Newfoundland and Labrador
Board of Commissioners of Public Utilities

Newfoundland Power's
2006 Accounting Policy Application

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On Behalf of
The Consumer Advocate

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Table of Contents

1 BACKGROUND

Newfoundland Power ("NP") filed its 2006 Accounting Policy Application ("2006 APA") with the Board of Commissioners of Public Utilities ("Board" or "PUB") on September 29, 2005. The 2006 APA addresses a number of issues that have arisen as a result of the resolution in June 2005 of NP's "longstanding tax dispute concerning its historical policy of revenue recognition for income tax purposes."[1] NP has divided the issues addressed in the 2006 APA into three areas:

- accounting policy for revenue recognition
- transitional issues
- consequential matters

The Government of Newfoundland and Labrador appointed Thomas Johnson as the Consumer Advocate ("CA") to represent the interests of consumers in connection with the 2006 APA. The CA has asked me as an economist who has specialized in the theory and practice of economic regulation for over 25 years to provide assistance to the Board by preparing evidence that addresses the following questions.[2]

1. Is the adoption of the Accrual Method of revenue recognition for regulatory purposes consistent with standard regulatory policies and practices?
2. Is NP's proposal to establish a 2005 Unbilled Revenue account to be disposed of to the benefit of ratepayers in 2005 and subsequent years consistent with standard regulatory policies and practices?
3. Is NP's proposal to apply $295,000 of the 2005 Unbilled Revenue to dispose of the current balance in the Unbilled Revenue Increase Reserve in 2006 consistent with standard regulatory policies and practices?

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[1] Newfoundland Power – 2006 Accounting Policy Application, Company Evidence, page 1.

[2] John Todd is President of Elenchus Research Associates Inc. (ERA). He established the predecessor firm, Econalysis Consulting Services Inc. (ECS) in 1980. Mr. Todd's curriculum vitae is attached as Appendix A. Additional information on ERA is available at www.era-inc.ca.

4. Is NP's proposal to apply $9.6 million of 2005 Unbilled Revenue to it's 2006 revenue for regulatory purposes consistent with standard regulatory policies and practices?
5. Is NP's proposal to defer the decision on the disposition of the remaining 2005 Unbilled Revenue of approximately $14.4 million for future consideration by the Board consistent with standard regulatory policies and practices?
6. Is NP's proposal to deduct the average value of the unrecognized 2005 Unbilled Revenue from rate base commencing in 2006 consistent with standard regulatory policies and practices?
7. Is NP's implied treatment[3] of the $2.1 million in interest revenue arising from the tax settlement consistent with standard regulatory policies and practices?
8. Are NP's proposals with respect to adopting the asset rate base methodology ("ARBM") consistent with standard regulatory policies and practices?

My evidence is divided into four additional sections. Section 2 provides a brief review of NP's proposals that relate to the questions I have been asked to address. Section 3 identifies the key regulatory principles that are relevant to the assessment of NP's proposals. My assessment of the proposals is contained in section 4. My conclusions and recommendations are summarized in section 5.

2 NEWFOUNDLAND POWER'S PROPOSALS

This section briefly reviews NP's proposals, highlighting the issues that are most relevant to the assessment that appears in section 4 of my evidence.

In its covering letter and in the Application NP states that it is seeking a Board order approving five specific requests.[4] In support of these requests, the Company's Summary of Proposals at pages 33-34 of the Evidence sets out eight proposals.

[3] Although NP has not requested the Board's approval to recognize the interest revenue in 2005 for regulatory purposes, the Company's response to PUB 10.0 NP makes it clear that that is NP's intent.

[4] A sixth request is included in NP's 2006 APA: "such further, other or alternate mattes which may, upon the record of proceedings in respect of this Application, appear just and reasonable in all of the circumstances."

1. *to change its accounting policy for revenue recognition for regulatory purposes to the Accrual Method commencing in 2006;*
2. *that the 2005 Unbilled Revenue be dealt with on a prospective basis over a Transition Period commencing in 2006;*
3. *to recognize for regulatory purposes in 2006, $9,579,000 of the 2005 Unbilled Revenue to recover forecast increased depreciation expense in 2006 and forecast income tax effects;*
4. *to apply the current balance of $295,000 in the Unbilled Revenue Increase Reserve to reduce the unrecognized 2005 Unbilled Revenue in 2006;*
5. *that the disposition of the forecast remaining unrecognized 2005 Unbilled Revenue of $14,388,400 (i.e., the forecast unrecognized 2005 Unbilled Revenue at year-end 2006) be determined by the Board in a future order;*
6. *to deduct the average value of the unrecognized 2005 Unbilled Revenue from rate base commencing in 2006;*
7. *to use book common equity in the calculation of rate of return on rate base commencing in 2006; and*
8. *that forecast 2006 values for rate base of $744,326,000 and invested capital of $745,752,000 be approved for use in the Formula for the calculation of Newfoundland Power's rate of return on rate base for 2006.*[5]

A further implicit proposal was identified in PUB 10.0 NP which queried NP about the timing of the recognition the $2.1 million in interest revenue arising from the tax settlement for regulatory purposes.

Having reviewed the evidence on the record to date, I have identified the following distinct issues that need to be assessed in order to respond to the CA's questions.

1. The change from the Billed Method to the Accrual Method for revenue recognition for regulatory purposes commencing in 2006.
2. The use of the 2005 Unbilled Revenue account to recognize the revenue accrued but not billed in 2005 (hence not recognized in 2005 under the Billed Method) and billed but not accrued in 2006 (hence not recognized in 2006 under the Accrual Method).
3. The disposition of the Unbilled Revenue Increase Reserve ($295,000) through the recognition of an equal amount of 2005 Unbilled Revenue.

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[5] Company Evidence, pages 33-34.

4. The recognition of a revenue deficiency of $10,036,000 for 2006 based on known and measurable increases to selected cost items, in the absence of a full GRA.
5. The offsetting of the known and measurable increases in selected cost items through (i) the recognition of $9,579,000 of the 2005 Unbilled Revenue (out of the total value of $24,262,400) and (ii) the *pro forma* revenue change of $457,000.
6. The recognition of $2.1 million of interest revenue arising from the tax settlement as revenue for regulatory purposes.
7. The Asset Rate Base Method ("ARBM") Review (Exhibit NP-9).

The remainder of this section provides a brief description of each issue. The issues are assessed in section 4.

2.1 CHANGE TO THE ACCRUAL METHOD OF REVENUE RECOGNITION

NP is proposing to move from the Billed Method to the Accrual Method for recognizing revenue for regulatory purposes. NP's Revenue Recognition Study (Exhibit NP-3) (the "Study") provides an excellent explanation of the change and its implications. The evidence of Mr. Browne provides a helpful supplement to the Study.

The difference between the two methods is clearly explained in the evidence of Mr. Browne for the Company.

> *Under the accrual method, revenues are recognized when services are provided. For rate setting purposes, rates are set so that the revenues from services provided in the test period equal the utility's revenue requirement for that period.*
>
> *Under the billed method, revenues are recognized when services are billed to ratepayers. For rate setting purposes, rates are set so that revenues from services billed in the test period will equal the utility's revenue requirement for that period.*[6]

NP is proposing to adopt the Accrual Method of revenue recognition commencing in 2006. The implications of moving to the Accrual Method in 2006 include the following:

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[6] Browne, John T. (28 Sept 2005) Newfoundland Power Changes to Regulatory Accounting, filed on behalf of Newfoundland Power.

