Based on this decision the Board calculates the impact on average rate base for the 2003-2004 test year period as follows:

	<b>2003</b> <b>(000's)</b>	<b>2004</b> <b>(000's)</b>
Average Rate Base as proposed by NP	\$599,245	\$622,650
Average deferred charges	<u>\$72,970</u>	<u>\$80,452</u>
Revised average Rate Base	\$672,215	\$703,102

The rate of return on rate base proposed by NP for the test year period is 10.55%. The decision to include deferred charges in rate base affects the translation of the weighted average cost of capital into an allowed rate of return on rate base. In moving to the Asset Rate Base method the Board accepts the premise that the change should be neutral in terms of its impact on total allowed return and revenue requirement. The Board calculates the change in revised rate of return on rate base for the test year period based on NP's Application and incorporating the Board's decisions on rate base and ROE as follows:

Applying Formulas Designated A & B:

**A. Weighted Average Cost of Capital (WACC) =**

$$\begin{array}{rcl}
 & \% \text{ Debt} & \times \text{ Embedded Cost of Debt} \\
 + & \% \text{ Preferred Equity} & \times \text{ Rate of Return on Preferred Equity} \\
 + & \% \text{ Common Equity} & \times \text{ Rate of Return on Regulated Common Equity}
 \end{array}$$

**B.**

$$\text{Rate of Return =} \quad \frac{\text{Invested Capital}}{\text{Rate Base}} \times \text{WACC} \quad + \quad \frac{Z}{\text{Rate Base}}$$

(RORB)

Calculations**2003**

A. 
$$\text{WACC} = (54.28\% \times 8.54\%) + (1.45\% \times 6.31\%) + (44.27\% \times 9.75\%)$$

$$= 9.04\%$$

B. 
$$\text{RORB} = \frac{\$668,416}{\$672,215} \times 9.04\% + \frac{(208)}{\$672,215}$$

$$= 8.96\%$$

**2004**

A. 
$$\text{WACC} = (54.05\% \times 8.39\%) + (1.39\% \times 6.31\%) + (44.55\% \times 9.75\%)$$

$$= 8.97\%$$

B. 
$$\text{RORB} = \frac{\$700,244}{\$703,102} \times 8.97\% + \frac{(150)}{\$703,102}$$

$$= 8.91\%$$

With respect to the calculation of WACC above, the Board has considered the various components which factor into this calculation.

In previous sections of this Decision, the Board has stated its findings with respect to the capital structure and the cost of equity (ROE).

The cost of preferred equity proposed by NP is 6.31%. The calculation of this rate is detailed in Exhibit BVP-14. This rate compares with the 6.33% cost assigned to preferred equity in Order No. P.U. 16(1998-99). The Board did not hear any evidence contesting this rate of return for preferred shares and accepts the 6.31% as the cost of preferred equity as proposed. This rate of return of 6.31% will also be used as the allowed rate of return on any regulated common equity in excess of 45%.

The embedded cost of debt proposed by NP is 8.54% for 2003 and 8.39% for 2004. The calculation of these rates are detailed in Exhibit BVP-12 (1<sup>st</sup> Revision). The Board has reviewed the evidence relating to embedded cost of debt, including the forecast short-term interest rates, and accepts the embedded cost of debt as proposed for 2003 and 2004 of 8.54% and 8.39% respectively.

**NP will be required to file a revised calculation of rate base and return on rate base for test years 2003 and 2004 which reflects the decisions taken by the Board.**

## 2. Range of Rate of Return on Rate Base

In Order No. P.U. 36(1998-99) the Board approved an increase in the range of return on rate base from 24 basis points to 36 basis points, stating at pg. 70:

*“The introduction of an expanded range of 36 basis points will provide an incentive for the company to improve productivity and will allow for some variation in financial variables other than those adjusted by the formula.”*

In this Application NP has proposed an increase in the range of return on rate base from 36 basis points to 50 basis points. According to NP the small changes in customer rates in 2000 and 2002 suggests that the range of rate of return on rate base used in the Formula is too narrow. The offsetting rate changes would not have occurred with a wider range. NP concludes that a wide range of rate of return on rate base will potentially result in greater rate stability and predictability for both NP and its customers. [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pg. 50]

NP’s cost of capital expert witnesses also supported the expansion of the range, stating that it will promote efficiency and result in less frequent rate changes. (Written Submissions, NP, Section B, pg. 11/9-12)

The Consumer Advocate does not support expanding the range to 50 basis points, stating that *“There is no verifiable evidence to show that the increased range from twenty-four basis points to thirty-six basis points provided a corresponding improvement in efficiency....”* (Final Submission, Consumer Advocate, pg. 30):

The Consumer Advocate argued that the only beneficiary was NP which benefited from additional revenue in 2000 and 2001 as a result of an expanded range of rate of return on rate base. If the range had been maintained at 24 basis points the Consumer Advocate submitted NP would have over earned in those years, and that this additional revenue would have gone into the Excess Revenue Account. (Final Submission, Consumer Advocate, pgs. 30-31)

In assessing this proposal Grant Thornton provided the following caution to the Board (Supplementary Evidence, Grant Thornton Report, pg. 7/15-18):

*“In assessing the Company’s proposal to expand the range of allowed return the Board should consider the issue in the context of the determination of the overall cost of capital. All of the factors related to rates of return and cost of capital are interrelated and none, including the range of allowed return, should be assessed in isolation.”*

Grant Thornton also suggested the Board consider three additional factors in assessing the appropriateness of an expanded range of rate of return on rate base:

- i) an expanded range will potentially decrease the number of rate changes and result in greater rate stability and predictability;
- ii) expanding the range results in a higher upper limit for the allowed return on rate base; and



- iii) the range of rate of return can provide an incentive for NP to improve productivity and generate operating efficiencies resulting in lower costs which would be passed on to ratepayers in a subsequent rate hearing.

The proposed change in the range of rate of return on rate base does not affect the determination of NP's overall revenue requirement for the test year period since the allowed return on rate base is the mid-point of the allowed range. The proposed change would result in a higher upper limit for the allowed return and for the purposes of defining the Excess Revenue Account.

In Exhibit BVP-20 (1<sup>st</sup> Revision) NP demonstrates that the proposed 50 basis point range of return on rate base is based on a 100 basis point range for rate of return on regulated common equity. In Supplementary Evidence (pg. 7/12-13), Grant Thornton stated that the current 36 basis point range for return on rate base has an implied 73 basis point range of return on regulated common equity for 2003. The Board notes that with the inclusion of deferred charges in rate base, this implied range of return on regulated common equity increases from 73 to 81 basis points. This change is not considered significant enough to warrant a change in the range of rate of return.

In the Board's view the range of rate of return on rate base can act as an incentive device to encourage NP to seek efficiencies between rate hearings, which can then be passed on to customers. This is evidenced in the operational efficiencies and cost savings that have been implemented by NP since the last rate hearing in 1998. The Board does not agree with the Consumer Advocate that only NP has benefited from the expanded range set by the Board in 1998. Ratepayers will derive the benefit for the efficiencies through lower costs, and hence lower rates into the future. The Board believes it is important to maintain the range as an incentive for NP to continue to seek efficiencies and productivity improvements in its operations.

The Board is not convinced however that a further expansion in the range from 36 basis points to 50 basis points, as proposed by NP, is warranted or necessary at this time. In the Board's view, while there are opportunities for future operating efficiencies, the Board feels that the existing range of 36 basis points has served both NP and ratepayers well over the period of operation of the Formula and should be maintained.

**The Board will approve a range of 36 basis points for the rate of return on rate base for test years 2003 and 2004 and for use with the Formula, unless otherwise ordered by the Board.**

## VIII. ACCOUNTING TREATMENT AND POLICIES

### 1. Amortization of Recovery of Balance in Weather Normalization Reserve

The Weather Normalization Reserve is a combination of two reserves: Degree Day Normalization Reserve and Hydro Production Equalization Reserve. The Degree Day Normalization Reserve normalizes the company's revenue and purchased power costs for annual variations in weather conditions. The Hydro Production Equalization Reserve normalizes the company's purchased power expense for annual variations in normal stream-flows to its hydro plants.

The balances in the Weather Normalization Reserve are filed with and approved annually by the Board. The balance in the reserve owing from customers as at December 31, 2001 is outlined below [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pg. 62]:

<b>Weather Normalization Reserve Balance as at December 31, 2001 (\$millions)</b>	
Hydro Production Equalization Reserve	9.4
Degree Day Normalization Reserve	<u>0.5</u>
<b>Total</b>	<b>9.9</b>

While the degree day variations have been observed to be approximating zero over time, the balance in the Hydro Equalization Reserve owing from customers has been increasing since 1987 and is at \$9,400,000 at the 2001 year end. The following table provides a breakdown of this balance for each contributing factor [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pg. 65]:

<b>Breakdown of the 2001 Hydro Production Equalization Reserve Balance (\$millions)</b>	
Increase in purchased power mill rate	4.9
Decrease in Income Tax Rate	0.7
Variation from Normal Stream Flows	<u>3.8</u>
<b>Total</b>	<b>9.4</b>

In Order Nos. P.U. 9(2001-2002) and P.U. 2(2002-2003) the Board ordered “*At the next general rate review, the function and methodology of the Weather Normalization Reserve will be reviewed by the Board whereby the Applicant shall present its views on the function and methodology of the reserve and its proposal for the disposition of the deficit balance contained in the reserve account.*” This issue was reviewed as part of this hearing. While NP has not proposed any changes in the function and methodology of the reserve account, NP does propose to recover the portion of the weather normalization reserve that is not expected to reverse over time.

NP states that the reserve balance of \$5,600,000 resulting from increases in the purchased power mill rate (\$4,900,000) and the income tax rate (\$700,000) is not expected to reverse over time. For this reason NP is proposing to amortize the recovery from customers of the \$5,600,000

balance in the Hydro Production Equalization Reserve (\$8,700,000 pre-tax) over 5 years beginning in 2003. The amortization for the period 2003 through 2007 increases purchased power expense by approximately \$1,700,000 in each year.

NP commissioned a Water Management Study in 2000 and, based on the recommendations of this study, adjusted its annual normal production levels for the purposes of calculating transfers to or from the Hydro Production Equalization Reserve. As recommended in the study, NP is also proposing a further review of normal hydro production levels and reserve balances in 2005, and every five years thereafter. This review will include a review of the mill rate and the income tax rate changes so that any necessary adjustments can be put to the Board for approval.

NP states that, as a result of its review, the Degree Day Normalization reserve is working as intended and no changes or necessity for further review are proposed.

NP's expert accounting witness, Mr. J. T. Browne, provided evidence as to whether NP's proposed treatment of the non-reversing portion of its Hydro Production Equalization Reserve is consistent with established regulatory principles. (Pre-filed Evidence, J.T. Browne, Accounting and Regulatory Issues Related to Future Employee Benefits and the Hydro Production Equalization Reserve, October 11, 2002, pgs. 15-16) Mr. Browne stated that the reserve represents a cost of providing regulated service and that, according to the cost of service standard, NP should have a reasonable opportunity to recover the balance through allowed rates, including the non-reversing amounts. He also stated that the issue is in what period should it recover the non-reversing amounts. Mr. Browne provides the following opinion on the recovery period at pg. 15 of his report:

*“With the information now available, the non-reversing amount represents costs of providing service in previous periods. Since it is not possible to adjust past rates, it would normally be appropriate to recover the balance through rates over as short a period as is reasonable, such as a period within three to five years. However, the non-reversing amount was built up over a period of 30 years. Therefore the principle of intergenerational equity is not as applicable as it might otherwise be. As a result, it is reasonable to place more of an emphasis on smoothing the impact of the amortization on rates, consistent with the principle of rate stability and predictability. An amortization period of five years achieves this. Accordingly, a five-year amortization is appropriate”.*

Mr. Browne concludes that NP's proposed treatment of the non-reversing portion of its Hydro Production Equalization Reserve is consistent with established regulatory principles.

In written submission (pg. 80-81) the Consumer Advocate cautioned the Board “*to rely on its own view of intergenerational equity*” when determining the length of time over which the outstanding balance should be recovered. Although not explicitly stated the Board takes from the Consumer Advocate's submission that a longer recovery period is preferable. A longer recovery period would reduce the revenue requirement in each year.

Grant Thornton reviewed NP's proposals with respect to the Hydro Production Equalization Reserve and found the proposals reasonable. Grant Thornton also agrees that the disposition of the \$5,600,000 outstanding balance that will not reverse over time is appropriate at

this time. The proposed amortization period of five years was seen as reasonable and in line with amortization periods used for prior balances, such as the amortization of the change in GEC from full cost accounting to incremental, and the true-up variance from the 1996 Gannett Fleming depreciation study. The impact on rates is also minimized as compared to a shorter recovery period such as three years. The impact on revenue requirement is \$1,120,000 for a five-year amortization period as compared to \$1,870,000 for a three-year recovery period. (Grant Thornton Report-NP 2003 GRA, pg. 6/7-9)

The Board is satisfied that NP's proposal to amortize the recovery of the non-reversing portion of the Reserve is reasonable and will address in part some the concerns raised in Order No. P.U. 9(2001-2002). With respect to the appropriate amortization period the Board accepts that five years is a reasonable recovery period which will allow NP to recover its costs while minimizing the impact on consumers. The Board is reluctant to extend recovery of any outstanding balance longer than necessary. The Board also accepts NP's proposal to review the balance in the reserve at the end of each five-year period and identify any non-reversing amounts. The timing of this review will coincide with the recovery period for the current outstanding balance approved in this Decision.

**The Board will accept NP's proposal to amortize the recovery of the \$5,600,000 balance in the Hydro Production Equalization Reserve over a period of five years, beginning in 2003. NP will be required to review the balance in the Hydro Production Equalization Reserve as of December 31, 2005 and to apply to the Board for an Order as to the disposition of outstanding balances, positive or negative, as part of its next general rate application.**

## **2. Adjustments to Pension Accounting**

NP currently uses the fair market method to value pension assets for the purposes of determining pension expense. NP has proposed to adopt the market-related method on a prospective basis beginning on January 1, 2003. NP states the basis for using the market-related value approach to calculate expected return on pension plan assets is to create a smoothing impact on its pension expense. NP also submits that the use of a three-year moving average provides a rational and systematic manner to recognize the pension expense and reduces the volatility of that expense caused by changing market conditions.

