NEWFOUNDLAND AND LABRADOR
BOARD OF COMMISSIONERS OF PUBLIC UTILITIES

AN ORDER OF THE BOARD

NO. P.U. 16(2021)

IN THE MATTER OF the *Electrical Power Control Act, 1994*, SNL 1994, Chapter E-5.1 (the *"EPCA"*) and the *Public Utilities Act*, RSNL 1990, Chapter P-47 (the *"Act"*), as amended, and regulations thereunder; and

IN THE MATTER OF an application by Newfoundland and Labrador Hydro for approval of two exceptions to financial reporting requirements relating to the Muskrat Falls Power Purchase Agreement and the deferral and recovery of capital-related overhead costs, pursuant to section 58 of the *Act*.

Background

During the review of the 2021 capital budget applications of Newfoundland Power Inc. ("Newfoundland Power") and Newfoundland and Labrador Hydro ("Hydro") the capitalization practices of both utilities was raised. It was noted that Newfoundland Power's and Hydro's approaches to capitalization of internal costs vary greatly as a result of different accounting standards.[1] Both Hydro and the Consumer Advocate submitted that a review of capitalization practices is warranted and Newfoundland Power acknowledged that its practice with respect to its General Expenses Capitalized ("GEC") calculation has not been reviewed since 1999.[2] In Order Nos. P.U. 5(2020) and P.U. 6(2020) approving the 2020 capital budgets of Newfoundland Power and Hydro the Board agreed that a review of the capitalization practices was warranted to ensure consistency with sound public utility practice and the provision of least-cost service to customers and stated it would establish a process for such a review.

On April 30, 2020 the Board directed Hydro and Newfoundland Power to each submit a report on capitalization policies and guidelines addressing: i) the particular accounting standards being

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[1] In Order No. P.U. 13(2012) the Board approved the adoption and use of International Financial Reporting Standards ("IFRS") by Hydro for financial reporting for regulatory purposes, effective January 1, 2012, with certain exceptions. Hydro deferred adoption of IFRS until January 1, 2014. Hydro also elected to adopt IFRS 14 – *Regulatory Deferral Accounts*, which permitted Hydro to continue to account for regulatory deferral account balances in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") in its initial adoption of IFRS and subsequent financial statements. The Board approved Newfoundland Power's use of US GAAP for financial and regulatory purposes in Order No. P.U. 11(2012).

[2] Order No. P.U. 5(2020), page 21/24-26

followed by the utility; ii) a discussion of how the capitalization practices and/or guidelines are in accordance with sound public utility practice and provide least-cost service to customers; iii) any other alternatives that may be available to be used by the utility, with advantages and disadvantages with respect to sound public utility practice and the provision of least-cost service to customers; and iv) a jurisdictional scan of other utilities in Canada with respect to capitalization policies. Newfoundland Power and Hydro each filed reports on August 14, 2020 setting out their respective capitalization policies and practices, regulatory considerations and the results of a jurisdictional scan of capitalization policies of other Canadian utilities undertaken jointly by both utilities.[3]

In its report *Review of Capitalization Policies and Guidelines* (the "August 2020 Report") Hydro noted that it capitalizes less than Newfoundland Power and other investor owned utilities, and that it capitalizes less overhead when compared to utilities with the same ownership structure and accounting standards as Hydro. The report also indicated that, while its current practice of expensing capital-related overhead costs is least-cost in the long-term, it results in a higher revenue requirement for customers in the short-term. According to Hydro increased levels of capitalization could be appropriate with a view towards improved intergenerational equity, as long as rate stability, predictability, and materiality are maintained and potential administrative burdens minimized.

Submissions were filed on January 15, 2021.[4] In its submission Hydro stated it believes it is appropriate for both Hydro and Newfoundland Power to have reasonably comparable approaches to the recovery of capital-related overhead costs. Hydro indicated they would file an application for deviation from IFRS in the coming months to permit an increase in the capitalization of overhead costs.