- 2005 revenue will be recognized in accordance with the Billed Method; 2005 revenue recognition will be based on energy billed to customers from January 1, 2005 through December 31, 2005.
- 2006 revenue will be recognized in accordance with the Accrual Method; hence, 2006 revenue recognition will be based on the energy consumed by customers from January 1, 2006 through December 31, 2006.
- The revenue related to power consumed during December 2005 but not billed until January 2006, will not be recognized either as 2005 revenue (based on the Billed Method) or as 2006 revenue (based on the Accrual Method). NP estimates that the quantum of this "orphaned" revenue is approximately $24.3 million.[7]

The transition from the Billed Method to the Accrual Method is a straightforward and standard accounting procedure. However, in the context of rate regulation the change gives rise to important transitional issues that must be addressed for regulatory purposes. In particular, the Board must make a determination as to the most appropriate method for recognizing this revenue for regulatory purposes. The mechanism proposed by NP for tracking the recognition of this revenue is the 2005 Unbilled Revenue account.

2.2 Establish 2005 Unbilled Revenue Account

As noted above, the 2005 Unbilled Revenue is the revenue that would have been recognized in 2005 under the Accrual Method but was not recognized under the Billed Method. NP's estimate of the 2005 Unbilled Revenue as of December 31, 2005 is $24,262,000.[8] The actual 2005 Unbilled Revenue will, of course, differ from this estimate. NP's estimate is based on normal weather and other factors. The actual 2005 Unbilled Revenue will depend on actual consumption during December. It will therefore be necessary for the Company to update this estimate once it has finalized its billing for the December 2005 period.

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[7] Company Evidence, page 2, lines17-19.
[8] Company Evidence, Exhibit NP-3, page 4.

NP's Revenue Recognition Study also identifies the change in Unbilled Revenue for the years 2006 through 2008.[9] The 2006 change in unbilled revenue is $457,000. This increase in unbilled revenue can be viewed in either of two ways. First, it can be viewed as the difference between 2006 Unbilled Revenue and 2005 Unbilled Revenue. Alternatively, it can be viewed as the amount by which revenue under the Accrual Method will exceed the revenue under the Billed method in 2006.

Whichever way it is viewed, it is clear that this increase in unbilled revenue represents an increase in 2006 revenue vis-à-vis 2005 revenue that serves to offset increases in costs in 2006. Hence, in assessing the impact of cost increases on the Company's rate of return it is clearly necessary to recognize that the change in unbilled revenue will provide an offset to the increased costs.

The purpose of the 2005 Unbilled Revenue account is to track the quantum of unbilled revenue that has not been recognized for regulatory purposes. Hence it is also referred to as the unrecognized 2005 Unbilled Revenue.[10] When some of the 2005 Unbilled Revenue is recognized for regulatory purposes, the remaining value in the account will decline. Once all of the 2005 Unbilled Revenue has been recognized, the value in the 2005 Unbilled Revenue account will decline to zero and the account can be eliminated.

Although the 2005 Unbilled Revenue may not be recognized fully for several years, NP will collect the full amount from customers in January 2006.[11] Hence, the 2005 Unbilled Revenue represents money that the Company has collected from customers although it has not been recognized as revenue for regulatory purposes. In effect, the money in the 2005 Unbilled Revenue account is money that customers have "loaned" to the company until it is recognized as revenue, for which the Company pays no interest. Hence, the 2005 Unbilled Revenue represents a no-cost source of capital for the Company.

The Company is proposing to deduct the 2005 Unbilled Revenue from rate base in recognition that the portion of rate base funded in this manner does not require a return.

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[9] Company Evidence, Exhibit NP-3, page 4, Table 1.
[10] Evidence of JT Browne, pages 14-20. He uses the acronym UUR for unrecognized unbilled revenue.
[11] Subject to late payments and bad debts.

The most significant issue for the Board to consider with respect to the 2005 Unbilled Revenue is the way in which it is recognized. The Board's policy decision will determine the extent to which customers benefit from the disposition of the $24.3 million that will be collected from them in January 2006, but not immediately recognized as revenue.

2.3 Disposition of Unbilled Revenue Increase Reserve

The Unbilled Revenue Increase Reserve ("Reserve") is a portion of the 2005 Unbilled Revenue that has already been recognized in prior years for regulatory purposes. Hence, the actual value of the 2005 Unbilled Revenue that will not be accrued and recognized as of December 31, 2005 is equal to the net value of the 2005 Unbilled Revenue minus the Reserve.

It is therefore appropriate, as a preliminary step in moving to the Accrual Method, to net the Reserve against the 2005 Unbilled Revenue to eliminate the Reserve and reduce the 2005 Unbilled Revenue to the level that accurately reflects the unrecognized 2005 Unbilled Revenue.

The value of the 2005 Unbilled Revenue after netting out the Reserve, which has already been recognized, is $24,262,000 minus $295,000 (i.e., $23,967,000).

2.4 Revenue Deficiency

NP's Forecast 2006 Financial Results indicate that in the absence of its proposals to recognize additional revenue in 2006, its rate of return on rate base will be 7.02%.[12] This calculated return is based on the Forecast Financial Statements[13] contained in the Evidence. The 7.02% forecast figure falls below NP's currently approved range for its rate of return on rate base, which is 8.50% to 8.86%.

When a regulated utility anticipates that it will fail to earn its allowed return it is entitled to request a rate increase. The standard process in Newfoundland, as in other

[12] Company Evidence, Exhibit NP-15, line 31, 2006 Existing.

[13] Company Evidence, Exhibit NP-14. The major inputs and assumptions used in the Forecast Financial Statements are listed at page 5 of Exhibit NP-14.

Canadian jurisdictions, for requesting a rate increase is that the company files a General Rate Application ("GRA") that contains a forecast of the utility's revenues and costs for the future test year, where the costs include the allowed (or requested) rate of return on rate base. The difference between the utility's forecast costs (its revenue requirement) and its forecast revenue is termed the revenue deficiency.

The utility's forecast of revenues and costs is then normally subject to a review process so the regulator is able to exercise due diligence in determining the level of costs that should be allowed and recovered from ratepayers. The revenues and costs that utilities forecast are frequently adjusted by the regulator for rate-setting purposes. Rates are then set at the level necessary to recover the utility's allowed costs based on the sales forecast that is approved by the regulator. Put differently, a rate increase is allowed that is sufficient to offset the utility's revenue deficiency. It is the process of subjecting the utility's forecast of revenues and costs to diligent scrutiny by the regulator and interested parties in a public hearing process that allows the regulator to make a determination that the rates it is approving are just and reasonable.

In this instance, NP has not addressed its forecast revenue deficiency by filing a GRA and requesting a rate increase. Instead it is seeking to recognize sufficient Unbilled Revenue to increase its forecast rate of return on rate base to 8.56%.[14] The Company has made it clear that it considers its revenue recognition proposals to be an alternative to a rate increase. For example, NP states:

> *This proposal defers an otherwise necessary rate increase in 2006, which provides tangible benefits to Newfoundland Power's customers in that year.*[15]

The Company appears to acknowledge that it is expected to provide an evidentiary base that will enable the Board to make a determination that the revenue recognition proposals are cost justified. However, its approach is not to subject its overall forecast of revenues and costs to regulatory scrutiny so that the Board can determine the quantum of the revenue deficiency and hence, the quantum of the additional revenue

[14] Company Evidence, Exhibit NP-15, line 31, 2006 Proposed.
[15] Evidence, page 3:4-6. NP says essentially the same thing at p. 26:22-23 and in several responses to RFIs. Mr. Browne makes the same point at page 17 of his evidence.

needed for the Company to earn its allowed return.[16] Instead it is seeking to offset known and measurable increases in depreciation expense and income taxes. If all other costs and revenues were unchanged from 2005 to 2006, then these increases would correspond to the year-over-year change in the Company's revenue deficiency.