Grant Thornton reviewed NP's proposal and found that the pension accounting changes as proposed are reasonable and in accordance with Section 3461 of the CICA Handbook and with Generally Accepted Accounting Principles (GAAP). The move to a market-related approach will reduce pension expense in 2003 from \$4,500,000 to \$3,300,000, and in 2004 pension expense will be reduced from \$3,600,000 to \$3,400,000. (Grant Thornton Report-NP 2003 GRA, pg. 6/38-43) This results in lower revenue requirement, and therefore lower rates.

NP is proposing to adopt this approach on a prospective basis beginning January 1, 2003 rather than on a retroactive basis. NP submits that this approach is consistent with other accounting policy changes previously approved by the Board. For example, in Order No. P.U. 17(1987) the Board approved the adoption of the CICA recommendations on pension accounting on a prospective basis. [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pg. 68/4-5]

**The Board will approve NP's proposal to adopt the market-related method of determining pension expense on a prospective basis, effective January 1, 2003.**

### **3. Depreciation Accounting**

#### **i) Depreciation Study Update**

In Order No. P.U. 7(1996-97) the Board ordered NP to submit its next depreciation study in 2001. On December 14, 2001 NP filed with the Board a depreciation study prepared by Gannett Fleming Valuation and Rate Consultants, Inc. ("*Gannett Fleming*") based on plant in service as at December 31, 2000. The service life analysis performed by Gannett Fleming in the 2001 study resulted in a reduction in the depreciation rates recommended for Distribution, Transmission, Substation and Transportation equipment. The study also provided a comparison between the accumulated depreciation recorded by NP with respect to plant in service as of December 31, 2000 and a calculated reserve based on the new depreciation rates recommended. The actual reserve variance as of December 31, 2000 was calculated by Gannett Fleming at \$5,100,000. [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pg. 55/20-22]

In addition to the change in depreciation rates, Gannett Fleming recommended that NP adopt the mid-year convention for book depreciation practices. NP had historically calculated annual depreciation expenses using the full year convention, which assumes all property is in service for twelve months in the year it is installed. This results in a full year of depreciation recorded for current year's additions. The mid-year convention assumes that all property is installed on July 1 of each year, so that only a half-year of depreciation expense is recorded for current year's additions. Based on Gannett Fleming's recommendation NP adopted the mid-year convention in 2001, resulting in a reduction in depreciation expenses for 2001 of approximately \$900,000 in that year. [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pg. 56/11-13]

As part of this Application NP filed an updated depreciation study, also completed by Gannett Fleming. This study reflects changes in plant in service as at December 31, 2001 and also includes, as part of the plant in service, the joint use poles purchased from Aliant. In addition Gannett Fleming calculated the accumulated reserve variance as at December 31, 2001 based on the mid-year convention for book depreciation as adopted by NP in 2001. In the updated study Gannett Fleming recommended that NP record the joint use poles purchased from Aliant using original cost and accumulated depreciation. Gannett Fleming also recommended that NP continue to use the straight-line equal life group method that it has been using for a number of years for its plant assets with the exception of certain General and Communication accounts.

The Consumer Advocate did not raise any specific objections to the recommendations of the 2002 Depreciation Study as proposed by NP to be adopted on a prospective basis. In written submission (pg. 80) the Consumer Advocate argued that, if NP had adopted the recommendations of the 2001 Gannett Fleming Study in 2002, NP's revenue requirement for that year could have been reduced by \$5,800,000. The Consumer Advocate submits that this contributed to NP's higher ROE return in 2002.

Grant Thornton reviewed the 2002 Updated Depreciation Study and confirmed that the results and recommendations of the study have been incorporated into NP's depreciation estimates for 2003 to 2004. Grant Thornton also confirmed that the use of the half-year rule for calculating depreciation on net capital additions is very common practice and is in compliance with generally accepted accounting principles. (Grant Thornton Report-NP 2003 GRA, pgs. 11-12)

The Board has reviewed the submissions and evidence regarding the Depreciation Study and accepts the recommendations of the study. The Board does not accept the Consumer Advocate's submission that adoption of the study in 2002 would have reduced NP's revenue requirement. The Board considers the issue of revenue requirement as part of its consideration of test year expenses in a general rate hearing. Adoption of any of the recommendations outside a test year period would not have affected rates to consumers, whether the impact was positive or negative.

**The Board will approve the 2002 Depreciation Study as filed. The depreciation rates as recommended in the Depreciation Study will be approved for calculating depreciation expense for the test year period 2003 and 2004**

**ii) Reserve Variance Adjustment**

Gannett Fleming has calculated the accumulated reserve variance as at December 31, 2001 based on application of the mid-year convention. This results in an increase in the reserve variance from \$5,400,000 as at December 31, 2000 to \$17,200,000 as at December 31, 2001. Gannett Fleming has recommended that where the reserve variance exceeds 5% on an individual account basis, the accumulated reserve variance for that account be amortized over the account's composite remaining life. This would result in a reduction of depreciation expense ("*true-up*") of \$1,200,000 in each of the next five years, and would still result in accumulated reserve variances not being fully amortized. This approach was also recommended by Gannett Fleming in the 1996 Depreciation Study. In Order No. P.U.7 (1996-97) the Board determined that from the perspective of correcting a depreciation estimate every five years (based on the time frame between depreciation studies) the amortization of the accumulated reserve variance over five years has the quality of intergenerational equity. If a 5-year amortization period is used for the true-up, depreciation expense is reduced by \$3,500,000 in each of the next 5 years. [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pgs. 58-59]

In this Application NP is proposing that the reserve variance in excess of 5% be amortized over a three-year period 2003-2005, resulting in a depreciation expense reduction or "*true-up*" of \$5,800,000 in each of these years. NP states that the three-year amortization period coincides with the next depreciation study expected in 2006, based on plant in service as of December 31, 2005 and is consistent with the Board's view on intergenerational equity expressed in Order No. P.U. 7(1996-97). This approach also reduces the costs borne by NP's customers for that period. [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision) pg. 60] Based on NP's proposal the amount of \$5,800,000 has been used to reduce NP's revenue requirement in each of 2003 and 2004.

While the Board adopted a five-year amortization period for the depreciation expense true-up in 1996, NP's proposal in this Application to use a three-year recovery period reduces expenses for the test year period and results in lower costs to be recovered from consumers. The Board agrees with NP that this proposal is consistent with the principle of intergenerational equity.

**The Board will approve NP's proposal to amortize the depreciation reserve variance over the three-year period 2003-2005.**

#### **4. Accounting Treatment for Other Employee Future Benefits**

NP's other employee future benefits, other than pensions, include retirement allowances to qualifying employees and the cost of health, medical and life insurance for retired employees. These expenses are currently recognized by NP on a cash basis. The current costs for health, medical and life insurance for retired and current employees is estimated to be \$1,400,000 in each of 2003 and 2004, of which approximately 75% is charged to operating expenses. The cost of retirement allowances in 2003 and 2004 is estimated to be \$200,000. These costs are tax deductible in the year they are incurred [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pg. 71]

Section 3461 of the CICA Handbook recommends the use of the accrual method of accounting for other employee future benefits effective January 1, 2000. The accrual method requires the financial statements to reflect the estimated cost incurred during the financial reporting period.

NP states that adopting the accrual method of accounting for these benefits would represent a change in accounting policy for the company. In Exhibit BVP-25 (1<sup>st</sup> Revision) NP compares the current cost of its employee future benefits and the estimated accounting expense for these benefits if the company adopted the CICA recommendations. According to this Exhibit a change to accrual accounting for other employee future benefits will result in a \$4,100,000 increase in revenue requirement for 2003, including additional income tax of \$1,500,000.

As a result of the impact of moving to the accrual method NP is proposing to continue to account for employee future benefits on a cash basis. NP also states that it will continue to monitor this obligation and corresponding regulatory practice and that it may propose to recover these costs on an accrual basis in the future.

NP's accounting expert witness, Mr. J.T. Browne, provided the following opinion on this issue (Pre-filed Evidence, J.T. Browne, Accounting and Regulatory Issues Related to Future Employee Benefits and the Hydro Production Equalization Reserve, October 11, 2002, pg. 10):

*“NP is not following Section 3461 in accounting for its OFEBs and what GAAP would normally require. However, as long as it is reasonably expected that rates will produce sufficient additional revenue to cover the cost of the future employee benefits in rates when payment is required and such rates will be chargeable and recoverable from customers, NP's accounting policy for its OFEBs is in accordance with GAAP. If the Board approves NP's proposal to continue with the pay-as-you-go method for rate setting purposes, it is likely that the above conditions will be met and NP's accounting policy for its OFEBs will be in accordance with GAAP.”*

In addressing the question of whether NP's treatment of employee future benefits for rate setting purposes is consistent with established regulatory practice, Mr. Browne concludes at pg. 13 of his report that:

*"From the perspective of the principle of intergenerational equity, the accrual method for recovering OFEB costs is preferable to the pay-as-you-go method proposed by NP. However, the NP proposal is a practical approach that recognizes the impact of dealing with the transition from one method to the other".*

Grant Thornton also reviewed NP's proposal and concluded that NP's proposal of using the cash basis for accounting for other future employee benefits is acceptable. (Grant Thornton Report-NP 2003 GRA, pg. 8/1-2)

In addressing this proposal the Board is cognizant of the fact that in Order No. P.U. 7 (2001-2002) it approved NLH's proposal to adopt the accrual method of accounting for other employee future benefits in accordance with GAAP. However as part of its proposal, NLH did not propose to recover from ratepayers the actuarial accrued balance of other employee future benefits of \$21,200,000, proposing instead to write-off this balance against prior period earnings. In the case of NP the additional cost to ratepayers of moving to the accrual method is in the order of \$4,100,000 in each of 2003 and 2004. To avoid rate impact on consumers the Board is prepared to accept NP's proposal to continue with using the cash basis for recognizing expenses for other employee future benefits.

The Board is concerned about the potential liability for employee future benefits and is of the view that NP should explore using the accrual method of accounting for these benefits. The Board recognizes that there are significant transitional obligations associated with this change in accounting policy but once the transitional obligation has been met these costs should decrease. NP should continue to monitor its obligations with respect to employee future benefits and corresponding regulatory practice. The Board will direct NP to propose a plan at its next general rate application for moving towards the accrual method of accounting for employee future benefits as recommended by CICA. The Board emphasizes such a plan should be presented to the Board as an alternative to the existing method and should address the transitional impact with a view to fulfilling NP's obligation to its employees while at the same time moderating its impact on rates. The Board will then be in a position to consider this alternative accrual method and its specific impacts at the next hearing.

**The Board will approve NP's proposal to continue using the cash basis for recognizing expenses for other employee future benefits. With its next general rate application, NP will be required to submit a report which addresses the use of the accrual method as an alternative to the existing accounting treatment for other employee future benefits.**



## 5. Amortization of Regulatory Costs

NP is proposing to amortize over a three-year period the estimated external costs of \$1,200,000 associated with the public hearing of this Application. This results in a recovery of \$400,000 per year for each of the next three years. This proposed treatment of hearing costs is similar to that approved by the Board in Order No. P.U. 36 (1998-99) following NP's 1998 General Rate Proceeding. In that Order the Board approved amortization of external hearing costs of \$1,150,000 over a three-year period commencing in 1999.

Grant Thornton has reviewed NP's proposal and concludes that the proposal is reasonable. According to Grant Thornton the deferral of such costs is intended to better match the costs of major proceedings over the intervening period and also smoothes the effect on NP's cost of service, which is advantageous to the consumer.

The Consumer Advocate and NLH did not raise any issues with this proposal. The Board accepts the proposal as reasonable and consistent with past regulatory practice.

**The Board will approve NP's proposal to amortize over a three-year period, beginning in 2003, the estimated regulatory costs of \$1,200,000.**

## 6. Disposition of Excess Revenue Account – 2001 Excess Earnings

In Order No. P.U. 29(2001-2002) the Board approved the following definition of the Excess Revenue Account:

*“This account shall be credited with any revenue in excess of the upper limit of the allowed range of return on rate base as determined by the Board. Disposition of any balance in this account shall be as determined by the Board. For 1998 all earnings in excess of 9.99% rate of return on rate base, for 1999 all earnings in excess of 10.16% rate of return on rate base, for 2000 and 2001 all earnings in excess of 10.46% rate of return on rate base, and for 2002 and subsequent years all earnings in excess of 10.24% rate of return on rate base shall, unless otherwise ordered by the Board, be credited to this account.”*

In 2001 NP earned excess revenue of \$944,000 over the upper limit of the allowed range of return on rate base of 10.46% as set by the Board for 2001. This amount was reported by NP to the Board in Return 10A of its 2001 Annual Report to the Board. As required this amount was set aside in the Excess Revenue Account to be disposed of as determined by the Board. In this Application NP is proposing to apply this excess revenue to reduce the revenue requirement equally for 2003 and 2004 (\$472,000 in each year), which will in turn result in lower rates to customers over this period. [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pg. 74/6-8]

Grant Thornton reviewed NP's proposal and concluded that NP's proposed approach was reasonable and that ratepayers will receive full recovery of the \$944,000 over the two-year period 2003 and 2004 (Grant Thornton Report-NP 2003 GRA, pg. 9/13-15). Grant Thornton also addressed the option of rebating the amount directly to consumers, as was approved by the Board in dealing with the disposition of the 2000 excess earnings of \$6,500,000. Grant Thornton points out that, since NP is requesting a rate increase in this Application, rebating the excess

earnings to consumers would result in a higher increase in rates being requested for 2003. As well the magnitude of the 2001 excess earnings is considerably less than it was for the 2000 excess earnings and hence the impact on consumers would be significantly less.

During the hearing the Consumer Advocate raised the issue of the appropriate disposition of the Excess Revenue Account, suggesting that any amounts in the Excess Revenue Account should be rebated to consumers forthwith. (Transcript, April 8, 2003, pg. 88/14-22 and pg. 89/6-12) The Consumer Advocate also suggested that NP's handling of the Excess Revenue Account disposition during its rate filing was not transparent and was confusing to consumers.

The Board is satisfied that NP has acted properly and in compliance with Board directives with respect to the Excess Revenue Account, and in particular in relation to the disposition of the existing balance. The Board approved the existing definition of this Account in Order No. P.U. 29(2001-2002) and NP has properly credited this account in 2001 with earnings above the 10.46% rate of return on rate base, as required. The Board has the authority and discretion to determine the disposition of this Account and the Board will exercise this discretion in this Decision.