Application

On February 24, 2021 Hydro filed an Application (the "Application") requesting approval to deviate from IFRS, using *IFRS 14 – Regulatory Deferral Accounts,* to allow Hydro to:

(i) recognize expenses related to the purchase of pre-commissioning energy in accordance with the commercial terms of the Muskrat Falls Power Purchase Agreement;
(ii) establish the Capitalized Overhead Deferral Account to enable the deferral and recovery of capital-related overhead costs to become effective January 1, 2022; and
(iii) apply an overhead capitalization rate of 2.3%, on an interim basis, in determining the annual transfers to the Capitalized Overhead Deferral Account.

Hydro requested an expedited review of the Application to maximize the benefits for customers associated with the Application. In response to NP-NLH-017, Hydro clarified that an expedited review was requested to ensure Hydro could maximize the potential benefits of the purchase of pre-commissioning energy. On March 22, 2021 the Board informed the parties that it would

[3] Hydro also included an expert report by JT Browne Consulting addressing the appropriate principles for capitalizing costs related to property, plant and equipment from a regulatory perspective.
[4] The Board wrote Newfoundland Power on February 16, 2021 requesting that Newfoundland Power include a review of its methodology and general expense cost ratios used to determine GEC in its next general rate application scheduled to be filed June 1, 2021.

bifurcate the Application and issue two separate orders. On March 26, 2021 Order No. P.U. 9(2021) was issued approving the proposal to recognize the purchase of pre-commissioning energy in accordance with the commercial terms of the Muskrat Falls Power Purchase Agreement. Hydro's proposals to establish a Capitalized Overhead Deferral Account to become effective January 1, 2022 and to use an interim overhead capitalization rate of 2.3% to calculate the annual transfers to the Capitalized Overhead Deferral Account are addressed in this Order.

The Application was copied to Newfoundland Power; the Consumer Advocate, Dennis Browne, Q.C.; a group of Island Industrial Customers: Corner Brook Pulp and Paper Limited, NARL Refining Limited Partnership and Vale Newfoundland and Labrador Limited (the "Industrial Customer Group"); Praxair Canada Inc.; and Teck Resources Limited.

Requests for information ("RFIs") were issued by the Board and Newfoundland Power which were answered by Hydro on March 5, 2021. The Board issued two additional RFIs which were answered by Hydro on March 12, 2021. Newfoundland Power and the Industrial Customer Group filed submissions on March 17, 2021. Hydro filed a reply submission on March 19, 2021.

Application Proposals

The Application requests a deviation from IFRS with respect to capitalization to allow for the deferral and recovery of capital-related overhead costs over an amortization period consistent with capitalization. According to the Application the August 2020 Report shows that Hydro's current practice of expensing capital related overhead costs, while least cost in aggregate, results in a higher revenue requirement for customers in the short term. The August 2020 Report also stated that Hydro's approach of expensing capital related overhead costs is inconsistent with the principle of intergenerational equity, as current customers are paying for costs associated with capital assets which provide benefits to customers beyond a single year. The Application states that the proposed deviation would decrease Hydro's revenue requirement in the short-term, increase intergenerational equity for Hydro's customers and provide comparability between Hydro and Newfoundland Power with respect to recovery of capital-related overhead costs.

The Application proposes to establish a Capitalized Overhead Deferral Account to be effective as of January 1, 2022. The Capitalized Overhead Deferral Account would include a percentage of operations and maintenance expense and the balance would be amortized on a straight-line basis.[5] The Application states that the establishment of the Capitalized Overhead Deferral Account is administratively simple, will allow Hydro to be more consistent with Canadian utility practice with respect to the recovery of capital-related costs as well as permit Hydro to plan effectively for its next general rate application and provide the Board and parties with a clear body of evidence.

