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December 2, 2015

The Board of Commissioners of Public Utilities
Prince Charles Building
120 Torbay Road, P.O. Box 21040
St. John's, NL A1A 5B2

Attention: Ms. Cheryl Blundon
Director Corporate Services & Board Secretary

Dear Ms. Blundon:

Re: Amended 2015 Cost Deferral Application - Reply

Enclosed you will find the original plus 12 copies of Newfoundland and Labrador's Reply in relation to the above noted matter.

Please contact the undersigned should you have any questions.

All of which is respectfully submitted.

NEWFOUNDLAND AND LABRADOR HYDRO

Geoffrey P. Young
Senior Legal Counsel

GPY/bs

cc: Gerard Hayes – Newfoundland Power
Paul Coxworthy – Stewart McKelvey Stirling Scales
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NEWFOUNDLAND AND LABRADOR HYDRO

REPLY REGARDING

AMENDED 2015 COST DEFERRAL APPLICATION

December 2, 2015

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1.0 BACKGROUND

On November 28, 2014 Hydro filed an application with the Board (the 2014 Cost Recovery Application) seeking approval of a 2014 revenue deficiency of $45.9 million. The application was required to provide Hydro the opportunity to defer 2014 costs as a result of the GRA extending into 2015. On December 24, 2014 the Board issued Order No. P.U. 58 (2014) approving the $45.9 million for deferral only, with recovery being subject to the Board's subsequent determination.

On July 23, 2015, Hydro filed a 2015 Cost Deferral Application requesting a cost deferral in amount of $20.0 million to reduce Hydro's forecast 2015 net income deficiency. Approval of the original 2015 Cost Deferral Application would have provided for a forecast net income of $11.4 million based upon the forecast 2015 Test Year. This amount was $21.8 million less than the proposed 2015 Test Year net income of $33.2 million. The original 2015 Cost Deferral Application did not anticipate the final GRA Order being delayed beyond 2015.

In the fall of 2015, it became evident to Hydro that the final GRA Order would not be issued until 2016. This necessitated amending the 2015 Cost Deferral Application to ensure Hydro had an opportunity to earn a just and reasonable return in 2015. As a result, on November 12, 2015 Hydro filed the Amended 2015 Cost Deferral Application with the Board seeking approval of, among other things, a 2015 Cost Deferral of $60.5 million. The Amended 2015 Cost Deferral Application proposed that $60.5 million in 2015 costs be approved for deferral only, with the decision on recovery to be determined at the conclusion of Hydro's GRA in 2016. Approval of the Amended 2015 Cost Deferral Application will provide Hydro the opportunity to earn rate of return on rate base of 6.62% in 2015, which is at the bottom of the range proposed in the Amended 2013 GRA.

2.0 ORIGINAL VS. AMENDED APPLICATION

Hydro's original 2015 Cost Deferral Application requested approval of the deferral of $20.0 million in 2015 costs. Board approval would have granted Hydro approval of 70% of the 2015 Test Year Net Income Deficiency due to delayed rate implementation. Table 1 provides a comparison of the original 2015 Cost Deferral application and the Amended 2015 Cost Deferral Application.

Table 1

Comparison of Cost Deferral Components

Line No.	Particulars ($ Millions)	Original Application	Amended Application	Variance
1	Delayed Rate Implementation	20.0	36.8	16.8
2	2015 Supply Costs	-	12.7	12.7
3	2015 RSP Interest	-	7.6	7.6
4	Other 2015 Deferrals	-	3.4	3.4
5	**Deferral Requested**	**20.0**	**60.5**	**40.5**

Delayed Rate Implementation

Hydro's original Application requested only a portion of the impact of delayed rate implementation consistent with regulatory precedent from interim rates decisions in other Canadian jurisdictions. Because the calculation of the impact of delayed rate implementation assumed Hydro's GRA would be completed before the end of 2015, no request was made to deal with (i) the net income impact of delayed rate implementation of the remaining 30% of the forecast 2015 Net Income Deficiency; (ii) the material increase in supply costs in 2015; and (iii) the higher than forecast RSP interest for 2015 resulting from continued operation of the RSP based on the 2007 Test Year. The Board's determination on these items was anticipated to be dealt with in the final GRA Order of the Board.

Hydro prepared the Amended 2015 Cost Deferral Application reflecting the cost recovery that would have been provided if the Board approved, effective January 1, 2015, the 2015 Test Year forecast costs, and approved the cost deferrals proposed in the Amended Application. The

Amended 2015 Cost Deferral Application does not propose deferral of any increased costs forecast in 2015 relative to the 2015 Test Year.

Based on Hydro's financial forecast for 2015 (reflecting actual results to the end of August), Board approval of a 2015 cost deferral of $60.5 million is required to provide Hydro the opportunity to achieve a rate of return on rate base at the bottom of the proposed range for 2015.