As a result of the Board's finding in this Decision on the ROE to be used in setting the rate of return on rate base, the Board expects that there will be a decrease in revenue requirement for the test year period. As a result NP's proposal to apply the 2001 excess earnings against the increased revenue requirement to minimize the rate increase is no longer valid. In the Board's view the appropriate disposition of this account would be to rebate the excess earnings to customers.

**The Board finds that the 2001 excess earnings of \$944,000 should be rebated to customers. NP will be required to submit a proposal for this rebate as part of its filing of revised rates.**

## **7. 1992-1993 Excess Earnings**

In Order No. P.U. 36(1998-99) the Board determined that there were excess earnings in 1992 and 1993 totalling \$1,908,000 on an after tax basis. The Board ordered "*The amount of \$1,908,000 which is the total of the after tax excess earnings for 1992 and 1993, be established as a component of common equity on which no return will be allowed for the period 1999-2003. The total amount to be recovered is \$954,000, which represents one-half of the after tax excess earnings, and a review will take place before the end of the year 2003 as to the disposition of any outstanding amount.*"

Since 1999 NP has been complying with this Order and, up to 2002, has recovered \$715,118 of the total \$954,000, leaving \$238,882 remaining to be recovered. [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision) pg. 85] The amount of \$715,118 recovered from 1999 to 2002 represents a reduction in revenue from rates and savings to ratepayers of \$1,233,000 over this period.

NP is proposing to recover the outstanding amount over the two-year period 2003-2004, by adjusting rates as of August 1, 2003 to give a prorated recovery based on energy sales from

August 1 to December 31, 2003. The effect of this adjustment would be a total recovery of \$112,000 in 2003 and \$335,000 in 2004, for a total recovery of \$447,000, including income tax effects. [Exhibit BVP-28, (1<sup>st</sup> Revision)]

Grant Thornton reviewed NP's proposal and concluded the approach was reasonable and achieves better than full recovery for ratepayers over the two-year period. (Grant Thornton Report-NP 2003 GRA, pg. 10/32-34)

**The Board will accept NP's proposal for adjusting 2003-2004 revenue requirement to recover the outstanding amount of the 1992-1993 excess earnings as required by Order No. P.U.36(1998-99), subject to any adjustments arising from this Decision.**

## **8. Deferral of Certain Outstanding Issues**

### **i) Revenue Recognition Study**

NP has asked the Board for approval to defer dealing with the outstanding issues relating to the revenue recognition study and the Unbilled Revenue Increase Reserve Account pending resolution of an outstanding dispute with the Canada Customs and Revenue Agency (CCRA). The dispute deals with NP's current policy of revenue recognition and an associated income tax reassessment by CCRA.

NP has always recorded revenue as customers are billed whereas CCRA's position is that NP is required to report its revenue on the accrual basis. NP maintains that it is recording revenue in accordance with Board Orders. The issue relates primarily to the billings and associated revenue for electrical consumption for the last two weeks of the year, for which bills are issued after December 31. The revenue for those two weeks is approximately \$20,000,000, before taxes. (Transcript, April 9, 2003, pg. 5/2-25; pg. 6/1)

In Order No. P.U. 36(1998-99) the Board ordered NP to file a revenue recognition study with the Board before its next general rate application or by March 31, 2000, whichever is earlier. The Board later amended this Order by deleting reference to March 31, 2000 and substituting the words "*at such time to be determined by the Board.*"

NP submitted that the filing of a revenue recognition study at this time could potentially prejudice its position with respect to its dispute with CCRA over the Income Tax Reassessment. According to NP if it were to lose this dispute it would mean a liability of approximately \$14,400,000, of which 50% has already been deposited with CCRA. This liability would have to be recovered through electricity rates.

The Consumer Advocate questioned NP's company witness, Mr. Perry and Mr. Brushett of Grant Thornton, the Board's Financial Consultant, on this issue. In response to a question from the Consumer Advocate on the revenue impact to NP of using the accrual method to recognize revenue, Mr. Brushett testified: (Transcript, April 9, 2003, pg. 6/12-25)

- A. From an accounting point of view, you're correct in that there would be additional revenue recognized offsetting an expense that would have to be recognized. But just so that the record's clear and the Board understands, there's no extra revenue. There will be no extra cash coming in. It's a timing thing. This is revenue that, under an accrual method, would be recognized in December instead of being recognized in January. So it's no extra cash available to pay it as such but it is, from an accrual accounting point of view, the timing of recognition, yes, one would offset the other.

The Consumer Advocate's position on this issue was set out in final submission (pg. 79):

*"If, as it appears, there is no detriment to consumers by changing to the accrual method advocated by CCRA no further expenditures should be made from regulatory funds in reference to this issue. If NP's shareholder wishes to proceed with the case for reasons best known to itself, the cost of financing this case, together with interest and penalties, should come from non-regulated funds or be supported entirely by NP's shareholders."*

The Board has outlined its position with respect to the revenue base and the revenue recognition policy of NP in Order No. P.U. 36(1998-99). The Board accepts NP's position in this proceeding that any further consideration of this issue at this time may prejudice the outcome of its current dispute with CCRA with respect to the Income Tax Reassessment relating to revenue recognition. The Board does not agree with the Consumer Advocate that NP's pursuit of this issue with CCRA is not beneficial to ratepayers. Resolution of the issue will provide certainty to the Board and NP on a go forward basis. The Board will deal with any issues arising from the final decision of the tax case, including any potential liabilities or benefits to ratepayers, once the case has been resolved.

**The Board will approve NP's request to defer dealing with the outstanding issues relating to the Revenue Recognition Study pending resolution of the dispute with CCRA.**

**ii) Unbilled Revenue Increase Reserve Account**

In Order No. P.U. 36(1998-99) the Board established an unbilled revenue increase reserve account to record the difference between recognizing revenue based on the two differing revenue recognition policies and the difference arising from a delayed implementation of an approved rate increase from January 1, 1999 to February 1, 1999. The Board ordered that the disposition of this account be dealt with after the revenue recognition policy has been fully reviewed at a public hearing.

**Since the Board has agreed to the deferral of the issues relating to the Revenue Recognition Study until the dispute between NP and CCRA is resolved, the Board will also approve NP's request to defer dealing with the disposition of the unbilled revenue increase reserve account. This issue will be dealt with as part of the Order arising from consideration of the Revenue Recognition Study to be filed by NP, as was intended in Order No. P.U. 36(1998-99).**

## 9. Accounting for Early Retirement Programs

The Consumer Advocate raised the issue of NP's accounting treatment of early retirement programs. In 1999 NP applied to the Board for approval to amortize and fund pension liability over an extended period, which was approved in Order No. P.U. 24(1999-2000). However in 2000 and 2001 early retirement programs were funded and expensed in those years. The Consumer Advocate argues that this *"uneven treatment of such an expense can lead to consumers losing out on a fair opportunity to share in NP's excess revenue if in that year NP manages to over-earn on its ROE but stays within its range of return on rate base, based on NP's interpretation of the Stated Case."* ( Final Submission, Consumer Advocate, pg. 81) The Consumer Advocate recommends a 10-year amortization for early retirement programs.

NP's position on this issue is stated below [Pre-filed Evidence, B. V. Perry (1<sup>st</sup> Revision, pg. 69/11-16]:

*"CICA recommendations provide that the cost of early retirement programs be recorded in the current period. When the forecast cost of any retirement program is so large that recognition of the costs in one accounting period will have a material negative impact on Newfoundland Power's financial position in that particular year, the Company has applied to the Board to deviate from CICA recommendations and amortize the early retirement program costs over a period of years."*

On questioning by Board Hearing Counsel Mr. Perry described NP's approach to deciding how to expense an early retirement program:

- A. ....I think when we assess the financial operations of the Company and make our decision whether to come before the Board, that's a management assessment, you know, we're at the point in the year when we're prepared to offer the program, can we expense it right away, get the cost out of the way immediately and not come before the Board based on our judgement of what the financial results are, I think that's management, you know, it's strictly management, so I believe it's working the way it is right now, and I think the Company has proven that its approach on early retirement programs are doing very good and it's been probably the biggest tool we've had to cut costs in our operations. So I'm not certain it's one that we should tinker with.  
(Transcript, March 11, 2003, pgs. 152-153/14-6)

Mr. Brushett of Grant Thornton was also questioned on this issue by the Consumer Advocate. When asked about the impact of expensing the early retirement programs in 2000 and 2001, both years when NP had excess earnings, Mr. Brushett stated:

- A. That's correct. In those two years, had there been a decision to defer and amortize, there would have been additional excess earnings. But I guess the other consideration that the Board would have to look at here is that the costs would be recovered from rate payers at some point. It's just a matter—what we're talking about now is the timing. So are they charging off in those years, in years when, for lack of better terminology, you know, they can be absorbed. They do reduce, hypothetically, a rebate that might otherwise go back to consumers, but that would be giving them a cheque today and taking it back from them in 2004, 5, 6, 7 and 8. So it's really what we're talking about is timing, and I think those are the issues that the Board would have to consider. At the end of the day, the total cost of these amendments to the pension plan and the cost of the early retirement programs would be recovered from rate payers. It's just a matter of can you absorb it in those years or-

- Q. Sure. And I'm not denying that they would be recovered, I'm just wondering what the timing is and shouldn't that be some consistent policy.
- A. So under the scenario that you're suggesting, you know, might have resulted in a rebate in those years, but then rates would be higher next year and the year after and so on as a result of that. So that's I guess the considerations that the Board would have to take into account in assessing it.

The Board agrees with NP that the decision to offer early retirement programs and the accounting treatment of those programs is a management issue and that CICA guidelines should apply in the first instance. If the impact on the financial position of NP of expensing the costs as required by CICA is material then NP would either have to not offer the program or apply to the Board to recover those costs over a period of time. The costs for the 2000 and 2001 early retirement programs were not recovered in rates and, now that the programs have been expensed, will not be required to be recovered in future rates. Consumers are also benefiting on a go forward basis from the lower operating costs resulting from reduced labour expenses. While amortization of the 2000 and 2001 programs may have resulted in higher excess earnings, amortization would also mean that those costs would now be incorporated into rates for recovery. The Board agrees with Mr. Brushett that, from a consumer perspective, it's an issue of timing and that ultimately the total costs of any program would be recovered.

**The Board accepts NP's treatment of expenses associated with the 2000 and 2001 early retirement programs.**

## IX. REVENUE REQUIREMENT

### 1. Test Year

Section 3(a)(ii) of the *EPCA* states:

*“It is declared to be the policy of the province that...*

(a) *the rates to be charged, either generally or under specific contracts, for the supply of power within the province...*

(ii) *should be established, wherever practicable, based on forecast costs for the supply of power for 1 or more years.”*

NP’s proposals for revenue requirement and resulting rate changes are based on test years 2003 and 2004. It has been the practice of the Board to utilize forward-looking test year costs for a single year. The 1998 hearing utilized forecast costs for 1999 as the test year for the purpose of setting rates and also for implementing the automatic adjustment formula.

The issue of the use of a 2003 and 2004 test year period was canvassed by Board Hearing Counsel in cross examination of Mr. Perry (Transcript, March 13, 2003, pg. 79/81):

Q. Mr. Perry, we’ll start with a general question, if you will, in a number of instances in the application, Newfoundland Power is asking for the Board’s approval of accounting treatments or rates of return or the fixing or determining of forecast rate base for both fiscal year 2003 and fiscal year 2004. And I’m wondering if you could tell us whether, from a Company’s perspective, do we have a 2003 test year that the Board’s dealing with or a 2004 test year or are both test years from the power company’s perspective?

A. Commissioners, we’ve had some debate on this, I guess, internal to the Company, but essentially we’re looking at both years. We believe that by the time we get through the hearing and we receive the order of the Board we’re going to be halfway through this year probably. So we feel that brings in 2004 as the year that will see the full impacts of the Company’s proposals and the Board’s order. So, we felt that it made sense if we could put together a proposal that carried us through both years and that’s how we see it.

Q. So, you see 2004 as a test year, then?

A. Yes, I guess I would say that, Mr. Kennedy, you know, essentially, it’s – we’re looking at the two-year period as what we’ve put before the Board as being, you know, what the Company believes is sufficient to carry it through to the end of 2004...

None of the other parties took a position on the issue of the test year.

The Board accepts NP’s reasoning for proposing a test year period to cover 2003 and 2004. Many of the proposals for deferred costs and amortization of recoveries have been spread over the two-year period. If the Board were to adopt a test year of 2003 along with an automatic adjustment formula, the Formula would have to be used in the fall of 2003 to set rates for 2004, which could result in two rate adjustments within a relatively short time frame.

**The Board will use fiscal years 2003 and 2004 as the test years for determining revenue requirement, as proposed by NP.**

## 2. Test Year Revenue Requirement

Revenue requirement is the sum of the required return on rate base, depreciation and total operating costs to be recovered from consumers in rates. Total operating costs include purchased power, income taxes and operating expenses.

NP's proposed revenue requirement is shown below: [Exhibit BVP-26 (1<sup>st</sup> Revision); Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pg. 83]

<b>Summary of Proposed 2003 and 2004 Revenue Requirement (\$000s)</b>		
	<b>2003</b>	<b>2004</b>
Purchased Power	226,499	229,941
Operating Expenses	51,837	52,434
Depreciation Expense	29,234	30,589
Income Taxes	16,644	16,983
Return on Rate Base	<u>63,209</u>	<u>65,668</u>
	<b>387,423</b>	<b>395,615</b>
Deductions:		
Other Revenue	(7,787)	(8,593)
2001 Excess Revenue	(472)	(472)
Non-Regulated Expenses (Net of Tax)	<u>(725)</u>	<u>(725)</u>
Revenue Requirement from Rates <sup>1</sup>	378,439	385,825
Revenue from Existing Rates <sup>2</sup>	<u>377,237</u>	<u>82,193</u>
<b>Required Increase in Revenue from Rates</b>	<b>1,202</b>	<b>3,632</b>

<sup>1</sup> Before adjustment for 1992-1993 Excess Earnings (See pg. 86 of this Decision).

<sup>2</sup> Rates as approved by Order No. P.U. 29 (2001-2002) as adjusted for RSA and MTA in Order No. P.U.22 (2002-2003) and continued as interim rates under Order No. P.U. 35 (2002-2003)

The following expenses comprising NP's proposed revenue requirement are reviewed by the Board:

### i) Purchased Power

Purchased power expense is the largest of NP's expenses in providing electrical service and accounts for almost 59% of NP's gross revenue requirement. Estimates of purchased power expense depends on the forecast energy sales and the rate charged to NP by NLH for electricity purchased by NP. Purchased power expense is affected by the operation of the Weather Normalization Reserve, as discussed on pgs. 77-79 of this Decision, and elasticity impacts due to the proposed rate increase.