In addition to the Capitalized Overhead Deferral Account, the Application also requests approval of an interim overhead capitalization rate of 2.3%, which is reflective of the rate utilized by Hydro prior to its discontinuance of the recovery of capital-related overhead costs with the adoption of IFRS. The Application states that an interim capitalization rate would permit Hydro to reflect capital-related overhead costs in its next general rate application. The Application also states that

[5] Hydro proposes a straight-line depreciation using a composite rate reflective of Hydro's approved depreciation rates, excluding the accelerated depreciation rates associated with the Holyrood Thermal Generating Station.

support to finalize the interim rate would be provided in its next general rate application and, if an adjustment to the internal capitalization rate is necessary as a result of the general rate application, such an adjustment could occur through Hydro's compliance application.

Submissions

Newfoundland Power submitted that, while it is generally supportive of Hydro's intention to recover certain general expenses attributable to its capital program over a more appropriate timeframe, Hydro has not provided evidence that justifies approval of the Capitalized Overhead Deferral Account at this time. According to Newfoundland Power Hydro has not completed a review to determine the general expenses accounts that are directly attributable to Hydro's capital program and what percentage of those general expenses accounts would be reasonable to allocate to the Capitalized Overhead Deferral Account. Newfoundland Power submitted that Hydro has also not provided details on forecast 2022 and 2023 charges to the Capitalized Overhead Deferral Account and that, without this information, it is difficult to determine if Hydro's methodology is reasonable to ensure only general expenses that are incremental to Hydro as a result of its capital program are capitalized. Newfoundland Power also submitted there does not appear to be any customer benefit associated with Hydro's Capitalized Overhead Deferral Account proposal that could not be achieved through a fulsome review at Hydro's next general rate application and that Hydro could include a review of its capitalized overheads methodology and general expense cost ratios to support the proposed Capitalized Overhead Deferral Account in its next general rate application.

The Industrial Customer Group supported Newfoundland Power's position that there is not sufficient information to determine whether this proposal is reasonable. They submitted that the present Application is not a suitable forum for obtaining all the necessary information and for a thorough review of same. According to the Industrial Customer Group a fair and reasonable approach would be for Hydro to include a review of its capitalized overheads methodology and general expense costs ratios in support of its Capitalized Overhead Deferral Account proposal in its next general rate application.

Hydro submitted that the positions of Newfoundland Power and the Industrial Customer Group are contradictory to the record before the Board. Hydro submitted that its proposal for the recovery of capital-related overhead costs followed a thorough review which began in 2020 and included a jurisdictional scan, reports from both utilities, an expert report, requests for information and two opportunities for comments from parties. According to Hydro there is no reason to conduct further review on whether Hydro should be permitted to capitalize overhead costs using an incremental basis as this has been demonstrated through the evidence before the Board. Hydro stated the only evidence lacking in its Application is what the final capitalization rate should be, and this would be supported in evidence as part its general rate application.

Hydro submitted that the lack of a final capitalization percentage is not a sound basis to not accept the proposed methodological approach. Hydro noted the proposed interim overhead capitalization rate of 2.3% is based on the average rate utilized by Hydro prior to adoption of IFRS and submitted that this is a sound evidentiary basis for establishing an interim rate. Hydro noted that the proposed interim rate of 2.3% is less than 50% of the capitalization rate currently used by Newfoundland

Power and that it is difficult to understand Newfoundland Power's suggestion that this level of capitalization by Hydro may not be reasonable.

Hydro also stated that: (i) a detailed analysis would be included as part of its general rate application evidence to support the finalization of an overhead capitalization rate; (ii) the interim rate is subject to adjustment by the Board through Hydro's compliance application; and (iii) such an approach permits Hydro to plan effectively for its next general rate application. According to Hydro this approach to capitalization of overheads would provide the basis for Hydro to develop its operating and maintenance and capital forecast for use in its general rate application. Hydro also stated that, from a regulatory efficiency perspective, methodological approaches should be addressed outside of general rate applications, as was the case in 1995 when the Board approved Newfoundland Power's transition from the "full cost" method to the incremental method for computing GEC.

