Q. You have recommended a common equity ratio of 45 percent for ratemaking purposes (page 4 of 67) and a return on common equity in the range of 11.5% - 12% (page 64 of 67). Assume, hypothetically, that the Board allows a 12% return on common equity and that the remaining 55% of the Company's capital structure is comprised of debt with a cost of 8%. Would the resulting allowed rate of return on rate base then be 9.8%?

.45	**x 12.00%**	**=**	**5.4%**
.55	**x 8.00%**	**=**	**4.4%**
			9.8%

If your answer is anything other than "yes", please provide a complete explanation.

A. No, the above example calculates the weighted average cost of capital. The Board has adopted a formula (approved in Orders P.U. 16 and P.U. 36 (1998-99)) which translates the weighted average cost of capital into an allowed rate of return on rate base.

The formula adopted for calculating the rate of return on rate base, using the hypothetical 9.8% weighted average cost of capital and Company's forecasts for 2003, would show a return on rate base of 10.98%, as shown below.

$$10.98\% = \left[\frac{\$670{,}191^{1}}{\$597{,}232^{2}} \times 9.8\%^{3} \right] + \frac{(\$66^{4} + \$30^{5} - \$216^{6})}{\$597{,}232^{2}}$$

[1] Forecast of Average Invested Capital for 2003 (BVP-10, page 1 of 1, line 6).
[2] Forecast of Average Rate Base for 2003 (BVP-9, page 1 of 2, line 27).
[3] Hypothetical Weighted Average Cost of Capital as shown above.
[4] Forecast of Amortization of Capital Stock Issue expenses for 2003 (BVP-13, page 1 of 1, line 31).
[5] Forecast of Interest on Customer Deposits for 2003.
[6] Forecast of Capitalized Interest for 2003 (BVP-13, page 1 of 1, line 32).

The formula adopted by the Board recognizes that investors have financed utility-related assets which are not included in the rate base as it is currently defined for Newfoundland Power. Those assets, primarily deferred pension expense, are, however, related to the operations of the utility. The costs of financing the assets need to be recovered for the utility to be kept whole and are properly recoverable from ratepayers. The formula permits the Company to recover those financing costs.

The formula adopted by the Board is similar to the approach taken by the Nova Scotia Utilities and Review Board (the "UARB") for Nova Scotia Power. Nova Scotia Power calculates the rate base in a manner similar to that of Newfoundland Power (e.g., excluding deferred charges such as deferred pension expense). However, the UARB determines the return on equity and return on rate base by reference to invested capital

(which finances the rate base as defined by the UARB as well as utility assets such as deferred pension expense).

Consequently, the UARB approach, similar to Newfoundland Power's formula, allows Nova Scotia Power the opportunity to recover all the financing costs associated with its utility-related assets.

The approach taken by the Board for Newfoundland Power is, in principle, similar to explicitly including other utility-related items in the definition of rate base. For example, in Order No. P.U.7 (2002-2003) (page 101), the Board allowed Newfoundland and Labrador Hydro ("Hydro") to include $85.2 million of unamortized foreign exchange losses in rate base, and noted Hydro's request, "that the unamortized portion of the realized foreign loss be included in the rate base because NLH (Hydro) must continue to finance this balance until it is fully recovered." Newfoundland Power's deferred charges, which account for the majority of the difference between its rate base and invested capital, are analogous to Hydro's foreign exchange losses. The costs of financing Newfoundland Power's deferred charges or Hydro's foreign exchange losses can be recovered either through the use of Newfoundland Power's formula or inclusion of the amounts in rate base; the results of either practice are the same.

Other regulatory jurisdictions in Canada include directly in rate base the types of deferred charges incurred by Newfoundland Power. In Alberta, for example, deferred pension expense, as well as other deferred charges, are included in rate base. The British Columbia Utilities Commission, National Energy Board and Ontario Energy Board have all allowed various types of deferred charges to be included in rate base. The use of a formula such as Newfoundland Power's, or the inclusion of deferred charges in rate base, both seek to accomplish the same objective: the opportunity to recover the actual costs of financing utility assets. Both approaches are accepted regulatory practice.