The forecast purchased power expense includes an amount of \$1,700,000 in each of 2003 and 2004 due to the amortization of the balance in the Weather Normalization Reserve. A reduction of \$100,000 in 2003 and \$300,000 in 2004 is applied to account for elasticity impacts.

The Board has accepted NP's forecast of customer growth and energy sales for the test year period as described on pg. 29 of this Decision. These forecasts, along with the wholesale



rate charged by NLH, form the basis for the purchased power expense. If the wholesale rate charged by NLH for purchased power changes as a result of NLH's general rate application to the Board, NP will apply for an increase in rates to account for this increased expense.

**The Board accepts the purchased power expense for the test year period 2003-2004, as proposed by NP, subject to any adjustments arising from this Decision.**

**ii) Operating Expenses**

Operating expenses account for approximately 13% of NP's total revenue requirement in each of 2003 and 2004. These expenses include labour costs, which account for over 50% of the total operating expenses, vehicle expenses, materials, travel, telecommunications, tools and clothing allowances, insurances, equipment rental and maintenance, vegetation management, and other similar types of expenditures.

NP can exercise some control over operating costs and this area is where NP has focused most of its effort in finding efficiencies and minimizing costs.

Over the period 1998 to 2003, NP's gross operating expenses are expected to remain relatively stable, ranging from \$55.4 million in 1998 to a forecast of \$54.5 million in 2004. [Pre-filed Evidence, E. A. Ludlow, (1<sup>st</sup> Revision), pg. 6/7-9] Over the same period the number of customers and NP's total sales will have increased by 4.9% and 10.8% respectively. On a per customer basis, gross operating expenses are forecast to decrease over the period by 7%, compared to forecast inflation of 11.9%. (Pre-filed Evidence, E. A. Ludlow, pg. 7/6-10)

The operating expense forecasts for the test year period 2003-2004 have been adjusted to account for the deferral and amortization of regulatory costs and the move to a market-related value for calculating pension expense, as shown below [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pg. 81]:

<b>Proposed Operating Expenses: 2003-2004</b>		
<b>(\$millions)</b>		
	<b>2003</b>	<b>2004</b>
Operating Expense Forecast	54.1	52.5
Deferral of Regulatory Costs	(0.8)	0.4
Pension Expense Changes	<u>(1.5)</u>	<u>(0.5)</u>
<b>Proposed Operating Expense Forecast</b>	<b>51.8</b>	<b>52.4</b>

The adjustments for regulatory costs and pension expense changes are discussed in detail on pg. 84 and pgs. 79-80 this Decision.

The majority of the proposed operating expenditures were not contested in the hearing. The primary area challenged by the Consumer Advocate was the level of executive compensation and the Board will deal with this area separately.

As a result of Order No. P.U. 7(1996-97), NP has been filing with the Board annually its Advertising and Marketing Report the purpose of which was to detail objectives for the year as

well as quantitative measures of success and a description of advertising efforts. Since 1997 the Board's Financial Consultants have included in their annual review of NP a report on its advertising and marketing expenses. Over that period they have consistently reported that nothing has come to their attention that would indicate that NP is not in compliance with Order No. P.U. 7(1996-97).

The Board will continue to instruct its Financial Consultants as part of their annual financial review of NP to report on advertising and marketing expenditures of the Company to ensure that these expenditures meet the criteria established in Order No. P.U. 7(1996-97). However, the Board feels that the annual filing of a separate report is no longer necessary.

**The Board accepts the proposed operating expense forecast for the test year period 2003-2004, with the exception of executive compensation which is dealt with separately below.**

**The Board will no longer require NP to file an annual Advertising and Marketing Report.**

#### Executive Compensation

The Consumer Advocate has taken issue with the level of executive compensation in this proceeding and has asked the Board to reduce the level of compensation recovered in rates.

In P.U. 36(1998-99) the Board reviewed in detail NP's overall methodology for setting executive and management compensation. During the 1998 proceeding NP submitted that its executive compensation plan was appropriate on the grounds that [Order No. P.U. 36(1998-99), pg. 36]:

- i) the process of determining compensation used by the company was reasonable, involving the Board of Directors (absent of the executives involved), Hay Management Group and a Human Resources Committee with independent parties;
- ii) the targets used are reasonable and represent an all Canadian industrial reference community; and
- iii) the implementation of the executive and management compensation plan below target was reasonable and conservative.

NP also argued at the 1998 hearing that, with respect to Short Term Incentives (STIs), the 1999 test year figures are based on bonuses at 100% of target, as compared with the awarding of 130% of target in 1997. Bonuses in excess of 100% of target are the responsibility of the shareholder. During the 1998 proceeding the Consumer Advocate took issue with the level of executive compensation and the magnitude of increases over a two-year period. Other issues raised by the Consumer Advocate in 1998 concerned the use of the all Canadian Industrial reference group and NP's assertion that it needed to use this reference community in order to be able to attract, motivate and retain executives.

In Order No. P.U. 36(1998-99) (pg. 41) the Board "*accepted the level of executive and management compensation as reasonable, in the absence of any evidence to the contrary*".

In this Application NP has not proposed any changes to the methodology for setting executive compensation. The following table compares the average base salaries, STI payouts and other compensation for the period 1999-2002, and for the forecast period 2003-2004.

<b>Executive Compensation 1999-2004F (Based on CA-664)</b>						
<b>Year</b>	<b>Total Base Salary<sup>1</sup></b>	<b>% Change</b>	<b>Total Short Term Incentive<sup>2</sup></b>	<b>% Change</b>	<b>Total Salary + STI</b>	<b>% Change</b>
1999	667,887		200,000		867,887	
2000	721,922	8.09%	268,558	34.28%	990,480	14.1
2001	818,000	13.31%	430,000	60.11%	1,248,000	28.0
2002	875,000	6.99%	487,500	13.37%	1,362,500	9.2
2003F	903,100	3.21%	257,775	-47.12%	1,160,875	(14.8)
2004F	930,193	3.00%	265,509	3.00%	1,195,702	3.0

<sup>1</sup> Certain figures have been omitted from the table for consistency and comparison purposes. Corporate Counsel & Secretary was removed from Management to Executive in 2001, and the Vice President, Engineering & Energy Supply retired in 2001 without being replaced.

<sup>2</sup> STI forecast for 1999 test year (during 1998 general rate application proceeding) at 100% payout for revenue requirement calculation. Grant Thornton's report filed at the 1998 proceeding (pg. 5) indicates 100% payout of STI was \$164,400. This table shows actual STI payouts, over and above the 100% payout level.

The Consumer Advocate argues that, since the Board approved NP's executive compensation in 1998, the level of compensation has risen dramatically. The Consumer Advocate also took issue with the submission of NP that it is necessary to compensate executives on a national scale to be able to attract and retain executives, suggesting that NP could provide but one example of an executive recruited on a national scale. It was argued by the Consumer Advocate that the evidence is that NP's policy is to promote from within NP and by way of transfer from within the Fortis Group of Companies, with three members of the Executive Team being transferred to Fortis since 1998. The Consumer Advocate favours the approach taken by the Nova Scotia Utility and Review Board (NSUARB) in their recent decision concerning executive compensation at Nova Scotia Power Inc. (NSUARB-NSPI-P-875, October 23, 2002), stating that the circumstances are similar. (Final Submission, Consumer Advocate, pg. 61)

The Governance and Human Resources Committee of NP's Board of Directors is responsible for providing advice and recommendations to the Board of Directors regarding bonuses and incentives as well as total annual compensation to NP's executives. Final approval of overall compensation and bonuses is made by the Board of Directors. Mr. Bruce Chafe, Chair of the Board of NP and Chair of the Governance and Human Resources Committee testified on the issue of executive compensation. In responding to questioning from the Consumer Advocate on the level of compensation paid to NP's executive Mr. Chafe provided the following comments: (Transcript, April 4, 2003, pg. 6-7)

- Q. So could you comment, please, Mr. Chafe, on the level of compensation paid to Newfoundland Power's executive?
- A. I firmly believe that the compensation paid to the executives of Newfoundland Power is fair and reasonable.
- Q. And are there basic goals within which—that you aim for in establishing the level of executive compensation?

- A. There are two primary goals. One is to attract and retain competent, skilled professional executives, and to do this, we have to set their base compensation on a median of industrial companies in Canada. We believe this is fair. Newfoundland Power is a large—I like to think of it as an industrial company, complex company, and I believe to base it on a median of industrial companies in Canada is reasonable, given that the market for these executives, this talent that we have to employ, is of a national scale.

The second, having set the base salaries, the second plank, and I believe these are the fundamentals to properly rewarding any executive group, the second plank is to provide an incentive. It's one thing to pay a base salary. Another is to provide a financial incentive primarily to ensure their performance. In Newfoundland Power's case, we have a balanced set of operating objectives which we set, as I mentioned earlier, in the meetings, the targets and goals to be achieved and these are pretty mathematical, as well as practical, and these targets include reliability, safety, controlling operating costs, and earnings.

Grant Thornton reviewed NP's approach and process with respect to setting executive compensation and compared it to the approach and process used in 1998, concluding (Grant Thornton Report-NP 2003 GRA, pg. 39):

*“Essentially the approach used today is the same as in 1998. Specifically, the overall design and components of the plan have not changed and the policy of setting compensation by reference to the median of the Canadian industrial practice is consistent with 1998.”*

The 2001 Hay Report (CA-251) reviewed the job evaluation ranking of executives, the competitive position of the individual elements of compensation, and the existing compensation policy. The analysis in the 2001 Hay Report compares compensation practice at NP to that of the median of Canadian Industrials, and outlines the recommendations with respect to compensation at NP. The most significant recommendation affecting executive compensation concerned the design of the STI program and non-cash benefits.

In the Board's view the information before it does not support the Consumer Advocate's contention that Executive Salaries have risen dramatically since 1998. While overall levels of compensation have increased, annual base salary increases have ranged from approximately 3%-8% once the salaries are normalized to adjust for retirements and hirings. These base salary increases are not, in the opinion of the Board, unreasonable. Most of the increase in overall compensation has been in the areas of STI payouts. However, the Board notes that STI payouts in excess of 100% of target, as approved by the Board in 1998, were borne by the shareholder, Fortis, since these amounts were not included in the 1999 test year revenue requirement. The forecast STI payouts for 2003 and 2004 in revenue requirement are based on 100% payout and are significantly lower than the payouts for 2000 and 2001.

In cross-examination of Mr. Hughes, Board Hearing Counsel raised the issue of STI payouts in excess of 100% of target in a year where NP had declared portion of the STI payout above 100% would decrease the amount of excess earnings that would otherwise have been declared by NP.

- Q. So, in a situation like that can I ask you what your view would be on that 150,000 figure that we're using, do you see that as a figure that should more properly be taken from the amount that would otherwise go to the shareholder as opposed to the amount that would otherwise go to the ratepayer?

- A. I think it's one of those issues you can argue many ways. This is just my opinion, and I think there are other valid opinions. I think where the Company has produced on the tax operating costs and the Aliant poles excess earnings of \$6.6 million for the benefit of consumers, the fact that an extra 100,000 retained by the Company I don't think is a huge issue. I understand the theory and I think you're right, Mr. Kennedy. You know, I mean, it's obviously true. But, I suppose I can't help but think that surely that's good for customers that the costs are coming down and so on. But, it's one of those issues, unlike some others, where I think it's legitimate to have different thoughts on it. You know, that happens to be my thought, but I-
- Q. It's not a policy carved in stone, if you may?
- A. I think different people would take different positions on something such as that. You know, you asked me what my opinion, and I view, well, it was \$6.6 million rebate against 100,150, but somebody could argue it the other way.  
(Transcript, March 6, 2003, pg. 14/6-25; pg. 15/1-12)

This issue was also addressed by the Consumer Advocate in final written submission (pgs. 61-62) stating that, if the STI payouts additional to the forecast had not been paid out, the same would have gone to excess earnings. The Consumer Advocate argues that NP's shareholder should be responsible for one-half of the compensation paid to NP's executives.

NP's revenue requirement for the test year includes an amount for STI payouts at 100% of target, and payouts in excess of this amount are borne by the shareholder, Fortis. The Board agrees that customers do benefit in the long-term when efficiencies are achieved and agrees that the use of STI payouts is an appropriate means of encouraging such efficiencies. However, the Board recognizes that such efficiencies also benefit the shareholder and concludes that any STI payouts in excess of 100% of target should be paid by the shareholder. This applies to both executive and management STI payouts.

**The Board will direct that any STI payouts in excess of 100% of target payouts will be the responsibility of the shareholder, Fortis, and will be charged to non-regulated operations.**

The Board agrees with the Consumer Advocate's submission that "*...the Board has within its purview the ability to set an amount for executive compensation and ratepayers would not be responsible over and above that amount.*" (Final Submission, Consumer Advocate, pg. 61) However, the Board in this case has not been provided with any evidence other than the assertion by the Consumer Advocate that compensation levels are too high. While the levels of individual compensation may be considered high by some measures, the Board does not have any information on the record which would enable it to evaluate other appropriate alternative comparators for NP's executive compensation.

The Board will accept the level of executive compensation as reasonable for the purposes of determining test year period costs.

**The Board accepts the level of executive compensation as part of NP's revenue requirement for the test year period 2003-2004.**

**iii) Depreciation Expense**

The depreciation expense forecast for 2003 and 2004 reflects the depreciation rates recommended in the 2002 Depreciation Study and a true-up of \$5,793,000 per year in each of 2003, 2004 and 2005.

The proposed depreciation expense for 2003 and 2004 is summarized below [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision), pg. 60]:

<b>Schedule of Depreciation: 2003-2004</b>		
<b>(000s)</b>		
	<b>2003</b>	<b>2004</b>
Depreciation Expense – Current Year	37,369	38,797
Adjustment for Proposed Depreciation Rates	(2,342)	(2,425)
Adjustment for True-up	<u>(5,793)</u>	<u>(5,793)</u>
<b>Proposed Depreciation Expense</b>	<b>29,234</b>	<b>30,589</b>

The Board has approved the updated 2002 Depreciation Study and revised depreciation rates as well as the true-up adjustment on pgs. 81-82 of this Decision. No objections or issues were raised with respect to the level of depreciation expense.