Hydro submitted the capitalization of overheads has been demonstrated as reasonable and is consistent with regulatory principles and generally accepted utility practice. Hydro advised the approval of the proposed 2.3% interim capitalization rate would result in approximately $3 million in reduced operating and maintenance costs to be reflected in Hydro's general rate application. Deferring this matter to the general rate application would not only be inconsistent with regulatory efficiency but would also result in a negative financial impact on Hydro in 2022 if the final Order for the general rate application is not released until 2023, as Hydro would not be able to reflect the reduction in operating costs in 2022 until it is approved by the Board. Hydro also noted section 75 of the *Act* permits the Board to make an interim Order unilaterally and without a public hearing or notice which Hydro considers appropriate with respect to the approval of an interim capitalization rate. Hydro also stated that, if the Board determined that a final overhead capitalization rate should be established prior to Hydro's next general rate application, it would expedite its analysis and submit an application to the Board on this matter by the end of June 2021.

Hydro concluded that the evidence before the Board justifies a deviation from IFRS to recognize the deferral of capital-related overhead costs beginning in 2022 based upon the proposed interim capitalization rate, to be finalized in Hydro's next general rate application, and the proposed deviation provides a reasonable balance between the interest of customers and the utility. Hydro requested that its proposals relating to the establishment of the Capitalized Overhead Deferral Account effective January 1, 2022 and the interim overhead capitalization rate of 2.3% be approved.

Board Findings

In Order No. P.U. 13(2012) the Board approved Hydro's proposal to modify its capital expenditure methodology to be in accordance with IFRS requirements. In accepting Hydro's proposal the Board noted Hydro's explanation that the use of IFRS requirements in its capital expenditures would enhance transparency and reduce administrative burden. Under IAS 16 – *Property, Plant and Equipment* Hydro currently capitalizes costs that are directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Other non-direct costs, such as overhead costs associated with salary and benefits for individuals who work on capital projects generally but do not directly work on any individual capital project, are expensed by Hydro when incurred.

In this Application Hydro stated that, while its current capitalization approach adheres to IFRS guidelines, the primary purpose of the IFRS accounting standards is to support financial reporting, not pricing or rate-setting decisions. Hydro proposes to deviate from IFRS through the approval by the Board of the Capitalized Overhead Deferral Account, which would allow Hydro to defer capital-related overhead that is directly attributable to its capital program but cannot be assigned to a specific capital project. This would result in increased capitalization of overheads and, according to Hydro, is consistent with regulatory principles. Newfoundland Power and the Industrial Group are generally supportive of Hydro's intention to recover certain general expenses related to its capital program over a more appropriate time frame but suggest that the record before the Board does not support approval of Hydro's proposal at this time. Both support a review of the methodology and general expense cost ratios as part of Hydro's next general rate application.

Regulatory principles require the Board to ensure that the capitalization practices of both Hydro and Newfoundland Power are consistent with sound public utility practice and the provision of least-cost service to customers. One of the considerations is the issue of intergenerational equity and ensuring, to the extent possible, that current customers are not paying more than their fair share of the utility's capital program costs with customers in the future benefiting from such capital improvements. Under IFRS Hydro currently expenses overhead costs which, while least-cost in aggregate, results in a higher revenue requirement for current customers. Capitalization of overhead costs that are incremental with changes in capital programs, which are currently expensed under IFRS, may be more consistent with the principles of intergenerational equity. As noted by Hydro's expert John Browne:

> The principle of intergenerational equity helps to determine when costs should be recovered. Under this principle, customers in a given period should pay only the costs necessary to provide them with service in that period. They should not have to pay for any costs incurred to provide them with service in another period. This principle is consistent with setting just and reasonable rates within each period.
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> In the case of capital projects, the avoidable costs should be capitalized; these would be costs that would be avoidable in relation to all capital projects in aggregate, and not just the individual assets. These costs are incurred solely for the benefit of future customers and should be capitalized and recoverable from future customers, not current customers.[6]

In addition, Hydro's proposal to capitalize overhead costs would result in an increased level of capitalization more aligned with that of other public utilities. According to Hydro's analysis of the jurisdictional survey results Hydro capitalized 2.9% of overhead as a percentage of total 2019 capital expenditures, in comparison to 11.7% for Newfoundland Power. When compared to other Crown-owned utilities using IFRS, Hydro's capitalized overhead percentage was among the lowest and below the Crown-owned average of 10.9% (excluding Hydro). According to Hydro increasing its level of overhead capitalization to 7.7%, in line with the overall survey average, would reduce Hydro's operating and maintenance expenses by approximately $6.4 million.[7]