2.5 Offset for Known and Measurable Cost Increases

In its evidence, NP identifies $10,036,000 in known and measurable cost increases from 2005 to 2006, consisting of depreciation expense increases ($6,950,000) and an increase in income taxes ($3,086,000).[17] The increase in depreciation expense is discussed in section 3.2.2 of the Company's Evidence and summarized in Table 3.

Table 3[18]
Forecast 2006 Depreciation Expense
(000s)

Forecast 2005 Depreciation Expense	*$32,129*
2006 Increases	
Conclusion of True-up Adjustment	*5,793*
Impact of Increased Plant Investment	*1,157*
Total of 2006 Increases	*6,950*
Forecast 2006 Depreciation Expense	*$39,079*

The true-up relates to the completion of the three-year amortization of the depreciation reserve variance approved by the Board in Order No. P.U. 19 (2003). The impact of increased plant investment reflects NP's increased forecast depreciation expense.[19]

The increase in income taxes payable includes the effects "related to (i) the recognition of the 2005 Unbilled Revenue for income tax purposes equally over 2006 – 2008 and (ii) the adoption of the Accrual Method of revenue recognition for income tax purposes commencing in 2006."[20]

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[16] Based on NP's 2006 Formula Application, dated November 30, 2005, its allowed rate of return on rate base for 2006, as determined by the Board-approved automatic adjustment formula, would be 8.54%.
[17] Company Evidence, page 22.
[18] Company Evidence, page 20.
[19] Company Evidence, Exhibit NP-5.
[20] Company Evidence, page 12, footnote 7. The details of the pro forma income tax effects for 2006 to 2008 are shown at Exhibit NP-2.

The Company proposes to offset those increases dollar-for-dollar through (i) a *pro forma* revenue change of $457,000 that corresponds to the forecast increase in unbilled revenue in 2006 and (ii) the recognition of $9,579,000 of the net unrecognized 2005 Unbilled Revenue ($23,967,000, as shown above).

2.5.1 Pro Forma Revenue Change

The move from the Billed Method to the Accrual Method of revenue recognition for regulatory purposes in 2006 will result in two adjustments to the 2006 test year forecast revenue:

- the elimination of the 2005 unbilled revenue, and
- the addition of the 2006 unbilled revenue.

The net effect of these two adjustments is that the 2006 test year forecast revenue increases by an amount equal to the increase in unbilled revenue from December 31, 2005 to December 31, 2006. This amount is $457,000.

This increase in 2006 test year forecast revenue is inherent in the change from the Billed Method to the Accrual Method and does not require an approval of the Board other than acceptance of the move to the Accrual Method. Nevertheless, the change to the Accrual Method, in effect, provides an automatic increase in revenue in 2006 as compared to 2005 of $457,000.

2.5.2 Recognition of 2005 Unbilled Revenue

The Company is proposing to recognize sufficient 2005 Unbilled Revenue in 2006 to offset the remaining identified increases in depreciation expense and tax expense noted above. The primary rationale for using the 2005 Unbilled Revenue in this way appears to be that doing so avoids a rate increase that, if implemented, would result in further tax effects related to the increased income.[21] Of course, this rationale presumes that the Company would, in fact, seek a rate increase for 2006 if the proposed recognition of

[21] NP provides a comparison of the total revenue requirement impact of offsetting the $10,036,000 in cost increases with unbilled revenue vs. a rate increase at Exhibit NP-6.

2005 Unbilled Revenue is not approved. It also presumes that if the company were to seek a rate increase by means of a GRA, the Company's revenue deficiency forecast that appears at NP-15 would be accepted by the Board after a full hearing. It is not self-evident that either of these assumptions have an evidentiary base that meets the normal standards of a rate-setting process.

2.6 Recognize Interest Revenue Due to the Tax Deposit in 2005

The Company's response to PUB 10.0 NP, acknowledges that it received $2.1 million of interest revenue arising from the tax settlement. It is, in effect, seeking the approval of the Board to recognize this interest revenue in 2005 for regulatory purposes. NP's rationale for recognition of the interest revenue on the tax deposit in 2005 for regulatory purposes appears to be based on consistency with GAAP, which has determined the timing of the recognition of this interest revenue in its accounts.

2.7 The ARBM Review

As the ARBM Review states:

> *This Asset Rate Base Method Review (the "Review") provides an update on the transition to ARBM based on the recommendations of the Report, taking into account the impact of Newfoundland Power's proposals with respect to recognizing revenue on an accrual basis beginning in 2006.*[22]

The primary implication of the Review is that there has been increasing alignment between average invested capital and average rate base as a result of various changes including the move from the Billed Method to the Accrual Method. Table 4 of the Report provides a reconciliation that shows that the difference between average invested capital and average rate base is projected to be less than 0.2% in each of the years 2006 to 2009.

Given the degree of alignment between average invested capital and average rate base, the distinction between the rate of return on invested capital and the rate of return

[22] Company Evidence, Exhibit NP-9 (Asset Rate base Method Review), page 1/

on rate base is becoming trivially small. As a result, it may be appropriate to implement a method of determining NP's rate of return on rate base that uses the weighted average cost of capital directly. This approach would be more consistent with the standard practice in other Canadian jurisdictions.

3 Regulatory Principles

The Board's decision in NP's last GRA included a discussion of regulatory principles that captures the consensus view of academics and regulators in a comprehensive yet succinct manner. The Board's discussion starts with the following paragraph:

> *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, Kamerschen 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.*[23]

The Decisions then proceeds to identify the following seven regulatory principles.

> *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*
>
>   ...
> 2. *Cost of Service*
>
>   ...
> 3. *Fair Cost Apportionment*
>
>   ...
> 4. *Efficiencies*
>
>   ...
> 5. *Rate Stability and Predictability*
>
>   ...
> 6. *End Result*
>
>   ...
> 7. *Practical Attributes*

[23] Board of Commissioners of Public Utilities, Decision and Order of the Board in the Matter of the 2003 General Rate Application filed by Newfoundland Power Inc., Order No. P.U. 19 (2003), page 14.

These principles, as elaborated on by the Board in the Decision, serve as guidance for my assessment of NP's proposals in section 4, below.[24]

4 ASSESSMENT OF NP'S PROPOSALS

This section provides my assessment of the seven issues identified in section 2, above in terms of the consistency of NP's proposed approach with generally accepted regulatory principles and practices.

4.1 CHANGE TO THE ACCRUAL METHOD OF REVENUE RECOGNITION

The evidence of the Company observes that "[h]istorically, regulated utilities have recognized revenue by one of two broad methods ... the 'Billed Method' ... [and] the 'Accrual Method' ... Revenue recognition using the Accrual Method is accepted Canadian public utility practice."[25] The point could actually be made more strongly. The accrual method is currently the near-universal practice[26]; hence, NP will essentially be moving into the mainstream by adopting the Accrual Method. As Goodman states:

> *Unbilled revenue: When the regulated company has failed or otherwise found itself unable to bill all its customers in the test year, it properly adjusts year-end test year revenue for unbilled revenue.*[27](Emphasis added.)

I concur with the Company, Mr. Browne and Grant Thornton that adoption of the Accrual Method of revenue recognition is appropriate for regulatory purposes. It will result in a better alignment of revenues and costs for future GRAs.

The Accrual Method is more consistent with the regulatory principles outlined by the Board in Order No. P.U. 19 (2003) which states that under the Cost of Service principle,

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[24] Evidence of JT Browne, Exhibit JTB-3, Regulatory Principles. In his evidence, Mr. Browne also identifies and discusses seven regulatory principles: just and reasonable; cost of service standard; prudence standard; fair return; used and required to be used; intergenerational equity; and rate stability and predictability. The two sets of principles appear to be consistent with each other and with the principles used explicitly and implicitly in other Canadian jurisdictions.

