Q. Please describe conditions or circumstances that may preclude or hinder consolidation of Newfoundland and Labrador Hydro's retail (i.e., distribution and customer service) and small hydro operations with those of Newfoundland Power. In the response please provide any reports and relevant document concerning this potential consolidation.

A. **A. General**

Newfoundland Power has been engaged with the Board and its consultants throughout the *Reference on Rate Mitigation Options and Impacts* (the "Reference") to assist in assessing potential options to mitigate the impact of Nalcor Energy's Muskrat Falls Project on customer rates.[1] This has included identifying options to consolidate Newfoundland and Labrador Hydro's ("Hydro") retail[2] and small hydro[3] operations with those of Newfoundland Power.

As of yet, Newfoundland Power has not prepared reports or other documentation concerning the potential consolidation of Hydro retail and small hydro operations with those of Newfoundland Power as is being considered in the Reference.

The conditions or circumstances that may preclude or hinder such a consolidation would vary widely depending on the terms of the transaction. For example, the terms, conditions and circumstances would likely differ if consolidation were to involve an operating arrangement, the purchase of assets, or the purchase of an organization.

The remainder of this response provides a list of potential conditions or circumstances that, in Newfoundland Power's view, may preclude or hinder consolidation as described in this Information Request. The list is non-exhaustive and conceptual in nature.

B. Conditions or Circumstances That May Preclude or Hinder Consolidation

Overview

In Newfoundland Power's view, conditions or circumstances that may preclude or hinder consolidation of Hydro's retail and small hydro operations with those of Newfoundland

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[1] On March 8, 2019, Newfoundland Power filed a *Request for Standing* to participate in the Reference. The *Request for Standing* was approved by the Board on March 13, 2019.

[2] Newfoundland Power is the primary distributor of electricity to customers in the province of Newfoundland and Labrador. Newfoundland Power currently serves approximately 268,000 customers on the Island Interconnected System, or 87% of all electricity customers in the province. The remaining 13% of customers are served by Hydro. Hydro's *2018 Operating Load Forecast*, filed in response to Information Request PUB-Nalcor-011, indicates Hydro currently serves approximately: (i) 22,900 customers on the Island Interconnected System; (ii) 11,300 customers on the Labrador Interconnected System; (iii) 800 customers in Island Isolated areas; and (iv) 3,600 customers in Labrador Isolated areas.

[3] Hydro is currently the bulk generator and transmitter of electricity in Newfoundland and Labrador. Hydro has an installed generating capacity of approximately 1,763 MW. This includes 9 hydroelectric generating stations ranging in capacity, 1 thermal plant, 4 gas turbines, and 25 diesel plants, including 21 isolated diesel systems. Newfoundland Power operates 23 small hydro plants, 3 gas turbines and 2 diesel units embedded in its distribution system, with a total installed capacity of approximately 137 MW.

Power can be broadly grouped in 3 categories: (i) customer service; (ii) economic; and (iii) public policy.

i. Customer Service Conditions or Circumstances

Consolidation of Hydro's retail and small hydro operations with those of Newfoundland Power may be precluded or hindered if it resulted in an increase in customer rates or a decrease in customer service quality.

Rates paid by customers on the Island Interconnected System represent the aggregate cost of service from both Newfoundland Power and Hydro. Transferring operations from Hydro to Newfoundland Power would result in added costs to Newfoundland Power's operations. Avoiding an increase in customer rates would require equal or greater cost savings to be achieved from within Hydro's operations. Any arrangement where added costs are not offset by sufficient cost savings would result in an increase in customer rates. This, in Newfoundland Power's view, may preclude or hinder consolidation.

Newfoundland Power manages the quality of its service delivery in a manner consistent with customers' service expectations.[4] Quarterly surveys routinely indicate the 2 most important issues to customers are price and reliability.[5] Consolidation of Hydro's operations with those of Newfoundland Power may, in Newfoundland Power's view, be precluded or hindered if it resulted in a degradation of service quality to Newfoundland Power's existing customers. Depending on the terms of consolidation, an arrangement may also be precluded or hindered if it resulted in a lesser quality of service being experienced by any customers that continue to be served by Hydro.

The requirement for a transfer of operations to be proven to benefit customers is consistent with previous findings of the Board[6] and The Liberty Consulting Group's

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[4] Between 1997 and 2017, Newfoundland Power reduced both the duration and frequency of customer outages by 39%. Over the same period, Newfoundland Power reduced its contribution to customer rates by 24% on an inflation-adjusted basis and maintained a consistent level of customer satisfaction averaging 87%. For more information on Newfoundland Power's performance, see response to Information Request PUB-NP-055.

[5] Newfoundland Power surveys approximately 1,800 of its customers each quarter to assess overall satisfaction with its service delivery.