2015 Supply Cost Variances

In the Amended 2015 Cost Deferral Application, Hydro has calculated additional 2015 supply costs of $12.7 million in a manner consistent with the proposed new supply cost recovery deferral accounts. The Amended 2015 Cost Deferral Application is requesting a one-time deferral of these supply cost variances due to the material impact on Hydro's 2015 financial results, and the delay in the Board's ruling on Hydro's proposals to implement these deferral accounts until 2016. A summary of the supply costs proposed for deferral are provided in Table 2.

Table 2

Proposed Supply Cost Variance Deferral for 2015

Line No.	Particulars	$000's (Due To)/From Customers
1	Isolated Systems Supply Cost Variance Deferral Account	(955)
2	Energy Supply Cost Variance Deferral Account	7,064
3	Holyrood Conversion Rate Deferral Account	2,418
4	Change in Test Year Holyrood Fuel Conversion Rate	4,214
5	Proposed 2015 Supply Cost Deferral	12,741

Hydro believes it is appropriate that it be provided the opportunity to recover supply costs that are prudently incurred in providing reliable service to customers. Recovery of prudently incurred supply costs is consistent with utility practice in Canada.[1]

For reasons beyond management's control, Hydro's supply cost mix can vary from forecast resulting in material financial impact on Hydro. For example, in 2015 Hydro has experienced lower production levels at Nalcor Exploits resulting in reduced power purchases. Replacement of Exploits purchases, at four cents per kWh, with thermal generation can result in Hydro incurring a material increase in supply costs in excess of what is recovered in customer rates. The variance from the 2015 Test Year is forecast to cost Hydro approximately $1.8 million in 2015.[2]

Hydro operates its generating plants to provide reliable service to its customers, by providing sufficient reserves to minimize impacts on customers for single contingency equipment outages. The growth in demand in recent years has resulted in a greater reliance on combustion turbines for this purpose. The addition of the Holyrood Combustion Turbine (Holyrood CT) provides Hydro a greater ability to secure reliable operation for such contingencies. Hydro is currently operating the Holyrood CT to provide additional security of supply. An example of this, presented to the Board during Hydro's GRA hearing, was the required annual planned outage of all units at the Holyrood Thermal Generating Station (Holyrood TGS) to complete common plant equipment maintenance. Having no units operating on the Avalon Peninsula exposes customers on the Avalon Peninsula to an outage in the event that a transmission line was forced out of service.

In the past, during the annual total plant outage at the Holyrood TGS, Hydro would keep the Hardwoods CT available if such a contingency occurred. The Hardwoods plant does not have

[1] See response to PUB-NLH-388.

[2] Production at Nalcor Exploits is forecast to be 27.0 GWh below the 2015 Test Year forecast. This results in savings of $1.1 million in power purchases offset by $2.9 million as the cost of an additional 27.0 GWh in production at the Holyrood TGS. Production at the Holyrood TGS is assumed to be at 607 kWh/bbl and No. 6 fuel priced at $64.41.

sufficient capacity to completely cover customer load requirements, thus leaving some customers exposed to an interruption during a line out contingency. With the addition of the Holyrood CT, and in response to this interruption risk, Hydro has been running the Holyrood CT at minimum output levels during peak periods of the day to provide enhanced reliability. This operational practice began in 2015 in response to enhanced reliability assessments following the March 4, 2015 outage event.

Without the proposed Energy Supply Cost Variance Deferral Account (ESCVDA), higher costs resulting from increased generation at the Holyrood CT to provide this higher standard of reliability would be borne by Hydro with no opportunity to recover the additional cost from customers. This scenario creates a financial disincentive for Hydro to operate the Holyrood CT in excess of the forecast Test Year levels, regardless of whether operation of the Holyrood CT results in more reliable service to customers.

Further, there may be times when Hydro has the opportunity to economically optimize operation of the Holyrood CT in conjunction with the Holyrood TGS.[3] A scenario where a unit at the Holyrood TGS can be brought offline for a week and the Holyrood CT is only used at peak times during that week can result in net fuel cost savings for customers through the RSP. Without the proposed ESCVDA, Hydro would be negatively impacted financially for optimizing the system in this fashion, as the Holyrood TGS fuel savings would accrue inside the RSP and flow to customers while all additional CT costs incurred would be borne by Hydro.

Hydro currently operates the Holyrood CT and Holyrood TGS to provide the most reliable, least cost service to customers. Where the Board has not yet made its decision on the supply cost deferral account, Hydro believes it is appropriate that these costs be deferred until the Board has decided on the appropriate treatment of these enhanced reliability and fuel efficiency costs.

[3] GRA Transcript, October 20, pages 132-136.