[25] Company Evidence, pages 8-9.

[26] Company Evidence, Exhibit NP-3 (Revenue Recognition Study), Appendix A.

[27] Goodman, Leonard Saul (1998) *The Process of Ratemaking*, Public Utilities Reports (www.pur.com).

> *Costs should be:…incurred and recovered (matching costs and benefits) during the same period;*

The Accrual Method achieves better matching of costs and revenues.

4.2 Establish 2005 Unbilled Revenue Account

The 2005 Unbilled Revenue account is a convenient mechanism for identifying and quantifying the revenue that is not recognized as either 2005 revenue under the Billed Method or 2006 revenue under the Accrual Method. Capturing the unrecognized revenue in this account does not constrain the Board's options for recognizing the revenue. It could be recognized in its entirety in 2006, or recognized over a period of years on the basis of any mechanism that the Board deems appropriate.

In itself, the 2005 Unbilled Revenue account cannot be said to be consistent or not with accepted regulatory principles and practices. It is the recognition method that must be assessed for its consistency with regulatory principles and practices.

4.3 Dispose of Unbilled Revenue Increase Reserve

As the Company observes, the Unbilled Revenue Increase Reserve ("Reserve") will have "limited, if any, future application."[28] It is therefore appropriate to reduce the balance in this account to zero so that it can be eliminated.

The Dec. 31, 2005 Reserve balance of $295,000 is the portion of the 2006 Unbilled Revenue that was recognized as revenue in 2005. Hence, the actual net amount of 2005 Unbilled Revenue that has yet to be recognized is $24,262,000 minus $295,000.

Consequently, the Reserve should be disposed of prior to making a determination as to the correct disposition of the 2005 Unbilled Revenue. Otherwise the actual quantum of 2005 Unbilled Revenue to be recognized will be overstated.

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[28] Company Evidence, page 24.

For purposes of my assessment of the issues, the 2005 Unbilled Revenue to be recognized in 2006 and subsequent years is therefore deemed to be $23,967,000 which is the forecast unrecognized 2005 Unbilled Revenue.

4.4 REVENUE DEFICIENCY

In order to properly assess NP's proposal to recognize $9.6 million of the 2005 Unbilled Revenue in 2005 it is essential to examine carefully the rationale for the proposal.

The Company derives the quantum to be recognized through a three-step process.

1. Quantify the increase in costs from 2005 to 2006 attributable to:
   - the conclusion of the depreciation true-up adjustment ($5.793 million)
   - the impact of increased plant investment ($1.157 million)
   - income tax effects related to the Tax Settlement ($2.921 million)[29]
   - income tax effect of the increase in unbilled revenue ($0.165 million)[30]

   These cost drivers total $10.036 million.
2. Quantify the inherent increase in revenue due to the adoption of the Accrual Method ($457 thousand).
3. Recognize sufficient 2005 Unbilled Revenue to cover the difference between the cost increases and the revenue increase determined above ($9.579 million).

The critical question related to this approach however is this:

> **Is the Board's decision with respect to the approval of the proposed recognition of $9.6 million in 2005 Unbilled Revenue independent of a determination as to whether there is a revenue deficiency? Put differently, is it appropriate to approve the recognition of the $9.6 million regardless of the impact on NP's forecast rate of return on rate base?**

[29] The income tax effect of the Tax Settlement is determined by multiplying the revenue recognized for income tax purposes by NP's tax rate. $8.087 million * 36.12% = $2.921 million. See Exhibit NP-2.

[30] The income tax effect of the increase in unbilled revenue is determined by multiplying the revenue increase by NP's tax rate. $0.457 million * 36.12% = $0.165 million. See Exhibit NP-2.

If the critical consideration is the forecast revenue deficiency for 2006, then it would be quite exceptional for the Board to approve the recognition of revenue for regulatory purposes (whether through a rate increase or the recognition of 2005 Unbilled Revenue) without the forecast revenue deficiency first being subjected to appropriate regulatory scrutiny. In general, this scrutiny is accomplished through a GRA. On the other hand, if it would be appropriate to offset these costs through a rate increase or revenue recognition in 2006 regardless of the Company's rate of return on rate base then a GRA would not be necessary.

There are circumstances in which it is consistent with accepted regulatory principles and practices to adjust rates without a GRA. The distinguishing characteristic of these situations is that the regulator has recognized in advance that approved rates do not recover the costs and a mechanism has therefore been approved <u>in advance</u> to adjust rates in response to changes in costs. Under these circumstances, it is only the change in costs that need be reviewed, not the overall change in the revenue deficiency.

For example, variance accounts are commonly used to track the difference between forecast and actual costs (e.g., for commodity costs through a purchased power or gas variance account). The pass-through of these costs is independent of the utility's actual rate of return earned on its regulated business (e.g., distribution); hence, the disposition of the variance account can be approved in the absence of a GRA.

Rate changes are also commonly approved in the absence of a GRA where comprehensive performance-based regulation (PBR) regimes are in place. For example, the British Columbia Utilities Commission ("BCUC") has used PBR for some utilities. They use a formula to establish target costs for most cost categories for a period of three or more years. Variances between the actual and target costs are then shared between the company and its customers. Rates are subject to an Annual Review process that is used to review the relevant utility's financial and service quality performance and to scrutinize costs that are not included within the incentive mechanism (e.g., some categories of capital). The incentive mechanism is deemed to serve as an alternative to regulatory scrutiny as a means of determining that costs have been prudently incurred and that the resulting cost-based rates are just and reasonable.

NP does not appear to be taking the position that it is appropriate to pass through rate increases or revenue recognition to offset the identified cost increases regardless of the Company's revenue deficiency and rate of return. In its response to CA 3.0 NP which asks in essence whether NP would consider it appropriate to recognize the $9.6 million in 2005 Unbilled Revenue if NP would not have a revenue deficiency in the absence of the additional revenue, the Company said:

> *No. The Company would not consider it appropriate to recognize $9,579,000 of the 2005 Unbilled Revenue in 2006 under the hypothetical situation described in CA 2.0 NP as it would result in a 2006 forecast return on rate base of 8.86% and excess revenue of approximately $5.9 million.*

This response is consistent with the Company's overall approach to the issue of the recognition of 2005 Unbilled Revenue throughout the 2006 APA. While the quantum of the proposed increase can be determined by reference to the increase in depreciation and tax expense, the Company makes it quite clear throughout its evidence that an underlying reason for the approval being sought is the forecast of a rate of return on rate base in 2006 that is below the currently approved range.

Strictly speaking, it is my view that it would be inconsistent with standard regulatory principles to approve additional revenue – whether from a rate increase or the recognition of revenue in some other way (e.g., NP's recognition of 2005 Unbilled Revenue) – in the absence of a process such as a GRA or PBR mechanism that allows the regulator to make a determination as to the reasonableness of the utility's forecast revenues and costs. A central aspect of the regulator's responsibility to consumers is the duty to scrutinize the utility's costs to ensure that they have been prudently incurred and to examine the utility's load forecast, revenue projections and cost forecast to ensure that the Cost of Service principle is honoured – no more, no less.

At the same time, it is not unusual for parties to regulatory processes to be interested in avoiding the cost and resource burden of a full GRA when it is reasonable to do so. The most common strategy for settling regulatory matters in the absence of a full review of the relevant evidence (e.g., without a full examination of the costs and revenues underpinning a revenue deficiency) is through a negotiation process.