[6] Section 48 of the *Public Utilities Act* states that a public utility shall not sell, assign or transfer the whole of its undertaking or a part of it to a person until the approval of the Board has been obtained. Such transfers have been previously considered by the Board. For example, in 2011 the Board considered an application by Newfoundland Power to sell certain support structures to Bell Aliant Regional Communications Inc. In considering this matter, the Board determined the proper test to be considered was whether it was *"shown on a balance of probabilities that, when the potential positive and negative impacts of the transaction are weighed, the balance favours customers or at least leaves them no worse off, having regard to all of the circumstances."* See Order No. P.U. 17 (2011), page 9.

("Liberty") Phase One Report as part of the Reference.[7]

ii. Economic Conditions or Circumstances

Consolidation of Hydro's retail and small hydro operations with those of Newfoundland Power may require Newfoundland Power to increase its investment in the electrical system. Increased investment may be precluded or hindered by economic conditions or circumstances that pose an increased risk to recovery of that investment.[8]

Newfoundland Power's ability to fully recover its investment may practically be constrained by factors or costs that increase customer rates and are outside of Newfoundland Power's control.[9] In recent years, rates to Newfoundland Power's customers have faced upwards pressure from increasing wholesale supply costs.[10] Further increases in wholesale supply costs may occur as a result of Nalcor Energy's Muskrat Falls Project. The risk of the Muskrat Falls Project to Newfoundland Power's ability to recover its costs has been routinely recognized by credit rating agencies.[11]

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[7] In its Phase One Report, Liberty stated that: *"Transferring responsibility for Hydro's current distribution operations to Newfoundland Power also has the potential for changing service quality levels (perhaps improving them). Moreover, costs saved by Hydro would be offset by costs assumed by the transferee. Therefore, this option requires consideration of the net cost effects for customers and of potential changes in service quality."* See Liberty's *Final Report on Phase One of Muskrat Falls Project Potential Rate Mitigation Opportunities*, December 31, 2018, page 29.

[8] Section 3(a)(iii) of the *Electrical Power Control Act, 1994* establishes that the rates to be charged for the supply of power within the province should provide sufficient revenue to the producer or retailer of the power to enable it to earn a just and reasonable return as construed under the *Public Utilities Act* so that it is able to achieve and maintain a sound credit rating in the financial markets of the world. The entitlement to an opportunity to earn a just and reasonable return is established under Section 80 of the *Public Utilities Act.*

[9] Increasing customer rates generally reduces electricity sales to customers. Newfoundland Power's analysis indicates that a 1.0% increase in rates will reduce sales by 0.21%.

[10] Over the period 1997 to 2017, the cost of serving customers has increased. On a ¢ per kWh basis: (i) purchased power costs from Hydro increased by 73%; (ii) Newfoundland Power's fixed costs (e.g. depreciation, taxes, finance charges and employee future benefits) increased by 24%; and (iii) Newfoundland Power's operating costs, which are within management's control, decreased by 7%. These cost dynamics tend to reduce Newfoundland Power's flexibility to respond to business risks. For more information, see Newfoundland Power's *2019/2020 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Section 3: Finance, page 3-27 et seq.*

[11] Moody's Investor Services' January 2018 credit rating assessment of Newfoundland Power stated that: *"The credit profile is constrained by the risk of future cost recovery associated with the Province of Newfoundland and Labrador's sizeable Muskrat Falls hydroelectric project. This politically sensitive project is large relative to the provincial economy and is expected to place considerable upward pressure on the future electricity rates of NPI, a credit negative."* Similarly, DBRS Limited's September 2017 credit rating assessment of Newfoundland Power stated that: *"DBRS remains concerned about the potential rate shock once the Muskrat Falls project, which is currently under construction by Nalcor Energy (Nalcor), comes on line in mid-2020. Nalcor expects that by 2022, rates in the Province of Newfoundland and Labrador (the Province) will increase to 23.3 cents per kilowatt hour (kWh), which is a substantial increase from current rates of around 11.7 cents/kWh. Should the upward pressure on rates affect Newfoundland Power's ability to fully pass on costs, or affect ratepayers' ability to pay their electricity bills, this could result in a negative rating action."* Copies of both credit rating assessments were filed as Exhibit 4 as part of Newfoundland Power's *2019/2020 General Rate Application.*

Newfoundland Power's ability to recover its costs may also be constrained by challenging demographic and economic trends in the province. The population of Newfoundland and Labrador is declining, aging and becoming more concentrated in urban areas.[12] These demographics impact the provincial economy, which is expected to remain weak compared to the rest of Canada.[13] Such broad demographic and economic trends may preclude or hinder recovery of future investment in the province's electrical system.[14]

iii. Public Policy Conditions or Circumstances

The consolidation of Hydro's retail and small hydro operations with those of Newfoundland Power may be precluded or hindered by public policy conditions or circumstances.

As Hydro is a crown corporation, any consolidation of Hydro's operations with those of Newfoundland Power would require a policy decision by the Provincial Government.

A policy decision to consolidate Hydro's operations with those of Newfoundland Power may be precluded or hindered by the province's existing regulatory framework. For example, the *Electrical Power Control Act, 1994* currently provides Hydro with the exclusive right to develop, own, operate and manage generation resources in the province, with some exceptions.[15] A decision to consolidate Hydro's small hydro plants with those of Newfoundland Power may require modification of this provision.