**The Board accepts the depreciation expense for the test year period 2003–2004, as proposed by NP.**

**iv) Income Taxes**

NP's forecast income tax expense for the test year period incorporates the tax impacts of the proposed increase in customer rates and the accounting changes described elsewhere in this Decision. No issues were raised with respect to this forecast expense.

**The Board accepts the forecast income tax expense for the test year period 2003-2004, as proposed by NP, subject to any adjustments arising from this Decision.**

**v) Return on Rate Base**

NP's forecast of return on rate base was calculated based on a forecast return on regulated common equity of 10.75% as proposed in its Application. As a result of the findings of the Board in this Decision, NP will be directed to recalculate the return on rate base. The revised amount will be incorporated into NP's revised filing of revenue requirement arising from this Decision.

### 3. Deductions from Revenue Requirement

NP's revenue required from consumer electrical rates is reduced by other revenue received by NP and also by deducting expenses incurred by NP in non-regulated activities. In this Application NP has also proposed applying 2001 excess revenue of \$944,000 to offset revenue requirement for the 2003 and 2004 test years.

These deductions are dealt with separately below

#### i) Other Revenue

NP has forecast other revenue of \$7,787,000 in 2003 and \$8,593,000 in 2004. This revenue is primarily derived from pole attachment revenue (\$6,430,000 in 2003 and \$7,333,000 in 2004) with other amounts received from customer jobbing, wheeling charges, fees and miscellaneous sources. [Pre-filed Evidence, B. V. Perry, (1<sup>st</sup> Revision) pg. 7]

**The Board accepts the deduction from revenue requirement of other revenue for the test year period 2003-2004, as proposed by NP.**

#### ii) Adjustment for 2001 Excess Revenue

The Board dealt with NP's proposal for the disposition of the Excess Revenue Account on pgs. 84-85 of this Decision.

**Since the Board will require that the 2001 Excess Revenue be rebated to customers, NP's revenue requirement will not be reduced by this amount, as proposed by NP.**

#### iii) Non-Regulated Expenses

Non-regulated expenses are those expenses that are not recoverable through rates under Section 80(2) of the *Act*. NP has estimated non-regulated expenses, net of tax, of \$725,000 in each of 2003 and 2004.

Grant Thornton reviewed the non-regulated expenses recorded by NP for the period ended September 30, 2002 and the forecast non-regulated expenses for 2002, 2003 and 2004. Grant Thornton's conclusion was that the non-regulated expense forecast appeared reasonable and is in accordance with Board Orders, including P.U. 7(1996-97).

**The Board accepts the deductions from revenue requirement of non-regulated expenses for the test year period 2003-2004, as proposed by NP.**

#### **4. Summary of Allowed Revenue Requirement**

**NP will be required to calculate and file a revised revenue requirement for 2003 and 2004 based on its proposals in this Application, and incorporating the changes set out in this Decision relating to the allowed rate of return on rate base and the adjustment for 2001 Excess Revenue.**

**The Board will accept, subject to review of reasonableness and prudence, certain other secondary or incidental changes in revenue requirement which arise as a result of this Decision.**



## **X. COST OF SERVICE**

### **1. Background**

NP's Cost of Service methodology was last reviewed by the Board at the company's 1996 general rate proceeding. At that time NP proposed changes to its Cost of Service methodology to reflect where appropriate recommendations arising from the 1992 generic Cost of Service Study hearing. In Order No. P.U. 7(1996-97) the Board approved NP's proposed changes on a temporary basis and ordered a detailed review of NP's Cost of Service methodology at its next rate hearing. The changes reflected the 1992 generic Cost of Service methodology, which was also adopted by NLH as part of its last general rate hearing.

Specific changes proposed by NP and temporarily approved by the Board in Order No. P.U. 7(1996-97) are as follows [Pre-filed Evidence, L. Henderson, (1<sup>st</sup> Revision), pg. 6]:

- Classification of NP's hydraulic plant using system load factor on energy rather than 100 % demand;
- Allocation of NP's generating plant (hydraulic and thermal) using a single coincident peak allocation ("1 CP") rather than non-coincident peak allocation ("NCP");
- Allocation of NP's transmission plant using 1 CP rather than NCP;
- Allocation of purchased power transmission demand costs using 1 CP rather than NCP;
- Allocation of purchased power generation demand costs using 1 CP rather than NCP; and
- Allocation of NP's funding of NLH's rural deficit based on allocated class cost and removal of the rural deficit from the calculation of revenue to cost ratios. Prior to 1996 the rural deficit was included in the purchased power expense and classified based on the demand energy split for purchased power expense.

### **2. NP's Proposed Cost of Service Methodology**

For the most part NP has incorporated into its Cost of Service methodology the Board's recommendations for NLH's Cost of Service study as approved in Order No. P.U. 7 (2001-2002) with the exception of the following (Exhibit LCH-1, pg. 4):

- NP uses a single NCP allocator for distribution costs related to demand while NLH uses the ICP allocator;
- NP uses a minimum system analysis (also called minimum size method) to classify distribution conductor, pole and fitting costs as either customer related or demand related while NLH uses the zero intercept method; and
- NP does not assign any of its transmission costs to the generation function and consequently none are allocated to energy.

### **3. Mediation Report**

As discussed on pgs. 4-5 of this Decision the parties to this proceeding agreed to put the Cost of Service and Rate Design issues to a mediation process. As a result a consent Mediation Report was filed and accepted by the Board as part of the proceeding, with the Board agreeing to incorporate into its Decision the recommendations of the parties as set out in the report.

The parties agreed in the Mediation Report that the Cost of Service proposals temporarily approved by the Board in Order No. P.U. 7(1996-97) should be approved in this Decision.

In addition the Mediation Report recommended the Board approve two additional changes to NP's Cost of Service methodology:

- General expenses (i.e. General System Costs and Administration and General Costs) should be functionalized and classified based on the assumption that a portion of these costs is related to net utility plant (capital labour expense as a percentage of capital labour expense plus operating labour expense), rather than assuming (as previously) that all of these costs relate to operating and maintenance (O&M) expense; and
- The Cost of Service study should use normalized revenue and normalized purchased power expense rather than actual revenue and purchased power expense, unadjusted for normalization, as previously.

It was also recommended that the Board approve NP's use of an NCP allocator for distribution demand costs even though this differs from the 1 CP allocator that NLH was directed to use for distribution demand costs in Order No. P.U. 7(2002-2003).

**The Board has reviewed the Mediation Report and the evidence filed relating to Cost of Service issues. The Board accepts the recommendations of the parties as set out in the Mediation Report and will approve the recommendations as presented.**

#### **4. Future Load Research**

The evidence filed by NP's Cost of Service expert witness Mr. L. Brockman indicated that NP's current load research data is nearing the end of its useful life as a predictor of class demand. This information is important in ensuring that the allocation of demand costs among customer groups is fair. To ensure the best available information on customer class demand is used updated load research data is necessary. NP is proposing to implement a new load research program including representative samples from each customer class. The load research study period is planned to begin in the 2003-2004 winter season and has a forecast capital cost of \$425,000 for the metering, meter reading equipment and computer software. NP has requested approval of this additional amount as part of its capital expenditures for 2003.

The parties agreed in the Mediation Report that this expenditure should be approved.

**The Board will approve additional 2003 capital expenditures of \$425,000 for a load research program, as proposed by NP.**

## **XI. RATES, RULES AND REGULATIONS**

### **1. Mediation Report**

In the Mediation Report the parties recommended the following with respect to rate design:

- The Board should approve tail block rate increases above the average class increase for Rates 2.2, 2.3 and 2.4 so as to better reflect short-run marginal energy costs in these tail block rates;
- The Board should approve the elimination of minimum monthly (“ratcheted”) demand charges, linked to the customer’s maximum demand during the previous twelve months, in General Service Rates 2.2, 2.3, and 2.4.
- The Board should retain the Curtailable Service Option Credit of \$29/kva in Rates 2.3 and 2.4 and require NP to inform customers of the possibility of significant future changes in this credit.<sup>1</sup>
- The Board should approve NP’s proposed merger of street light and area lighting rates for the 400W MV fixtures with the 250W HPS fixtures that replace them. The Board should also approve NP’s proposed removal from the Schedule of Rates, Rules and Regulations, the charges for the 1,000W MV fixture, the 700W MV fixture and the 150W HPS post top fixture, since these no longer exist on NP’s system.
- To the extent possible, there should be no adverse customer rate impacts. Any overall revenue change should be distributed equally to each class of customers. With the exception of any change in basic customer charges, no customer should have a rate change that produces an annual cost change that is more than twice the system average (unless the dollar impact is minimal).<sup>2</sup>
- The Board should approve a change to Regulation 9(o) to reduce the application fee for a customer name change from \$14.00 to \$8.00 (the current new service fee).
- The Board should approve the removal of clause 9(n) to eliminate charges for the preparation of account statements for billing information prior to the most recent twelve months.
- The Board should approve a change to Regulation 9(f) and a proposed new clause 12(g) permitting charging the reconnect fee to new customers in apartments where a reconnection is required subsequent to a request by a landlord to disconnect an apartment. Such customers will not be required to pay the new service application fee.

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<sup>1</sup> It was noted in the Mediation Report that whereas NP states the \$29 credit “is reasonable” the CA’s position is that until there are cost-reflective wholesale power purchase rates (from Newfoundland Hydro), benefit to NP from the Curtailable Service Option will be hidden, and there is now little evidence to suggest changing the current option. The implication is that while all parties agree that the Curtailable Service Option Credit should now be retained as it is, a change may be appropriate if Hydro’s wholesale rates change.

<sup>2</sup> It was noted in the Mediation Report that possible future rate changes, such as those that may be justified by the results of future load research, may warrant a redistribution of revenue responsibility between rate classes and/or annual cost changes for some customers that differ significantly from the system average.

- The current basic monthly customer charges for domestic (residential) service and small general service rate 2.1 should be reduced by \$1.00. The revenue loss associated with this change should be made up by adjusting the energy component of these same rates so that the change does not impact customers in other rate classes.

As part of this proposal NP also agreed that: (1) it will not propose a basic customer charge increase as a result of any wholesale rate increase in NLH's 2003 general rate proceeding; and (2) in its next general rate application, NP will cap the customer charge recovery of distribution costs allocated to customers at 50% of these allocated distribution costs for rate classes, with the remainder to be recovered through energy charges. Distribution costs are network costs beyond the service drop and do not include customer specific costs such as meters, meter reading, billing and service drops.

It was also agreed by the parties to recommend that the Board proceed, as planned, to consider implementation of improved cost-reflective wholesale power rates to be charged to NP by NLH. To facilitate that process, the Board should schedule (and provide such notice as may be required) a one-day consultation to take place within 30 days after NLH's general rate filing, wherein NLH would discuss and provide information to stakeholders on its proposed wholesale power rate design.

As well the parties recommended that the Board direct NP, in consultation with the Consumer Advocate and Board Staff, to propose a "*peer group*" of utilities and performance measures upon which to evaluate NP's performance. Upon Board approval of the peer group and performance measures, NP will collect and report annually statistical information relative to the peer group performance. NP should be entitled to recover its reasonable documented costs of this effort.

**The Board has reviewed the Mediation Report and the evidence filed relating to Rate Design issues. With the exception of the issue relating to meter reading, which was not agreed to by the parties, the Board accepts the recommendations of the parties as set out in the Mediation Report and will approve the recommendations as presented.**

**Since the conclusion of the hearing of this Application, NLH has filed its general rate application for 2004. The Board will direct that the scheduling of the consultation recommended in the Mediation Report on NLH's wholesale power rate design be considered at the pre-hearing conference for NLH's general rate application.**

**The Board will direct NP to propose to the Board for approval of a "*peer group*" of utilities and performance measures upon which to evaluate NP's performance in accordance with the terms of the Mediation Report.**

The Board once again expresses its appreciation for the efforts of the parties in settling these issues through the mediation process.

## 2. Outstanding Issues Relating to Rates, Rules & Regulations

### i) Meter Reading

During mediation the issue of meter reading as provided for in NP's Rules and Regulations was not agreed upon by the parties. The Consumer Advocate recommended in the Mediation Report that the wording of the first sentence of "*Rules and Regulations 8. Meter Reading*" should be revised to read:

*"With the exception of circumstances beyond its reasonable control, the company shall read meters monthly."*

NP recommended retaining the present language which states:

*"Where reasonably possible the Company shall read meters monthly provided that the Company may, at its discretion, read meters at some other interval and estimate the reading for the intervening months."*

The parties agreed that the resolution of this issue does not require the calling of expert cost of service or rate design witnesses, and that the Board panel is able to resolve the issue based on arguments that the parties will make in their briefs and on hearing examination of the parties' policy and revenue requirement witnesses.

The Consumer Advocate's position as set out in the Mediation Report was that customers who receive estimated bills often think that the estimates are high and that they would prefer an actual meter reading rather than an estimated bill. The Consumer Advocate also argued during the hearing that, since NP is paid as part of the basic customer charge to read meters, estimates should only be allowed in exigent circumstances. The Consumer Advocate also submits that the practice of estimating meters during the summer months should be stopped.

NP believes that its estimates are reasonably accurate, that there are few customer complaints and that the estimation process during summer vacation months saves costs (approximately \$40,000) by reducing the need for temporary employees. NP submitted that the summer estimating program is a management issue, and that the program is part of an overall approach to manage the cost of meter reading. Savings from the summer estimating program ranged from \$20,000 to \$45,000 for the years 2000 to 2002, compared to total meter reading costs of \$2,000,000 per year. Based on these savings NP plans to continue with its summer meter reading program. NP's position is that no change in Regulation 8(a) is warranted. (Written Submissions, NP, Section F, pgs. 3-4)

The Board has reviewed the submissions of the parties on this issue and notes that there appears to be a number of separate issues raised, namely meter reading frequency, the recovery of the costs of meter reading and estimation of meters.

The issue of monthly vs bi-monthly meter reading was addressed by the Board at NP's 1996 general rate hearing after which the Board accepted NP's proposal to return to monthly meter reading. The issue of the summer estimating program is not, in the Board's view, related

to monthly meter reading but is rather a management issue aimed at efficiencies and cost savings. Under the existing regulations NP has the discretion to implement such a program and did not seek the Board's approval at the time. The Board notes the savings to ratepayers of the estimating program. The Board has monitored this program since it was put in place by NP in 2000 and observes that it does not appear to have had any adverse impact on customers. The Board will not order NP to end this program at this time and incur additional costs to be recovered from ratepayers.