If consideration is to be given to resolving the matters that NP has included in its 2006 APA without a full GRA, two broad issues need to be addressed.

- How much uncertainty should be attributed to the Company's Forecast 2006 Financial Results (Exhibit NP-15)?
- Are the cost items that are included in the derivation of the $10.036 million that the Company is seeking to offset indisputable?

The first question has no clear answer. NP's request puts the Board in the unenviable position of having to make a decision without having the opportunity to test the relevant evidence. Because of this, it can be concluded that there is uncertainty regarding the extent to which the Forecast 2006 Financial Results would stand up under regulatory scrutiny. Under these circumstances, it would appear to me to be inappropriate for the Board to consider itself to be obligated to recognize sufficient revenue for NP to achieve even the minimum of the allowed rate of return on rate base range (8.50%). An untested forecast is not evidence that rates are not just and reasonable, nor is it evidence that the Company does not have an opportunity to earn its allowed rate of return.

With regard to the second question, in assessing the extent to which it is indisputable that the cost increases included in the Company's $10.036 million claim, it is necessary to consider each item separately. This is done is section 4.5.3 below.

4.4.1 Consistency with the PUB's Past Regulatory Practices

NP's response to CA 11.0 NP identifies past Board orders that in the view of the Company are relevant to the issue of awarding increased revenue to offset increased costs in the absence of a GRA. The Company states:

> *Customer Rates have been revised based on updated 2004 test year parameters to reflect (i) an increase in the purchased power rate paid to Newfoundland and Labrador Hydro ("Hydro") and (ii) the operation of the Automatic Adjustment Formula (the "Formula"). These rate changes were implemented without the requirement for Newfoundland Power to file a GRA.*[31]

[31] CA 11.0 NP, page 1, lines 29-33.

In my view these precedents are consistent with the approach that I have outlined above. The purchased power cost is a cost pass-through item that is separate from the rate-setting process for NP, as is evident from the way NP reports its financial results.[32] Purchased power expense is deducted from total revenue to derive the "contribution". NP's rate-setting process only addresses the revenue requirement and deficiency related to this contribution. The GRA focuses on NP's costs that are recovered through this contribution. The rates that determine the purchased power expense are set through the separate Newfoundland and Labrador Hydro rate-setting processes.

Turning to the Automatic Adjustment Formula, it seems clear that it is a mechanism that was specifically designed to operate outside the GRA process. It is quite clear that it was the Board's intent to make appropriate rate adjustment in response to changes in the formula without recourse to a GRA. Treating the impact of Formula changes in this way was clearly pre-approved.

The critical point here is that in both cases a mechanism exists to automatically deal with both increases and decreases in relevant costs and make appropriate rate adjustments. The automatic nature of the treatment of these costs ensures that impacts are dealt with symmetrically. That is, the Board and customers can be confident that all changes will be recognized and passed through, whether they increase or decrease rates. There can be no assurance that other *ad hoc* adjustments that will only be recognized in non-GRA years if the Company chooses to bring them to the Board's attention will be treated symmetrically. The GRA process is the customers' guarantee that they will not be disadvantaged as a result of the Company selectively passing through cost increases in the absence of a full review of the overall revenue deficiency.

The implication of these comments is that the Board should be extremely cautious about allowing revenue increases that offset *ad hoc* cost increases in the absence of a GRA. Rate increases and revenue recognition should be approved outside of a GRA only where there is an established process that is specifically designed to pass through cost variances in a manner that ensures consistency with regulatory principles.

[32] See for example, Company Evidence, Exhibit NP-15, Forecast 2006 Financial Results

4.5 *Offset for Known and Measurable Cost Increases*

NP's proposal to recognize 2005 Unbilled Revenue, and make other minor accounting adjustments, as a means to offset known and measurable increases in depreciation and income taxes raises important issues related to the application of the regulatory principles that the Board set out in Order No. P.U. 19 (2003), in particular the fair return and cost of service principles.

4.5.1 Fair Return

An important consideration in the Company's rationale for its proposals is the **Fair Return** principle. Based on its forecast 2006 Financial Results[33], it appears that the Company will earn a rate of return on rate base of 7.02% if neither the 2006 Unbilled Revenue Accrual ($457,000) nor the proposed recognition of 2005 Unbilled Revenue ($9,579,000) is approved. This rate of return would be below the currently approved range of 8.50% to 8.86%, suggesting that the Company would not have "the opportunity to earn a fair rate of return" in 2006 as required by the Fair Return principle.

With both amounts approved, NP's 2006 forecast rate of return on rate base would increase to 8.56%, which is within the currently allowed range of 8.50% to 8.86%. Given that NP is forecasting that it will realize a return within the allowed range, it is clear that the Company will have the opportunity to earn a fair rate of return in 2006 if its proposals are accepted.

As already discussed, however, regulators normally apply the Fair Return principle only within the context of a GRA since it is only on the basis of a regulatory review of all forecast costs and revenues that regulators are able to ensure that the allowed revenue and rates are just and reasonable.

4.5.2 Cost of Service

In Order No. P.U. 19 (2003) the Board explained the **Cost of Service** principle as follows.

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[33] Evidence, Exhibit NP-15.

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.*[34]

Similarly, Mr. Browne in his discussion of the Cost of Service Standard noted:

At the heart of rate regulation is the cost of service standard, sometimes referred to as the revenue requirement standard.

Under this standard, a regulated entity is permitted to set rates that allow it the opportunity to recover its costs for regulated operations, including a fair rate of return on its investment devoted to regulated operations – no more, no less.[35]

Mr. Browne addressed the points identified in the first two bullets appearing in the preceding quote in the Board Order as separate standards. His evidence states:

PRUDENCE STANDARD

The prudence standard modifies the cost of service standard. Under this standard, ratepayers should be charged only for prudently incurred costs. This recognizes the fact that regulated entities have a responsibility to manage themselves in a prudent manner.

Deciding what is prudent is done by determining what a reasonable person would have done in a similar situation. This should not be done in hindsight. A regulated entity's management can be expected to rely only on information reasonably available to it when it makes its decision.

It's generally assumed that management has acted prudently unless evidence exists to the contrary.[36]

...

USED AND REQUIRED TO BE USED

Under this standard, customers should pay only for the cost of those assets that are used and required to be used, to provide them with service.

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[34] Order No. P.U. 19 (2003), page 15.
[35] Company of JT Browne, Exhibit JTB-3, page 2.
[36] Ibid., page 3.

> *This principle is applicable to the case of a diversified company with both regulated and non-regulated operations. The customers of the regulated operations should not be required to pay for assets used to supply non-regulated services.*
>
> *The principle has also been applied to assets acquired for regulated operations. Regulators have denied the recovery and/or return on assets that were acquired for regulated operations, but are not currently required to provide service.*[37]

There can be little doubt that when the Fair Return and Cost of Service principles are considered together, the implication is that the "opportunity to earn a fair rate of return" should be assessed in the context of a determination by the Board that the utility's forecasts of revenues and costs are reasonable and all costs have been prudently incurred.

While there may well be sufficient information on the record of this proceeding for the Board to determine whether the individual cost items identified by NP (i.e., the impact of the conclusion of the true-up adjustment; the impact of increased plant investment and the impact of the tax settlement and the change to the Accrual Method on income taxes) have been prudently incurred, it is clear that the company's forecast of total costs and revenues have not been subjected to the level of scrutiny that would normally be required to satisfy the Cost of Service principle.