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12 The province's population peaked in 2017 at 531,130 and is expected to decrease by approximately 11% to 472,043 by 2040. The median age of the Newfoundland and Labrador population is approximately 5 years higher than the median age of the Canadian population. In addition to a declining and aging population, the population on the island portion of the province is becoming more concentrated on the Northeast Avalon, which is expected to increase by 15% by 2036, whereas the remainder of the island's population is expected to decrease by 25%. For more information, see Newfoundland Power's *2019/2020 General Rate Application, Volume 1, Application, Company Evidence and Exhibits, Section 3: Finance, page 3-22 et seq.*

13 In 2018, the Conference Board of Canada stated: *"The depletion of oil reserves and the aging population will severely slow overall economic growth in Newfoundland and Labrador over the forecast period, leaving it with the lowest average annual growth rate of any province for the 2018-40 period."* See the Conference Board of Canada's *Provincial Outlook 2018, Long Term Forecast,* January 19, 2018, page v.

14 The effects of current economic challenges are observed within Newfoundland Power's recent sales, which have modestly declined each year since 2016.

15 Section 14.1(1)(b) of the *Electrical Power Control Act, 1994* states that a retailer or an industrial customer shall purchase electrical power or energy exclusively from Hydro. Section 14.1(2) states that a retailer or an industrial customer shall not develop, own, operate, manage or control a facility for the generation and supply of electrical power. Listed exceptions include generation used exclusively in emergency circumstances and generation facilities owned, operated, managed or controlled by a retailer or an industrial customer where those facilities existed on December 31, 2011.

Additionally, rates for service to Hydro's rural customers are established by public policy and not through regulatory processes before the Board.[16] Public policy also requires that service to Hydro's customers, with the exception of those on the Labrador Interconnected System, be subsidized by Newfoundland Power's customers.[17] This is referred to as the Rural Deficit and is effectively Provincial Government social policy delivery.

Hydro's role in social policy delivery has been previously recognized by the Board.[18] The Board has previously concluded that funding of the Rural Deficit *"is not only a regulatory concern but is equally a public policy question that should bear the scrutiny of periodic review by Government."*[19] Consolidation of Hydro's operations with those of Newfoundland Power may necessitate a review of the Rural Deficit and other existing forms of subsidization.[20] It may also necessitate a review of the various operating arrangements that exist in other jurisdictions where investor-owned utilities deliver services to customers on behalf of government entities.[21]

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16 Order in Council OC2018-116 requires that any changes in rates charged to Hydro's Non-Government Rural Isolated Domestic and General Service customers shall be equal to changes approved for equivalent rate classes of Newfoundland Power customers. This policy was previously established in OC2006-512, OC2008-365, OC2009-390, OC2010-322, OC2012-329, OC2014-372, OC2015-300, OC2016-104, OC2016-287, OC2017-121, and OC2017-193.

17 The cost of providing service to Hydro rural customers exceeds the revenues collected from customer rates. This results in a deficit commonly referred to as the Rural Deficit. Until 1989, the Rural Deficit was funded by the Provincial Government. However, as a result of a change in policy by the Provincial Government in 1989, the Rural Deficit is currently funded by means of a cross-subsidy from other ratepayers. Evidence filed as part of Hydro's *2017 General Rate Application* indicates the Rural Deficit increases rates for customers of Newfoundland Power by approximately 10% and rates for customers on the Labrador Interconnected System by approximately 15%. The projected deficit in Hydro's *2017 General Rate Application* was $68.1 million in 2018 and $73.2 million in 2019.

18 In listing the main difference between the way Hydro is intended to operate and an investor-owned utility, the Board stated: *"As a Crown Corporation, NLH may receive directions from its shareholder, the Government of Newfoundland and Labrador, which reflects social or public policy considerations, not in conflict with legislation, which NLH will implement."* See Order No. P.U. 7 (2002-2003), page 41.

19 See Order No. P.U. 14 (2004), page 119.

20 Service to Hydro's customers served by the Labrador Isolated and L'Anse au Loup systems is subsidized by the Provincial Government through a rebate announced under the *Northern Strategic Plan* in 2007. This rebate effectively subsidizes these customer rates below those paid by Newfoundland Power's customers.

21 For example, the Long Island Power Authority ("LIPA") is a non-for-profit public utility of the State of New York. Service to LIPA customers is currently delivered by an investor-owned utility, PSEG-Long Island, under an Operating Service Agreement. Under this arrangement, the LIPA is the asset owner and PSEG-Long Island is the asset manager. Similar operating arrangements also exist within the Fortis Group of Companies. For example, FortisBC operates 5 hydroelectric generating facilities on behalf of other entities, including crown corporations of the Government of British Columbia. These 5 facilities are the Waneta Expansion Project, the Waneta Dam, the Arrow Lakes Generating Station, and the Brilliant Dam and Brilliant Expansion.