The costs of meter reading are recovered by NP in the Basic Customer Charge (BCC). The BCC includes those customer related costs that occur because a customer is connected to the system, regardless of whether energy is used or demand is incurred. These costs usually include the cost of the meter, the cost of the service wire, and the costs associated with billing customers, including meter reading costs, collection costs, billing system costs and customer service costs. NP's expert witness on Cost of Service confirmed that NP's BCC for residential and small general service classes recovers 100% of the cost of metering, billing, customer information and service wire costs, and 60% of the customer related distribution system cost. (Pre-filed Evidence, L. Brockman, pg. 10)

Even though the BCC recovers those costs associated with meter reading, it is not correct to say that NP is being paid to read every customer's meter. The BCC recovers NP's total customer related costs by spreading the total of those costs to all customers connected to the system, regardless of where they live or how much each customer contributes to the BCC on an individual basis. The BCC represents in effect the average customer cost and does not reflect the actual cost of the specific components of the cost, such as the cost of reading that customer's meter. In the Board's view the issue of recovery of meter reading costs is not an issue in this hearing requiring a determination by the Board. NP is entitled to recover its total cost of providing service and, if the costs are not recovered in the BCC, the costs will be recovered in rates.

It is the role of the Board to investigate, mediate and try and resolve complaints from customers experiencing problems with the utilities. The Board's regulatory staff tracks complaints and their resolution and through this process is able to identify issues which may require intervention with the utility by either the Board or its staff. For example it was as a result of this complaint process that the Board initiated a comprehensive review in 1996 of the CIAC Policy, culminating in a public hearing in the fall of 1997.

Several specific examples were raised during the hearing, both by the Consumer Advocate and by individual presenters, regarding meter reading practices of NP. As well since the commencement of this hearing Board staff have received a number of complaints regarding meter reading and estimating of meters such that a review of this issue is viewed by the Board as warranted at this time.

**The Board will not direct any changes to the wording of Rules & Regulations 8-Meter Reading at this time. The Board will undertake a review of NP's meter reading program with a focus on the estimating methodology and process. This review will also include an assessment of existing regulatory and utility practice in other Canadian jurisdictions.**

## ii) Demand Charges for Recreational Facilities

Mr. Gary Milley of the Newfoundland & Labrador Parks/Recreation Association raised the issue of demand charges for major recreational facilities during his presentation to the Board in St. John's. Mr. Milley requested the Board to consider either reducing or eliminating the demand rate charged community facilities such as stadiums and swimming pools. If this couldn't be done Mr. Milley requested that some type of rebate or benefit program be put in place for community facilities. (Transcript, April 3, 2003, pg. 81)

NP's position on this issue is that elimination or reduction of demand charges to these customers for essentially social welfare considerations is not consistent with the objectives of good rate making. NP points out that a similar discount on demand charges provided to churches and schools was eliminated during the 1980s. [P.U. 47(1982), P.U. 51(1982)] NP submits that demand charges that apply to major recreational facilities should be maintained at the same level as those for other general service customers served under the same respective rate class. (Written Submissions, NP, Section F, pgs. 6-7)

No other submissions were made by other parties on this issue.

The Board has been presented with similar requests in previous hearings, which essentially petition the Board to consider the "*ability to pay*" of the consumer. The Board has outlined its position on this issue in reference to its statutory powers and responsibilities on pg. 17 of this Decision. While the Board acknowledges the challenges these major recreational facilities face with respect to operating costs in general, and costs for electricity consumption specifically, the Board agrees with NP that demand charges should be maintained at the same level as those for other general service customers. This is consistent with cost based ratemaking and is fair and equitable to all customers in that class. To do otherwise would involve a subsidy to one group of customers at the expense of another. The Board notes that the approval of NP's proposal to discontinue demand related minimum monthly charges will partially address some of the concerns raised by Mr. Milley.

**The Board will not make any adjustments to the application of demand charges within the General Service Rates.**

## iii) Availability of the Domestic Rate

Mr. Owen Crossan of Regency Management Ltd. and Mr. Charlie Oliver of Martek Morgan-Finch requested the Board amend NP's Schedule of Rates, Rules and Regulations so that the rates for the house meters of apartment buildings be classified as a residential rate, instead of a commercial rate. Their position is that the house meter in an apartment building is used for a non-commercial, exclusively domestic use such as washers and dryers and lights in hallways and stairways. Mr. Crossan submitted that the Provincial and Federal Government have, through taxation policies, agreed that apartment buildings are solely for residential use and should be classified as such. He cited as examples the fact that the Provincial Government does not require HST to be charged for the use of the washers and dryers by the tenants and the fact that the Federal Government does not require payment of HST on a lease of one month or more.

NP submits that the common areas of apartment buildings and condominiums provide a service to all tenants of the facility and do not meet the definition of a Domestic Unit in the Rules and Regulations. The “*Customer*” in the case of the common area is the management of the apartment building or condominium, and is not the same “*Customer*” as referred to in the Availability Clause for the Domestic Rate 1.1. NP argues that the management of the apartment complex or condominium is engaged in a commercial enterprise and the service provided by the appropriate General Service Rate. (Written Submissions, NP, Section F, pg. 10)

NP also notes in written submission (Section F, pg. 10) that this issue has been before the Board in previous hearings in 1987, 1989 and 1991. At these hearings the Newfoundland and Labrador Pensioners and Senior Citizens Federation requested that Domestic Rate be used for their clubrooms rather than the General Service Rate. In Order No. P.U. 6(1991) the Board confirmed NP’s definition of a Domestic Unit and found that these clubrooms do not meet that definition. [P.U. 6 (1991), pg. 80-81]

NP’s Rules and Regulations define a “*Domestic Unit*” as follows:

*“Domestic Unit means a house, apartment or similar residential unit which is normally occupied by one family, or by a family and no more than four other persons who are not members of that family, or which is normally occupied by no more than six unrelated persons.”*

If a customer does not meet this definition of a domestic unit the rate charged will be the applicable General Service Rate, depending on demand. Common areas of apartment buildings or condominiums do not meet the definition of the Domestic Rate class in NP’s rate structure. In the Board’s view making the domestic rate available to common areas of apartment buildings and condominiums would not be fair to other customers in substantially similar circumstances who are also charged a commercial rate.

The Board agrees with NP’s submission that the management of the apartment complexes and condominiums are engaged in commercial activity. The argument against this position appears to be based on the fact that the end users of the electrical service are the same tenants who live in the buildings and who meet the definition of “*Domestic Unit*”. However, the “*Customer*” in the case of the common areas of the building for the purpose of provision of electrical service by NP is the building management and not the tenant. This service is properly charged under the commercial rate structure, and presumably the costs are incorporated into the rental rates of the tenants.

**The Board will not order the Domestic Rate be made available to house meters of apartment buildings.**



**iv) Requirement for Security Deposit**

In presentations to the Board during public participation day in Corner Brook, Mr. Mark Baldwin and Mr. Peter Blake raised the issue of the appropriateness of NP's policy regarding payment of security deposits and its effect on small business. Mr. Blake is a small business owner in Corner Brook who testified about the impact the requirement to pay a security deposit required has on cash flow and start up costs for a small business in its first year of operation. Mr. Blake also questioned the interest rate of two percent less than prime which is paid by NP on deposits stating that in his view NP is making a profit off his deposit. (Transcript, April 11, 2003, pgs. 74-79)

In written submission (Section F, pgs. 11-14) NP argued that the requirement of a security deposit helps to minimize costs resulting from the outstanding bills left by new businesses which fail. If the security deposit were not in place other customers would have to pay those costs. As electrical service is provided in advance of payment by customers, the amount of deposit, equivalent to two months usage, is viewed by NP as justified.

NP further argued that the existing annual expense of \$700,000 for uncollectable bills (net of application of security deposits) would increase to approximately \$1,100,000 annually if the Customer Deposit Policy was not in place. As to the interest paid on deposits, NP's position is that the rate paid on cash security deposits is approximately equal to the rate the customers would earn on a 2-year GIC and similar to the rate NP pays on short-term borrowings, and hence is reasonable.

Regulation 4 (a) of the Rules and Regulations states as follows:

- "4. Security for Payment*  
*(a) An applicant or a customer shall give such reasonable security for the payment of charges as may be required by the Company pursuant to its Customer Deposit Policy as approved by the Board, from time to time."*

The Board approved the existing Customer Deposit Policy in March 1988. This policy sets out the conditions under which reasonable security for payment shall be required and also sets out the form of the security as either cash deposit, bank letter of credit, payment bond, letter of guarantee or any other form of security acceptable to NP.

In addressing this issue the Board acknowledges that the payment of a cash security equivalent to the average cost of two months service may create a financial burden for certain new businesses. However, the Board also recognizes a fairness principle in that, if these new businesses do fail other customers will have to pay for the costs incurred to provide electrical service for which NP will not recover. The security deposit has been used to offset these potentially unrecoverable costs in the past. The Board notes the amount of \$400,000, which is the difference in uncollectable bills net of application of the security deposit, as a significant cost to be borne by other customers.

In the Board's view this would not be fair to other customers on the system, especially those who have already paid their full cost towards their electrical service. The existing policy is seen by the Board as reasonable and in the best interests of all customers. The Board notes that there are several options as to the form of security a new business customer may elect to provide and expects that these options are made known by NP and available to customers.

**The Board is not persuaded that changes to the Customer Deposit Policy or to the Rules and Regulations respecting security deposits would be fair to other customers. The Board will not order a change in the present policy covering the rate of interest paid to customers on cash security deposits.**

**v) Requirement for Inspection of Service Prior to Reconnection**

In his presentation to the Board Mr. Crossan also requested that the Board eliminate the requirement for inspections prior to the reconnection of service where the unit is vacant for any period of time and there has been no electrical work or repairs carried out. According to NP, this requirement is based on written direction from the Province's Chief Electrical Inspector that, where a service has been disconnected for more than 90 days, an electrical inspection is required prior to the reconnection of service. Mr. Crossan stated that it was his understanding this requirement is as a result of an existing rule of the Board.

The Board does not have any such rule in place relating to inspections prior to reconnections. This requirement is put in place for NP by the Province's Chief Electrical Inspector. NP states that it must abide by the requirements of the Chief Electrical Inspector unless informed otherwise and that it has no discretion with respect to this issue. The Board agrees with NP.

**The requirement for inspection of service prior to reconnection is primarily a safety issue and the Board will not intervene.**

**vi) Rate Change Implementation**

**In order to finalize rates to be implemented as a result of this Application, NP will be directed to re-file, along with its revised revenue requirement and revised calculations of rate base and return on rate base, its Schedule of Rates, Tolls and Charges to be effective for billings on or after August 1, 2003 incorporating the decisions of the Board. The rates shall be calculated on the same basis as in the Application and shall be designed to remain in effect through 2004.**

**NP will also be directed to file a proposal as to the finalization of interim rates as set by Order No. P.U. 35(2002-2003) and the disposition of any variance between revenue generated based on these interim rates and the revised 2003 test year revenue requirement. The proposal should include a plan for the rebate of this amount to customers.**

**The Board will review NP's revised filing to ensure its decisions are appropriately incorporated and then issue a final Order, approving or modifying, as it deems appropriate, NP's rate base, NP's return on rate base and the revised rates for NP's customers as of August 1, 2003.**

## XII. OTHER ISSUES

### 1. Conservation/Demand Side Management

The issue of conservation and demand side management was raised in this proceeding by the Consumer Advocate. In final submission (pg. 74) the Consumer Advocate stated that “*NP’s efforts toward conservation are virtually non-existent.*” The effectiveness of NP’s activities in demand side management and energy efficiency programs was also questioned by the Consumer Advocate. He cited the evidence provided by Ms. Sarah Peckford and Mr. Terry McNeil, both of the Conservation Corps, who made a presentation to the Board during the public participation day in St. John’s. Due to a lack of funding the Conservation Corps has had to lay off staff and the partnership negotiated between the Corps and NP as of December 2002 is effectively at an end. This means that Newfoundland and Labrador is the only province in Canada in which an Energuide Assessment Program is not available. The Consumer Advocate argues that

*“This lack of a conservation agent and an Ener-Guide Assessment comes at a time during which consumers owe \$100 million to pay the cost of Bunker C fuel burned at the Holyrood Generating Station, and it comes at a time during which consumers are using electricity more, not less. The average consumption in Newfoundland has risen.”*

(Consumer Advocate, Final Submission, pgs. 75-76)

The Consumer Advocate requests that the Board provide policy and give specific and meaningful direction to the utilities on conservation issues.

The other parties to the hearing did not address this issue and NP did not provide its position in final submissions or oral argument. In addition to the presentation provided by the representatives from the Conservation Corps and their responses to questions, there were several information requests regarding conservation and DSM to which NP responded.

NP outlined its approach to demand side management and energy efficiency programs in its response to CA-239:

*“The intent of DSM programs is to manage the demand side use of electrical energy in order to minimize electricity rates. During the last several years, Newfoundland Power has focused its DSM activities on programs that improve customer service and enhance the value customers receive from electricity. The Company has taken this approach because the size and isolated nature of the Newfoundland electrical system, and its current dynamics as reflected in load forecasts and generation cost projections, suggest that larger scale DSM activities are unlikely to have significant impact, either on load or on generation requirements. Unless circumstances warrant a change in direction, the Company will maintain the current focus of its DSM activities into the future.*

*It is the intent of the Company that all customers benefit from the Company’s DSM activities either directly as participants, indirectly as non-participants or through improved customer service. DSM initiatives will be assessed on an ongoing basis to ensure they meet the needs of the Company’s customers.”*

Since 1990 NP has been required to file annually with the Board a progress report of its DSM activities. These reports describe the benefits of NP's DSM activities, including results and associated costs. In the Board's view these reports have been informative and provides important information, especially with respect to customer based activities. The Board will continue to require these reports as ordered in Order No. P.U. 7(1996-97).

This issue was raised during the hearing of NLH's general rate application in 2001. In Order No. P.U. 7(2002-2003) the Board recognized and supported NLH's efforts in partnering with the Conservation Corps. The Board also stated that activities in this area should be implemented and monitored within the customer service group, as one of the main goals of such programs is improving customer access to conservation tools and energy saving initiatives, which is the case with NP. NP should consider expanding its customer satisfaction survey to obtain more specific information from customers with respect to conservation of energy and customer needs.