The Company appears to be of the view that a full GRA is not required in this case for reasons including:

- NP is not asking for a rate increase.[38]
- The size of the revenue deficiency is large enough that it is "not a reasonable expectation" that it could be made up through revenue increases or cost decreases.[39]

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[37] Ibid., page 5.
[38] See PUB 2.0 NP.
[39] NP states in its response to CA 2.0 NP (lines 23-30):

> *As noted at page 22 of 34 of the Company Evidence, approximately $15,700,000 in additional cash revenue from customers through rates or reduced operating costs would be required in 2006 to fully offset the impact on Newfoundland Power's return if $10,036,000 in unbilled revenue is not recognized in 2006.*
>
> *Newfoundland Power's forecast operating costs for 2005 and 2006 are approximately $54 million. These costs are comparable to those used to set rates for 2004. A single year operating cost decline of $15.7 million, or almost 30%, is not a reasonable expectation.*

Because the Company has chosen to deal with its forecast substandard rate of return on rate base by means of the 2006 APA rather than by means of a GRA, it has created a dilemma for the Board.

- On the one hand, the Board does not have the evidence before it to make a determination that the full amount of the requested recognition of the 2005 Unbilled Revenue is necessary for NP to have a reasonable opportunity to earn its allowed rate of return on rate base.
- On the other hand, the evidence does lend credence to the view that it is reasonable to recognize some of the 2005 Unbilled Revenue in 2006 in order for NP to have a reasonable opportunity to earn its allowed rate of return.

The problem arises because the Cost of Service principle requires the Board to allow the company to recover its costs "- no more, no less" in the words of both the Board and Mr. Browne. In the context of the Cost of Service principle, costs to be recovered are clearly limited to costs that the Board determines are reasonable and prudently incurred. Without the scrutiny of a GRA, the Board does not have the evidentiary base to determine whether the Company's revenue and cost forecasts should be allowed for regulatory purposes. If the entire quantum of the Company's revenue deficiency forecast would not withstand the scrutiny of a GRA, the expected consequence would be that there would be a reduction in the quantum of 2005 Unbilled Revenue that should be recognized in order to allow the Company to recover its 2006 costs.[40]

As a consequence of this dilemma, it seems to me that the Board is left in the difficult position of having to choose among several imperfect options, including the following:

1. Accept the Company's forecast revenues and costs for 2006 for regulatory purposes. The implication of this option is that the Board would have to implicitly accept that the rate of return on rate base will be 7.02%, which is below the currently approved target range of 8.50% to 8.86%, in the absence of an offsetting rate increase in revenue recognition along the lines proposed by the Company.

[40] The reductions would not match precisely, if the allowed return was not set equal to the Company's forecast rate of return on rate base of 8.56%.

2. Determine that in the absence of a GRA the Board cannot make a determination with respect to the Company's revenue deficiency and rate of return on rate base. The implication of this option is that there would be no basis for accepting the Company's proposal to recognize 2005 Unbilled Revenue at this time. If it wishes, the Company could then address the evidentiary impediment to approving its proposals by filing a rate application, as discussed in its response to PUB 6.0 NP and elsewhere.
3. The Board could establish a policy for recognizing the 2005 Unbilled Revenue in a manner that is reasonable in its own right and is adequate to allow the Company a reasonable opportunity to earn its allowed rate of return on rate base, recognizing that the evidence before the Board with respect to NP's 2006 rate of return has not been tested in a manner that satisfies the Cost of Service principle. Given the linkage between the Tax Settlement and the change to the Accrual Method, there would be logic in adopting a policy for recognizing the 2005 Unbilled Revenue for regulatory purposes in the same manner as the Company agreed to recognize it for income tax purposes – one-third each year for the three years 2006, 2007 and 2008. The implication of this approach would be that 1/3 of the $23,967,000 unrecognized 2005 Unbilled Revenue would be recognized each year (i.e. $7,989,000 each year).
4. The Board could accept the proposition that due to the unique circumstances present in this case, it will as a pragmatic measure approve the recognition of 2005 unbilled revenue as necessary to offset the cost increases proposed by the Company, subject to the Board's determination as to the extent that they should be recognized for regulatory purposes as increased costs that have no offsetting financial benefit.
5. The Board could adopt a more nuanced approach that examines each component of the increased costs that NP is proposing to address and accepts, rejects or defers to a GRA each cost item on its own merits.

The next section considers the last option in more detail.

4.5.3 Assessment of Individual Cost Increases Identified by NP

<u>The Tax Effect</u>

In Order No. P.U 19 (2003), page 87, the Board stated that:

> *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.*

It is arguable that the Board viewed the revenue and cost implications of the tax dispute as being outside of the normal rate-setting processes. On that basis they could be addressed in the same manner as other distinct pass-through items such as variances in commodity costs that are tracked in variance accounts and disposed of outside of a full GRA. Assuming that was the Board's intent in setting aside the consequences of the tax dispute in Order No. P.U. 19 (2003), it would be consistent with accepted regulatory principles and practices to deal with the implications of the Tax Settlement in the context of the 2006 APA, although there is no opportunity to scrutinize all of the costs and revenues that make up the Company's Forecast 2006 Financial Results.[41]

As noted above, the portion of the total *pro forma* tax effect ($3.086 million) that is attributable to Tax Settlement is $2.921 million. The remaining $165,000 is attributable to the increase in unbilled revenue that results from the adoption of the Accrual Method. This latter amount was not identified by the Board in advance as a cost that should be considered independently of a full GRA. However, it is arguably an indirect consequence of the Tax Settlement which triggered the change to the Accrual Method.

<u>Conclusion of the True-up Adjustment</u>

Although the dollar value of the impact of the conclusion of the true-up is known, I am aware of no evidence that the Board has pre-approved recognition of the impact of this event as being a pass-through item that should be offset through a rate increase, or other form of revenue recognition, in the absence of evidence of an overall revenue deficiency. In making its decision on this point, the appropriate question for the Board

[41] A corollary of this interpretation would be that the interest revenue, which was another consequence of the Tax Settlement would also be addressed and disposed of appropriately in the context of the 2006 APA.

to address is: If NP was earning a rate of return on rate base in excess of 8.50% prior to recognizing any 2005 Unbilled Revenue, would it recognize the $5.793 million necessary to offset the impact of the conclusion of the true up?

If the answer to this question is "no", then it follows that the justification for revenue recognition is not the conclusion of the true-up itself and the loss of this amortization that offsets other depreciation expense. The real justification for recognizing 2005 Unbilled Revenue, or allowing a rate increase, is the overall revenue deficiency to which the conclusion of the true-up contributes. Without a GRA to verify the revenue deficiency, it would be contrary to accepted regulatory principles to make an *ad hoc* revenue adjustment to offset this cost increase.

Impact of Increased Plant Investment

The evidence of Grant Thornton for the Board provides an explanation of the reasons that it would be particularly inappropriate to allow a rate increase or revenue recognition to offset the impact of increased plant investment in the absence of a process (i.e. GRA) that explicitly recognizes the other revenue and cost impacts of the investments.