[6] Hydro's August 2020 Report, Attachment 1, page 11 of 26 to page 12 of 26
[7] Hydro's August 2020 Report, Table 1, page 3

The Board is satisfied that, consistent with sound public utility practice and intergenerational equity regulatory principles, Hydro should be permitted to capitalize overhead costs through approval of an IFRS deviation under IFRS 14. This will result in Newfoundland Power and Hydro having similar approaches to the recovery of capital-related overhead costs, which would allow for better comparability of cost management practices between the utilities. In addition, as noted by Hydro, higher levels of capitalization could represent a small source of rate mitigation at the same time as increased revenue requirements associated with Muskrat Falls are coming into effect.[8]

While the Board is satisfied that Hydro's proposal to capitalize overhead construction costs should be accepted the Board is not satisfied there is sufficient information on the record to approve the proposed Capitalized Overhead Deferral Account definition and the proposed interim capitalization rate. The proposed Capitalized Overhead Deferral Account definition provides for inclusion of a portion of the operating and maintenance expenses which are directly attributable to Hydro's capital program but cannot from their general nature be assigned to a specific project. Hydro's application does not detail the nature of these expenses. In its response to NP-NLH-014 Hydro stated that it has not finalized its detailed study to determine the general expense accounts that are directly attributable to Hydro's capital programs but cannot be assigned to a specific capital project. In the absence of the results of this study Hydro proposes an interim overhead capitalization rate of 2.3% based on Hydro's historical experience using an incremental approach prior to its adoption of IFRS in 2014. In NP-NLH-013 Hydro stated that interim approval of an overhead capitalization rate of 2.3% is requested given that the 2022 and 2023 operating and maintenance expense forecasts have not been finalized.

The Board is not satisfied that the proposed Capitalized Overhead Deferral Account definition or the proposed interim capitalization rate should be approved at this time. The Board agrees with Newfoundland Power that details on the expense accounts to be included in the account and the applicable capitalized overhead percentage to be used to determine the amounts of the transfers should be filed prior to approval of Hydro's proposal. The Board also agrees that the upcoming general rate application, currently scheduled to be filed in October 2021, will allow for a full review of the proposed capitalized overheads methodology in the context of forecast test year costs and revenue requirement. Hydro can file its specific proposals for the Capitalized Overhead Deferral Account definition and the associated capitalization rate along with any necessary supporting documentation, including the results of its ongoing review, with its general rate application. The Board is satisfied that acceptance of Hydro's proposal to defer and recover capital-related overhead costs beginning on January 1, 2022 through the establishment of a deferral account, without approval of the specific methodology and account definition, will provide certainty for Hydro in putting forward its proposals in its upcoming general rate application.

In relation to Hydro's submission on the impact of deferring consideration of this matter to the general rate application, the Board is satisfied that existing regulatory processes allow for the consideration of this matter in advance of the end of 2022 if circumstances are such that the Board's Order is not issued by then.

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[8] Hydro's August 2020 Report, pages 6-7

IT IS THEREFORE ORDERED THAT:

1. Hydro's proposal to defer and recover capital-related overhead costs beginning on January 1, 2022 through the establishment of a deferral account under IFRS 14 is accepted.

2. Hydro shall file, for approval, the proposed Capitalized Overhead Deferral Account definition, including evidence to support the proposed methodology and capitalization rate, as part of its general rate application.

3. Hydro shall pay all expenses of the Board arising from this Application.

DATED at St. John's, Newfoundland and Labrador, this 20th day of May, 2021.

Darlene Whalen, P. Eng., FEC
Chair and Chief Executive Officer

Dwanda Newman, LL.B.
Vice-Chair

John O'Brien, FCPA, FCA, CISA
Commissioner

Cheryl Blundon
Board Secretary