The Board supports NP's past efforts in partnering with the Conservation Corps to provide customer access to the Corps' services and encourages NP to continue to pursue similar partnerships and initiatives in the future. The Board was impressed with the presentation by the Corps on its programs and the potential benefits to homeowners in terms of energy conservation and resulting lower energy bills, and acknowledges the Corps' current funding challenges. NP was just one of the parties participating in supporting the Ener-Guide Program and the Board is not prepared to direct NP to support any particular conservation initiative on its own accord or to fund any specific group.

In the Board's view the issue of conservation and energy efficiency is one the Board can consider in the context of least cost electricity for consumers in the province. The relationship between rates and electricity consumption and the impact of DSM and energy efficiency programs is complex, especially when overlaid with the impact on the electrical system and generation planning. The differences in the structure and customer profile of each of the utilities also has to be considered. The Board acknowledges the reports on NP's DSM activities provide useful information. The Board finds it difficult, however, to provide specific and meaningful policy direction to the utilities on DSM and conservation issues in the absence of supporting evidence and related impacts on the system overall. This matter would be most appropriately addressed in the context of a generic proceeding involving both utilities and interested parties. The Board will consider the manner and timing of such a proceeding following the hearing of NLH's general rate application.

### **PART THREE. SUMMARY OF BOARD DECISIONS**

#### **I. SUBMISSION OF CONSUMER ADVOCATE ON EXCESS EARNINGS**

1. The Board finds that it has no jurisdiction under the *Public Utilities Act* to require payment by NP into a reserve account or otherwise deprive NP of any amount which is within the allowed return on rate base as fixed and determined by the Board pursuant to Section 80(1) of the *Act*.

#### **II. FORECASTING ISSUES**

2. The Board will accept NP's customer and energy sales forecasts for the test year period 2003-2004.

#### **III. RISK ASSESSMENT**

3. The Board does not anticipate a change in the business risk of NP in the foreseeable future and concurs with the assessment of NP and the cost of capital experts that NP is of average business risk compared to other utilities.
4. The Board finds that capital market conditions, in particular affecting the equity market, have changed substantially since 1998. This volatility has contributed to an overall reduction in investor expectations in the equity market from historic levels. In addition, volatility has contributed to greater spreads being demanded by corporate bondholders and equity investors to account for added risk as compared to long-term government securities. The Board finds these trends will similarly influence NP but present no greater financial risk to NP than will be experienced by other comparable Canadian utilities.
5. The Board finds that based on its financial performance NP continues to sustain a sound credit rating which is providing appropriate and cost efficient access to the financial markets.
6. The Board concludes that in the interest of both the utility and its customers. NP should continue to be treated as a stand-alone utility. Therefore, the Board will require NP to take all appropriate steps necessary to preserve the financial integrity and independence of the utility. As a first step, NP will be required to file a report by June 30, 2004 addressing how it can ensure stand-alone status in respect of its corporate credit linkage by S & P to Fortis. This report should: 1) document discussions with the credit rating agencies and Fortis on this issue; 2) explain how other regulated Canadian utilities are facing similar challenges; 3) provide a list of possible mitigating actions; and 4) provide a plan of implementation of recommended actions.

7. Despite the change in circumstances since 1998, the Board finds that the overall investment risk of NP is average when compared to other Canadian utilities. This finding will be the basis on which the Board will consider a commensurate capital structure and ROE for the utility.

#### **IV. FINANCIAL TARGETS AND OBJECTIVES**

8. Having reviewed the evidence the Board is of the opinion that it is reasonable and prudent to maintain the capital structure deemed appropriate in Order No. P.U. 16(1998-99). The proportion of regulated common equity in the capital structure should not exceed 45%. Any regulated common equity in excess of 45% will only be entitled to a rate of return equal to the rate of return on preferred equity. For the purpose of determining the weighted average cost of capital, the Board accepts NP's proposed forecast average capital structure for the 2003 and 2004 test years.
9. The Board will continue to rely principally on the equity risk premium test and will determine a return on regulated common equity primarily with a view to establishing a risk-free rate based on long-term Government of Canada bond yields plus an appropriate risk premium.
10. The Board will utilize 5.60% as the forecast of the risk-free rate to be applied in the equity risk premium test for the test years 2003 and 2004.
11. The Board will make no adjustment to the equity risk premium test for financing costs.
12. The Board will incorporate a risk premium of 4.15% in the equity risk premium test in calculating the cost of common equity.
13. The Board will utilize a return on regulated common equity of 9.75% for the purposes of determining the WACC for both 2003 and 2004.
14. The Board finds an interest coverage in the order of 2.4x is acceptable given NP's level of risk and the Board's findings in this Decision with respect to NP's capital structure and return on regulated equity.

#### **V. INTER-CORPORATE RELATIONSHIPS AND CHARGES**

15. NP will be required to observe the following principles in all inter-corporate transactions:
  - (i) All inter-corporate transactions between a utility and its affiliates shall be fully transparent and are subject to scrutiny by the Board.
  - (ii) A utility shall have the right to manage its affairs but it must demonstrate to the satisfaction of the Board that all affiliate transactions are prudent.
  - (iii) A utility shall ensure that inter-corporate transactions will not disadvantage the interests of ratepayers and furthermore that ratepayers and the utility will derive some demonstrable benefit from such transactions.

- (iv) The onus is on the utility to show that it is in compliance with the guidelines and principles with respect to inter-corporate transactions.
16. These principles may be amended by the Board from time to time. Given the implications of these principles on both NP and its affiliates, NP will be required to undertake a review and update of its operating practices and procedures relating to any and all inter-corporate transactions to ensure that the principles as set out above are reflected. The results of such a review shall be reported to the Board no later than March 31, 2004.
17. NP will be directed to prepare a report which should compare and quantify the benefits to NP and ratepayers of its administration of and participation in a centralized insurance program for the Fortis Group of Companies, rather than be insured on a stand-alone basis. This report should be filed with the Board no later than March 31, 2004.
18. NP will be required to modify its quarterly reports on inter-corporate charges to show separately associated labour and other staff and expense charges billed in relation to NP's insurance administration on behalf of Fortis and related companies.
19. As part of the review of operating practices and procedures relating to inter-corporate transactions NP will be required to investigate the utilization of market rates for executive and management time charges. In lieu of market rates, NP shall propose an appropriate markup on its cost-based rates as a proxy for market in the event that utilization of market rates is not practical.
20. NP will be required to apply billing and collection practices with respect to inter-corporate transactions which are consistent with those applied to unrelated parties. Billings to Fortis and related companies should also be undertaken within 30 days of the service and/or expenses being charged for recovery.

## **VI. AUTOMATIC ADJUSTMENT FORMULA**

21. The Board will continue to use the existing methodology in the Automatic Adjustment Formula for calculating the risk-free rate. However, the risk-free rate will now be calculated based on the actual yields of the three most recent series of long-term Government of Canada bonds during the 10 trading days being monitored as reported in The Globe and Mail under the heading "*Ask Yields*". The observed average of the daily ask yields for the last five trading days of October and the first five trading days of November for these three most recent issues will be used to forecast the risk-free rate for the upcoming year, in each year of operation of the Formula.
22. The Board has determined that a total risk premium of 415 basis points, or 4.15%, is reasonable. This is the value that will be used and adjusted on the same basis as was ordered in Order No. P.U. 36(1998-99) in the application of the Formula.

23. NP will be required to modify the schedule filed as part of its annual return that calculates the embedded cost of debt to identify specifically the causes of variations in the actual embedded cost of debt from the cost forecast for the test year period.
24. The Board will establish a mechanism tied to the observed rate of return on regulated common equity which may trigger an early review of the Formula and cost of capital. Where the actual rate of return on regulated equity in any intervening year exceeds the cost of equity determined by the Formula by more than 50 basis points, then NP will be required to file a report with the Board in its annual return setting out the circumstances and facts contributing to the difference.
25. The Board will approve the use of the Formula, as modified by this Decision, for a further three-year period. Customer rates will be set for 2003 and 2004 by this Decision and Order. The Formula will be used to set the rate of return on rate base, and hence customer rates, for 2005, 2006 and 2007.
26. The Board finds that the Asset Rate Base method should replace the Invested Capital approach currently used to calculate NP's rate base. The move to the Asset Rate Base method will begin in 2003 by incorporating deferred charges in rate base. The Board will direct NP to implement the following guidelines in switching to the Asset Rate Base method:
  - (i) Average deferred charges based on BVP-11 to be added to the average rate base for the 2003 and 2004 test years and all subsequent fiscal years.
  - (ii) Evidence relating to changes in deferred charges, in particular deferred pension costs, to be filed annually at the capital budget hearing.
  - (iii) NP will provide a reconciliation of average Rate Base to average Invested Capital annually at the capital budget hearing.
  - (iv) NP will review no later than its next general rate application, the appropriateness and approach to including the remaining reconciling items in the Rate Base. This review will address the issue of discontinuing the use of regulated common equity in favour of book equity.

## **VII. RATE BASE**

27. NP will be required to file a revised calculation of rate base and return on rate base for test years 2003 and 2004 which reflects the decisions taken by the Board.
28. The Board will approve a range of 36 basis points for the rate of return on rate base for test years 2003 and 2004 and for use with the Formula, unless otherwise ordered by the Board.



**VIII. ACCOUNTING TREATMENT AND POLICIES**

29. The Board will accept NP's proposal to amortize the recovery of the \$5,600,000 balance in the Hydro Production Equalization Reserve over a period of five years, beginning in 2003. NP will be required to review the balance in the Hydro Production Equalization Reserve as of December 31, 2005 and to apply to the Board for an Order as to the disposition of outstanding balances, positive or negative, as part of its next general rate application.
30. The Board will approve NP's proposal to adopt the market-related method of determining pension expense on a prospective basis, effective January 1, 2003.
31. The Board will approve the 2002 Depreciation Study as filed. The depreciation rates as recommended in the Depreciation Study will be approved for calculating depreciation expense for the test year period 2003 and 2004.
32. The Board will approve NP's proposal to amortize the depreciation reserve variance over the three-year period 2003-2005.
33. The Board will approve NP's proposal to continue with the cash basis for recognizing expenses for other employee future benefits. With its next general rate application, NP will be required to submit a report which addresses the use of the accrual method as an alternative to the existing accounting treatment for other employee future benefits.
34. The Board will approve NP's proposal to amortize over a three-year period, beginning in 2003, the estimated regulatory costs of \$1,200,000.
35. The Board finds that the 2001 excess earnings of \$944,000 should be rebated to customers. NP will be required to submit a proposal for this rebate as part of its filing of revised rates.
36. The Board will accept NP's proposal for adjusting 2003-2004 revenue requirement to recover the outstanding amount of the 1992-1993 excess earnings as required by Order No. P.U. 36(1998-99), subject to any adjustments arising from this Decision.
37. The Board will approve NP's request to defer dealing with the outstanding issues relating to the Revenue Recognition Study pending resolution of the dispute with Canada Customs and Revenue Agency (CCRA).
38. Since the Board has agreed to the deferral of the issues relating to the Revenue Recognition Study until the dispute between NP and CCRA is resolved, the Board will also approve NP's request to defer dealing with the disposition of the unbilled revenue increase reserve account. This issue will be dealt with as part of the Order arising from consideration of the Revenue Recognition Study to be filed by NP, as was intended in Order No. P.U. 36(1998-99).

39. The Board accepts NP's treatment of expenses associated with the 2000 and 2001 early retirement programs.

#### **IX. REVENUE REQUIREMENT**

40. The Board will use fiscal years 2003 and 2004 as the test years for determining revenue requirement, as proposed by NP.
41. The Board accepts the purchased power expense for the test year period 2003-2004, as proposed by NP, subject to any adjustments arising from this Decision.
42. The Board accepts the proposed operating expense forecast for the test year period 2003-2004, with the exception of executive compensation which is dealt with separately below.
43. The Board will no longer require NP to file an annual Advertising and Marketing Report.
44. The Board will direct that any STI payouts in excess of 100% of target payouts will be the responsibility of the shareholder, Fortis, and will be charged to non-regulated operations.
45. The Board accepts the level of executive compensation as part of NP's revenue requirement for the test year period 2003-2004.
46. The Board accepts the depreciation expense for the test year period 2003-2004, as proposed by NP.
47. The Board accepts the forecast income tax expense for the test year period 2003-2004, as proposed by NP, subject to any adjustments arising from this Decision.
48. The Board accepts the deduction from revenue requirement of other revenue for the test year period 2003-2004, as proposed by NP.
49. Since the Board will require that the 2001 Excess Revenue be rebated to customers, NP's revenue requirement will not be reduced by this amount, as proposed by NP.
50. The Board accepts the deductions from revenue requirement of non-regulated expenses for the test year period 2003-2004, as proposed by NP.
51. NP will be required to calculate and file a revised revenue requirement for 2003 and 2004 based on its proposals in this Application, and incorporating the changes set out in this Decision relating to allowed rate of return on rate base and the adjustment for 2001 Excess Revenue.
52. The Board will accept, subject to review of reasonableness and prudence, certain other secondary or incidental changes in revenue requirement which arise as a result of this Decision.

**X. COST OF SERVICE**

53. The Board has reviewed the Mediation Report and the evidence filed relating to Cost of Service issues. The Board accepts the recommendations of the parties as set out in the Mediation Report and will approve the recommendations as presented.
54. The Board will approve additional 2003 capital expenditures of \$425,000 for a load research program, as proposed by NP.

**XI. RATES, RULES AND REGULATIONS**

55. The Board has reviewed the Mediation Report and the evidence filed relating to Rate Design Issues. With the exception of the issue relating to meter meading, which was not agreed to by the parties, the Board accepts the recommendations of the parties as set out in the Mediation Report and will approve the recommendations as presented.
56. Since the conclusion of the hearing of this Application, NLH has filed its general rate application for 2004. The Board will direct that scheduling of the consultation recommended in the Mediation Report on NLH's wholesale power rate design be considered at the pre-hearing conference for NLH's general rate application.
57. The Board will direct NP to propose to the Board for approval a "*peer group*" of utilities and performance measures upon which to evaluate NP's performance in accordance with the terms of the Mediation Report.
58. The Board will not direct any changes to the wording of Rules & Regulations 8-Meter Reading at this time. The Board will undertake a review of NP's meter reading program with a focus on the estimating methodology and process. This review will also include an assessment of existing regulatory and utility practice in other Canadian jurisdictions.
59. The Board will not make any adjustments to the application of demand charges within the General Service Rates.
60. The Board will not order the Domestic Rate be made available to house meters of apartment buildings.
61. The Board is not persuaded that changes to the Customer Deposit Policy or to the Rules and Regulations respecting security deposits would be fair to other customers. The Board will not order a change in the present policy covering the rate of interest paid to customers on cash security deposits.
62. The requirement for inspection of service prior to reconnection is primarily a safety issue and the Board will not intervene.