> *The increase in depreciation expense which the Company attributes to plant investment amounts to $1.157 million. This component of the increase is a different issue than the true-up adjustment. The Company undertakes a capital program and incurs capital expenditures each year and these expenditures impact a number of elements of the revenue requirement in addition to depreciation. For example, a large portion of plant investment in any given year is attributable to customer growth. Growth in customers leads to increased energy sales and additional revenues to the Company. Other capital projects relate to replacement, refurbishment or upgrading of plant in service which can impact other costs including maintenance expenses. In normal circumstances the ongoing annual investment in plant by the Company does not in itself impact revenue requirement to the extent that the Company would seek rate relief between general rate hearings.*

Resolving the Board's Dilemma Through Item-Specific Treatment

Given the preceding comments, it would seem to me to be reasonable to break down NP's requests and treat each item from the perspective of the extent to which recognition of offsetting revenue would be consistent with accepted regulatory principles and practices. A "package" along the following lines would, in my view, be reasonable:

1. Dispose of the Unbilled Revenue Increase Reserve by writing it off against the 2005 Unbilled Revenue, thereby adjusting the net 2005 Unbilled Revenue amount to equal the actual unrecognized 2005 Unbilled Revenue.
2. Recognize $2.921 million in 2005 Unbilled Revenue to offset the income tax effect related to the Tax Settlement on the grounds that it is one of the "issues arising from the final decision of the tax case" which the Board specifically set aside from other GRA matters in Order No. P.U. 19 (2003).
3. Recognize $165,000 in 2005 Unbilled Revenue to offset the income tax effect of the increase in unbilled revenue, which is a minor item related to the change to the Accrual Method. Arguably, the change to the Accrual Method is also a direct effect of the Tax Settlement.
4. Recognize the $2.1 million in interest revenue in 2006 for regulatory purposes on the grounds that this revenue is another issue arising from the Tax Settlement and represents an offset to the cost borne by ratepayers over the years to financing the tax deposits. This point is addressed in the next section.
5. Defer consideration of the request to recognize 2005 Unbilled Revenue to offset the impact of the Conclusion of the True-up mechanism until a determination can be made in the context of a GRA as to whether the full amount of the offset is required in order for the Company to have a reasonable opportunity to achieve its allowed rate of return on rate base in 2006. It is not appropriate to allow a revenue increase in any form unless it can be demonstrated with properly tested evidence that it is justified on the basis of a demonstrated revenue deficiency.
6. Provide no offset for the impact of the increased plant investment on the grounds that, in general, investments in plant will be economically justified on the basis of incremental revenue (e.g., new customer additions) or avoided costs. In either case, a full revenue offset is not required.

In my view, this package could serve as a pragmatic approach to resolving the issues currently before the Board without requiring the Board to establish any precedents that are inconsistent with the regulatory principles it has endorsed or the standard practices of Canadian regulators.

4.6 Recognize Interest on Tax Deposit in 2005

A preliminary matter in addressing the issue of how the interest revenue on the tax deposit should be recognized for regulatory purposes is whether it is an historic (i.e., 2005) issue and therefore not relevant to the 2006 rate year. In my view, this issue can be resolved by reference to the Board Order No. P.U. 19 (2003) in which the Board stated that "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 implication of this statement is that all matters related to the Tax Settlement would be addressed at a future time. This approach is analogous to placing all of the consequences of the Tax Settlement into deferral accounts for future disposition in a manner that the Board considers to be just and reasonable.

NP's rationale for recognizing the $2.1 million in interest on the tax deposit in 2005 appears to rest on two considerations.[42]

- NP appears to consider it relevant that the GAAP "required that the refund interest be recognized by Newfoundland Power as revenue in 2005."
- NP appears to consider it relevant that customers have benefited from the Company's tax dispute and ultimate settlement.

In order to assess these rationales it is helpful to examine them from the perspective of the Board's accepted regulatory principles.

4.6.1 Consistency with GAAP

The evidence of the Company's expert Mr. Browne speaks very eloquently to the issue of whether the treatment of the interest revenue under GAAP should dictate its treatment under regulatory accounting policies ("RAP"). He starts his discussion of RAP vs. GAAP by noting the difference in objectives that exist for the two purposes.

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[42] See in particular the PUB 10.0 NP, PUB 12.0 NP and CA 23.0 NP.

> ***OBJECTIVES***
>
> *Both regulators and financial accountants require accounting policies to establish a utility's costs. There is usually a great deal of consistency between the two sets of policies. However, for most utilities, there are at least some differences. The differences usually arise from differences in objectives.*
>
> *...*
>
> *Although regulators and financial accountants are both attempting to establish a utility's costs, they have different objectives:*
>
> - *Regulators are attempting to set just and reasonable rates. They expect to have a direct impact on the economic results of a utility.*
> - *Financial accountants are attempting to report on the economic position of the reporting entity and the change in its economic position. They do not intend to have a direct impact on the economic results of a utility. They are attempting only to report those economic results.*
>
> *The difference in objectives can result in differences between RAP and GAAP. Still, GAAP is usually a major influence on RAP, and although RAP does not determine GAAP, it can affect what should be reported in accordance with GAAP.* [43]

Mr. Browne proceeds to address specifically the impact of GAAP on RAP.

> ***IMPACT OF GAAP ON RAP***
>
> *GAAP is a major influence on the RAP established by each regulator and is usually the starting point for RAP ...*
>
> *Although regulators generally refer to GAAP in setting their RAP, they are usually not required to do so and there are a number of examples where regulators have deviated from GAAP. For example:*
>
> *...*
>
> - *Regulators often allow utilities to defer and recover in future periods large costs that were not considered in setting current rates, even though GAAP would normally require that they be expensed in the period the costs are incurred.*
>
> *Presumably, regulators deviate from GAAP because they believe that it results in rates that are more just and reasonable. For example:*
>
> *...*
>
> - *Regulators may allow the future recovery of costs not covered by existing rates so as to provide a utility with a reasonable opportunity to recover its costs in accordance with the cost of service standard.* [44]

As the discussion of the Company's expert makes clear, the GAAP treatment of the $2.1 million interest revenue on the tax deposit does not dictate the treatment for

[43] Evidence of JT Browne, page 2.
[44] Evidence of JT Browne, page 3.

regulatory purposes. To determine the appropriate treatment for regulatory purposes, it is necessary to consider the regulatory principles that have been endorsed by the Board, such as the Cost of Service standard to which Mr. Browne refers.

As noted above in the discussion of the Cost of Service principle, the Board stated that:

> *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.*[45]

It is clear that the company's rates for 2005 were set at a level that gave it the opportunity to earn its allowed rate of return on rate base without taking into account the unanticipated \$2.1 million in interest revenue from the tax deposits held by CRA during the period 1995 through 2005. If the Company believed it did not have a reasonable opportunity to earn its allowed return, it could have filed a GRA. The fact that it did not file a GRA indicates that it was satisfied with its financial position prior to negotiating the Tax Settlement which included the payment of interest revenue in 2005.

It is therefore incumbent on the Board to determine whether it is more appropriate to recognize this revenue in 2005 or to direct the Company to establish a deferral account so that the revenue can be disposed of at a later date to the benefit of ratepayers.

Again, NP's expert, Mr. Browne, provides guidance as to the approach that the Board should take in determining whether the interest revenue should benefit the company or the ratepayers. He concludes his "Current Status" discussion with the comment that:

> *Regardless of what the CICA decides, it will not prevent regulators from deviating from GAAP for regulatory purposes. Moreover, it is likely that regulators will continue to believe that just and reasonable rates may require such deviations in certain specific cases.*[46]

I concur with his view expressed in general terms and would suggest that the Board should make a determination in this specific case that will result in just and reasonable rates both in 2005 and in the future. The key question is: Which treatment will allow the Company to recover its allowed costs – <u>no more, no less</u>?

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[45] Order No. P.U. 19 (2003), page 15.
[46] Evidence of JT Browne, page 9.