63. In order to finalize rates to be implemented as a result of this Application, NP will be directed to re-file, along with its revised revenue requirement and revised calculations of rate base and return on rate base, its Schedule of Rates, Tolls and Charges to be effective for billings on or after August 1, 2003 incorporating the decisions of the Board. The rates shall be calculated on the same basis as in the Application and shall be designed to remain in effect through 2004.
64. NP will also be directed to file a proposal as to the finalization of interim rates as set by Order No. 35(2002-2003) and the disposition of any variance between revenue generated based on these interim rates and the revised 2003 test year revenue requirement. The proposal should include a plan for the rebate of this amount to customers.
65. The Board will review NP's revised filing to ensure its decisions are appropriately incorporated and then issue a final Order, approving or modifying, as it deems appropriate, NP's rate base, NP's return on rate base and the revised rates for NP's customers as of August 1, 2003.

**PART FOUR. BOARD ORDER****IT IS THEREFORE ORDERED THAT:****CAPITAL STRUCTURE**

1. The proportion of regulated common equity in the capital structure shall not exceed 45%. Regulated common equity in excess of 45% of the total invested capital shall not attract a rate of return higher than the rate of return on preferred equity of 6.31%.
2. For purposes of determining the weighted average cost of capital, the Board accepts the forecast average capital structure for the 2003 and 2004 test years as proposed by NP. The forecast average capital structure for 2003 shall be deemed to be debt of 54.28%, preferred equity of 1.45%, and common equity of 44.27%; and, for 2004, debt of 54.06%, preferred equity of 1.39%, and common equity of 44.55%.

**RATE BASE/RETURN ON RATE BASE**

3. NP shall move toward the adoption of the Asset Rate Base method for determining rate base and beginning in 2003 shall incorporate the average deferred charges, as set out in its Application, to the average rate base.
4. NP shall calculate and file a revised average rate base and return on rate base for 2003 and 2004, based on its proposals in this Application, incorporating the changes set out in this Decision and Order, which include:
  - i. A return on regulated common equity of 9.75% is to be used for calculating the weighted average cost of capital for the 2003 and 2004 test years; and
  - ii. The move to the Asset Rate Base method of determining rate base.
5. NP shall file annually with its capital budget application, unless otherwise ordered by the Board:
  - i. Evidence relating to changes in deferred charges, including pension costs; and
  - ii. A reconciliation of average rate base to average invested capital.
6. NP shall file no later than its next general rate application a report on including in rate base the remaining reconciling items between rate base and invested capital as described in this Decision and Order.
7. The allowed range of rate of return on rate base shall be 36 basis points for 2003 and 2004 and for use in the Automatic Adjustment Formula, unless otherwise ordered by the Board.

**AUTOMATIC ADJUSTMENT FORMULA**

8. Unless the Board otherwise orders upon application by NP or by the Board of its own motion, the rate of return on rate base for the years 2005, 2006 and 2007 shall be set using the Automatic Adjustment Formula that was established by the Board in Order No. P. U. 36 (1998-99), incorporating the changes set out in this Decision and Order, including:
  - i. The move to the Asset Rate Base method; and
  - ii. The use of the three most recent, rather than the two previously specified, series of long-term Government of Canada bonds in determining the risk-free rate.
9. NP shall apply no later than November 30<sup>th</sup> in each of 2004, 2005 and 2006 for the application of the Automatic Adjustment Formula to the rate of return on rate base and for a revised Schedule of Rates, Tolls and Charges effective January 1 in each year following.
10. NP shall prepare and file with the Board:
  - i. With its annual return until otherwise directed by the Board, a modified schedule calculating the embedded cost of debt for the reporting year to identify specifically the causes of variations in the actual embedded cost of debt from the cost forecast for the test period; and
  - ii. With its annual return where in a year the actual rate of return on regulated equity is greater than 50 basis points above the cost of equity as determined by the Formula, a report explaining the circumstances and facts contributing to the difference.

**INTER-CORPORATE RELATIONSHIPS AND CHARGES**

11. NP shall review and update its operating practices and procedures to reflect the principles governing all inter-corporate transactions as set out in this Decision and Order, and which may be amended by the Board from time to time.
12. NP shall file with the Board:
  - i. By June 30, 2004 a report addressing its stand-alone status in respect of the corporate credit linkage of NP to Fortis, as detailed by the Board in this Decision and Order.
  - ii. By March 31, 2004 a report as to its operating practices and procedures relating to any and all inter-corporate transactions, including:
    - a) An investigation of the utilization of market rates or a suitable proxy markup for executive and management time charges;

- b) Quantification of the benefits to NP and its customers of its administration of and participation in a centralized insurance program for the Fortis Group of Companies and comparing these benefits to being insured on a stand-alone basis;
  - c) A comparison of NP's billing and collection practices with respect to affiliate companies and unrelated parties.
- iii. Modified quarterly reports which show separately the associated labour and other staff and expense charges billed in relation to NP's insurance administration on behalf of Fortis and related companies.

#### ACCOUNTING TREATMENT AND POLICIES

13. NP's proposal to amortize the recovery of the \$5,600,000 balance in the Hydro Production Equalization Reserve over a period of five years, beginning in 2003, is approved.
14. NP's proposal to adopt the market-related method of determining pension expense on a prospective basis, effective January 1, 2003, is approved.
15. The 2002 Depreciation Study and depreciation rates included therein are approved.
16. NP's proposal to amortize the depreciation reserve variance over the three-year period 2003-2005 is approved.
17. NP's proposal to continue using the cash basis for recognizing expenses for other employee future benefits is approved.
18. NP's proposal to amortize over a three-year period, beginning in 2003, regulatory costs of \$1,200,000 is approved.
19. NP's request to defer dealing with the outstanding issues relating to the Revenue Recognition Study and the unbilled revenue increase reserve account is approved.
20. NP shall file with the Board:
  - i. A new depreciation study as of December 31, 2006;
  - ii. No later than with its next general rate application a report which addresses the use of the accrual method for other employee future benefits; and
  - iii. As part of its next general rate application a proposal as to the disposition of the balance in the Hydro Production Equalization Reserve as of December 31, 2005.

**REVENUE REQUIREMENT**

21. NP shall calculate and file a revised total revenue requirement for the 2003 and 2004 test years based on its proposals in this Application, incorporating the changes set out in this Decision and Order.
22. NP shall rebate to customers the 2001 excess earnings of \$944,000 and shall file for the approval of the Board a proposal for this rebate.
23. NP's proposal for adjusting 2003-2004 revenue requirement to recover the outstanding amount of the 1992-1993 excess earnings as required by Order No. P.U. 36(1998-99) is approved, subject to any adjustments arising from this Decision and Order.
24. Regulated expenses for 2003 and subsequent years shall exclude short-term incentive program payouts in excess of 100% of target.
25. NP is no longer required to file the Advertising and Marketing reports required by Order No P. U. 7(1996-97).

**COST OF SERVICE**

26. NP shall revise its cost of service methodology, using the COS methodology as proposed by NP, incorporating the changes set out in this Order which include the recommendations of the Mediation Report, as set out in Schedule 1 of this Decision and Order.

**RATES, RULES AND REGULATIONS**

27. NP shall revise and file for the approval of the Board a revised Schedule of Rates, Tolls and Charges which shall be effective for monthly bills issued August 1, 2003 through to December 31, 2004, based on the proposals of NP in its Application, incorporating the changes set out in this Decision and Order, which include the recommendations of the Mediation Report as set out in Schedule 2 of this Decision and Order.
28. NP shall file a proposal as to the finalization of interim rates as set by Order No. P.U. 35(2002-2003) and the disposition of any variance between revenue generated based on those interim rates and the revised 2003 test year revenue requirement.
29. NP shall revise and file for the approval of the Board revised Rules and Regulations, based on the proposals of NP in this Application, incorporating the changes set out in this Decision and Order, which include the Recommendations of the Mediation Report as set out in Schedule 2.



30. NP shall revise and file for the approval of the Board the definition of “*excess earnings*” in the company’s system of accounts to reflect earnings above the maximum of the allowed range of rate of return on rate base.
31. NP shall file with the Board by March 31, 2004 a report suggesting a “*peer group*” of utilities and performance measures upon which to evaluate NP’s performance, in accordance with the terms of the Mediation Report.

**CAPITAL ITEM**

32. The additional 2003 capital expenditure of \$425,000 for a load research program as proposed by NP is approved.

**HEARING COSTS**

33. NP shall pay the expenses of the Board arising from this Application, including the expenses of the Consumer Advocate incurred by the Board, pursuant to Section 117 of the *Act*.

Dated at St. John's, Newfoundland and Labrador this 20<sup>th</sup> day of June 2003.

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Robert Noseworthy,  
Chair & Chief Executive Officer.

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Darlene Whalen, P.Eng.,  
Vice-Chairperson.

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John William Finn, Q.C.,  
Commissioner.

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G. Cheryl Blundon,  
Director of Corporate Services  
and Board Secretary.

**SCHEDULE 1**  
**COST OF SERVICE**  
**RECOMMENDATIONS OF**  
**THE MEDIATION REPORT**  
**ORDER NO. P. U. 19(2003)**

**COST OF SERVICE**  
**RECOMMENDATIONS OF**  
**THE MEDIATION REPORT**

1. Newfoundland Power's ("NP's") cost of service study filed in this proceeding is fundamentally appropriate and in general compliance with Board Orders from previous hearings that have accepted NP's use of embedded cost of service studies as a guide in determining the revenue requirement increases or decreases to be applied to each class.
2. The following changes to NP's cost of service methodology, which received temporary Board Approval in NP's 1996 General Rate Proceeding, should be approved in this case:
  - Classification of NP's hydraulic plant using system load factor on energy rather than 100 per cent demand;
  - Allocation of NP's generating plant using a Single Coincident Peak allocation ("1CP") rather than Non-Coincident Peak allocation ("NCP");.
  - Allocation of NP's transmission plant using 1CP rather than NCP;
  - Allocation of purchased power transmission demand costs using 1CP rather than NCP;
  - Allocation of purchased power generation demand costs using 1CP rather than NCP;
  - Allocation of NP's funding of Newfoundland Hydro's rural deficit based on allocated class costs (with the rural deficit amount removed from determination of allocators to class cost).

**COST OF SERVICE**  
**RECOMMENDATIONS OF**  
**THE MEDIATION REPORT**

3. The Board should approve two additional changes to NP's cost of service methodology:
  - General expenses (i.e., General System Costs and Administration and General Costs) should be functionalized and classified based on the assumption that a portion of these costs is related to net utility plant (capital labor expense as a percentage of capital labor expense plus operating labor expense), rather than assuming (as previously) that all of these costs relate to operating and maintenance (O&M) expense.
  - The cost of service study should use normalized revenue and normalized purchased power expense rather than actual revenue and purchased power expense, unadjusted for normalization, as previously.
  
4. The Board should approve NP's use of an NCP allocation for distribution demand costs even though this differs from the 1CP allocator that Newfoundland Hydro was directed to use for distribution demand costs in Order No. P. U. 7(2002-2003).

**SCHEDULE 2**  
**RATES, RULES AND REGULATIONS**  
**RECOMMENDATIONS OF**  
**THE MEDIATION REPORT**  
**ORDER NO. P. U. 19(2003)**

**RATES, RULES AND REGULATIONS**  
**RECOMMENDATIONS OF**  
**THE MEDIATION REPORT**

1. The Board should approve tail block rate increases above the average class increase for Rates 2.2, 2.3 and 2.4 so as to better reflect short-run marginal energy costs in these tail block rates.
2. The Board should approve the elimination of minimum monthly (“ratcheted”) demand charges, linked to the customer’s maximum demand during the previous twelve months, in General Service Rates 2.2, 2.3 and 2.4.
3. The Board should retain the Curtailable Service Option Credit of \$29/kva in Rates 2.3 and 2.4 and require NP to inform customers of the possibility of significant future changes in this credit.
4. The Board should approve NP’s proposed merger of street light and area lighting rates for the 400W MV fixtures with the 250W HPS fixtures that replace them. The Board should also approve NP’s proposed removal from the Schedule of Rates and Regulations, the charges for the 1,000W MV fixture, the 700W MV fixture, and the 150W HPS post top fixture, since these no longer exist on NP’s system.
5. To the extent possible, there should be no adverse customer rate impacts. Any overall revenue change should be distributed equally to each class of customers. With the exception of any change in basic customer charges (see issue “9”, below), no customer should have a rate change that produces an annual cost change that is more than twice the system average (unless the dollar impact is minimal).
6. The Board should approve a change to Regulation 9(o) to reduce the application fee for a customer name change from \$14.00 to \$8.00 (the current new service fee).
7. The Board should approve the removal of clause 9(n) to eliminate charges for the preparation of account statements for billing information prior to the most recent twelve months.
8. The Board should approve a change to Regulation 9(f) and a proposed new clause 12(g) permitting charging the reconnect fee to new customers in apartments where a reconnection is required subsequent to a request by a landlord to disconnect an apartment. Such customers will not be required to pay the new service application fee.

**RATES, RULES AND REGULATIONS  
RECOMMENDATIONS OF  
THE MEDIATION REPORT**

9. The current basic monthly customer charges for domestic (residential) service and small general service rate 2.1 should be reduced by \$1.00. The revenue loss associated with this change should be made up by adjusting the energy component of these same rates so that the change does not impact customers in other rate classes. NP also agrees that (1) it will not propose a basic customer charge increase as a result of any wholesale rate increase in Hydro's 2003 GRA proceeding, and (2) in its next GRA, NP will cap the customer charge recovery of distribution costs allocated to customers at 50% of these allocated distribution costs for these rate classes, with the remainder to be recovered through energy charges. Distribution costs are distribution network costs beyond the service drop and do not include customer specific costs such as meters, meter reading, billing and service drops.





*Newfoundland & Labrador*

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