4.6.2 Customer Benefit Flowing from the Tax Dispute

The Company's view that the interest revenue should flow to the benefit of its shareholders appears to be built on the premise that customers have benefited from the Company's efforts in disputing the transition to the Accrual Method for tax purposes, thereby deferring taxes. This view is expressed in great detail in the response to PUB 12.0 NP and CA 23.0 NP. NP takes this position although it acknowledges that since 1997 the tax deposit has been included in Invested Capital; hence, customers have borne most of the interest cost associated with financing the tax deposit.[47]

Based on my review of the Company's rationale, it appears to reduce to a simple concept: The $2.1 million benefit should flow to the Company as a reward for having pursued the tax dispute that has produced benefits for customers. While this argument may be consistent with an incentive regulation approach to rate making, it appears to violate the Cost of Service principle that is endorsed by the Board. Under the Board's rate making methodology, the flow of revenue should match the incidence of costs. If the Company had borne the interest cost associated with the tax deposits it should benefit from the partial offset provided by the deposit interest received. However, it was customers, not the company that bore this cost. In the absence of recoverable costs, the Company has no entitlement to the interest revenue for regulatory purposes under the Cost of Service principle.

4.6.3 Regulatory Symmetry

NP's proposed treatment of the interest revenue on the tax deposit raises an important issue related to the risk of an asymmetry in the regulatory process. Although the issue is not explicitly addressed in the Board's discussion of regulatory principles in Order No. P.U. 19 (2003), it would compromise the basic principles if the Board were to allow

[47] NP compares the customer costs and NP cost of the tax dispute in CA 23.0 NP, Attachments 2 and 3. The calculated financing cost is based on the premise that the level of financing costs embedded in rates changes only where there is a rate increase. Based on the alternate premise that in the absence of a GRA total revenues are deemed to be sufficient to recover total costs, although costs and revenues change every year, it can be said that customers bore 100% of all costs related to the tax dispute. If the Company's rates were insufficient to recover all of its costs, it would have been entitled to seek an increase in rates by filing a GRA.

positive outcomes of uncertain events (e.g., the tax dispute) to flow to the Company while flowing negative outcomes to customers, or vice versa. It is therefore important for the Board to consider how it would have handled any unexpected penalties, had they occurred as a result of the Tax Settlement. Would the costs have been recovered from customers or would they have been left with the Company?

The view of NP on this matter is disclosed to investors in its 2004 Annual Report.[48]

> ***Contingent Liability***
>
> *The Company has disclosed a contingent liability of $16.2 million as at December 31, 2004 related to a reassessment by the Canada Revenue Agency ("CRA") on its 1993 taxation year. At issue is the method the Company uses to recognize revenue. The Company believes it has reported its tax position appropriately and has filed a Notice of Appeal with the Tax Court of Canada.*
>
> *Should the Company be unsuccessful in defending its position, a liability of approximately $16.2 million, including accrued interest, would arise. In this event, the Company would apply to the PUB to include the amount in the rate making process. This application may include a request to change the current practice of recognizing revenue when billed to recognizing revenue on an accrual basis.*
>
> *The decision of the Court is not expected before 2006. The provisions of the Income Tax Act require the Company to deposit one half of the amount in dispute with CRA. The amount currently on deposit with CRA is $6.9 million.*

This view was echoed in the Company's response to PUB 12.0 NP which stated that "The contingent liability presented a risk to Newfoundland Power's <u>customer rates</u>."[49] (emphasis added) Further, as NP's response to CA 16 NP discloses, consumers paid NP's legal fees of about $810,000 in addition to financing the deposit. A policy of passing costs through to customers and benefits to the Company would be inconsistent with the basic notions of equity embedded in generally accepted regulatory principles.

4.7 THE ARBM REVIEW

Based on the comments in section 2.7, it would be reasonable for the Board to accept the ARBM Review.

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48 Newfoundland Power 2004 Annual report, page 32.

49 PUB 12.0 NP, lines 10-11. The Company cited Decision NSUARB-NSPI-P-881, 2005 NSUARB 27 in support of its view that the costs would be an appropriate pass through to customer rates.

5 CONCLUSIONS AND RECOMMENDATIONS

This section summarizes my conclusions and recommendations with respect to the eight questions posed by the CA.

1. Is the adoption of the Accrual Method of revenue recognition for regulatory purposes consistent with standard regulatory policies and practices?

Yes. The Accrual Method is the standard method used to recognize revenue in jurisdictions across Canada.

2. Is NP's proposal to establish a 2005 Unbilled Revenue account to be disposed of to the benefit of ratepayers in 2005 and subsequent years consistent with standard regulatory policies and practices?

Yes. Establishing the 2005 Unbilled Revenue account is a convenient transitional mechanism that can be used to recognize the cash revenues that are not recognized either by the Billed Method in 2005 or the Accrual Method in 2006. Having captured the revenues in this account, the Board will be able to recognize the revenue for regulatory purposes in the manner that it considers most appropriate.

3. Is NP's proposal to apply $295,000 of the 2005 Unbilled Revenue to dispose of the current balance in the Unbilled Revenue Increase Reserve in 2006 consistent with standard regulatory policies and practices?

Yes. The 2005 Unbilled Revenue account overstates the unrecognized unbilled revenue because a portion of the 2005 Unbilled Revenue has already been recognized as revenue in previous years. The Reserve was the mechanism used to recognize some of the unbilled revenue in previous years under the Billed Method of revenue recognition.

Eliminating the reserve by reducing the 2005 Unbilled Revenue account has the effect of making the necessary adjustment to ensure that the amount in the 2005 unbilled revenue is limited to unbilled revenue that has not been recognized. The net balance is the amount that is appropriate to recognize in 2006 and subsequent years.

4. Is NP's proposal to apply $9,579,000 of 2005 Unbilled Revenue to NP's 2006 revenue for regulatory purposes consistent with standard regulatory policies and practices?

No. In the absence of a GRA that allows the Board to determine the revenue deficiency that it considers reasonable based on a full review of the Company's Forecast 2006 Financial Results, it would be appropriate to recognize at most sufficient revenue to offset the tax effects ($3.086 million).

5. Is NP's proposal to defer the decision on the disposition of the remaining 2005 Unbilled Revenue of approximately $14.4 million for future consideration by the Board consistent with standard regulatory policies and practices?

Yes, although the amount remaining in the 2005 Unbilled Revenue after 2006 will be substantially more than $14.4 million if the preceding recommendation is accepted by the Board. It would also be consistent with standard regulatory policies and practices to establish a policy at this time for recognizing the full amount of the unrecognized 2005 Unbilled Revenue. For example, the Board could choose to recognize 1/3 of the 2005 Unbilled Revenue in each of 2006, 2007 and 2008 so as to parallel the way the unbilled revenue is being recognized for tax purposes. Doing so would have the benefit of "locking-in" the timing of revenue being recognized which would reduce future uncertainty but would have the downside of limiting the Board's ability to use the timing of revenue recognition to stabilize rates in the coming years.

6. Is NP's proposal to deduct the average value of the unrecognized 2005 Unbilled Revenue from rate base commencing in 2006 consistent with standard regulatory policies and practices?

Yes. This is appropriate in light of the fact that the balance in the 2005 Unbilled Revenue account at any time represents a zero-cost source of capital for the Company.

7. Is NP's proposed treatment of the $2.1 million in interest revenue arising from the tax settlement consistent with standard regulatory policies and practices?

No. The interest revenue is essentially an offset to the carrying cost that was borne by ratepayers to finance the income tax deposits that NP was required to make over the years. It is therefore clear that this revenue is not required to compensate the Company for costs it has incurred in order to provide regulated service to its customers.

The Company's implicitly proposed treatment of the interest revenue for regulatory purposes violates the Cost of Service principle. In all years including 2005, NP's regulated rates were set by the Board at a level that allowed the Company to recover its costs and gave it the opportunity to earn its allowed rate of return on rate base. If this revenue had been included in the forecast revenue for 2005 it would have reduced NP's overall revenue requirement.

8. Are NP's proposals with respect to adopting the asset rate base methodology ("ARBM") consistent with standard regulatory policies and practices?

Yes.