2015 RSP Interest and Test Year Holyrood Conversion

Hydro notes that both the RSP interest of $7.6 million and the $4.2 million fuel cost impact of delayed implementation of the 2015 Test Year Holyrood fuel conversion rate result from continuing to operate the RSP based on the 2007 Test Year on an interim basis for 2015.[4] These amounts (a combined $11.8 million of the $60.5 million requested for deferral) will automatically reverse in 2016 when Hydro reruns the RSP to reflect the 2015 Test Year.[5] Approval of these amounts by the Board for deferral would have no impact on customers, as stated in the Application, and simply allows for more accurate financial reporting of Hydro's results.

3.0 INTERVENOR SUBMISSIONS

Newfoundland Power (NP)

Similar to NP's position on Hydro's 2014 Cost Recovery, NP takes issue with the 2015 Application before the Board. NP's main assertions from their 2014 submission filed December 10, 2014 were that the cost increases from 2007 were not tested and approval of the deferral as requested would "effectively amount to a guarantee of Hydro's 2014 rate of return". NP stated that this was not consistent with their interpretation of Section 80 of the Public Utilities Act.[6] Hydro notes that the 2014 Cost Recovery Application was ultimately approved for deferral in Order P.U. 58 (2014).

Hydro notes that NP's 2015 submission contains a similar argument as well as a number of mischaracterizations of the Amended 2015 Cost Deferral Application. Page 5 of NP's submission states:

[4] See Hydro's Amended 2015 Cost Deferral Application, Appendix A, Lines 30 and 32.

[5] This assumes the Board approves the RSP inputs included in the Amended Application but using a 2015 Test Year fuel cost of $64.41 per barrel.

[6] Newfoundland Power submission on Newfoundland and Labrador Hydro's 2014 Cost Recovery Application dated December 10, 2014, Section D, Page 4 of 6.

> "Hydro has chosen to file the amended Application to defer consideration and recovery of a 2015 net income deficiency in November 2015. By November, the year is substantially complete. Seeking to establish an appropriate return in such a timeframe is not consistent with having a just and reasonable 2015 rate of return for Hydro determined on predictive techniques and methodologies."

The $60.5 million deferral requested is based on a forecast which includes actual results to August 2015. This was noted in Appendix A of the application and acknowledged by NP's counsel at Hydro's GRA hearing on November 16, 2015.[7] NP's suggestion that the August forecast represents results from a "substantially complete" year based on the filing date is inaccurate.

NP, on page 5 of its submission, takes the same position as it did in 2014: that approval of the deferral as requested would effectively guarantee Hydro's rate of return in 2015:

> "Deferring a net income deficiency for future consideration and recovery substantially eliminates the risk to Hydro arising from its management decision making and economic uncertainty. <u>It appears that Hydro is proposing that it should be permitted deferred recovery of all 2015 test year costs which the Board may ultimately approve, together with an ROE of 8.8%.</u> The deferred recovery is to be considered in a compliance application following the Board's 2016 order. This effectively amounts to (i) determination of Hydro's 2015 return in 2016 and (ii) <u>a guarantee of an ROE of 8.8%.</u> Neither of these results is consistent with the prospective nature of ratemaking in this province."
> [emphasis added]

Hydro agrees that the Amended 2015 Cost Deferral is based on the assumption that the 2015 Test Year is approved in its entirety, for twelve months of 2015. The 2015 Test Year is a forecast

[7] Transcript of November 16, 2015, page 213, line 5 to 8.

test year, filed with the Board in 2014, using “predictive techniques” to determine future costs. It is then unclear to Hydro why NP would characterize approval of costs based on a forecast test year to result in a *guaranteed* rate of return. To the extent that costs other than supply costs have increased from the 2015 Test Year, they have not been included in the Amended 2015 Cost Deferral.

Page 6 of NP’s submission continues:

> “In July 2015, Hydro sought a $20 million deferral to reduce its forecast 2015 net income deficiency. By the filing of the amended Application 4 months later in November 2015, Hydro's proposed deferral to reduce the forecast 2015 net income deficiency had tripled to $60.5 million.”
>
> “<u>The dramatic increase in the recovery sought in relation to Hydro's forecast 2015 net income deficiency is the result of Hydro management decisions and/or economic uncertainty. The Application, if approved, will transfer the risks of 2015 management decisions already made and economic uncertainties already encountered from Hydro to its customers.</u>” [emphasis added]

This is again a mischaracterization of Hydro’s Application by NP. First, Hydro notes that no recovery has been sought in this application. Hydro’s application is for deferral only. Second, Hydro’s July 2015 application sought to defer 70% of the impact of delayed rates only.[8] It did not include supply costs variances for the proposed supply cost deferral accounts, nor did it include the impact of delayed implementation of a 2015 RSP Test Year, or account for the continuation of Hydro’s GRA into 2016. These items account for $23.7 million of the increase between the original and amended applications.[9] These are changes in forecast assumptions

[8] Original 2015 Cost Deferral Application, Page 4, Point 11.
[9] Amended 2015 Cost Deferral Application, Table 6, Line 2 + Line 3 + Line 4.

based primarily on the fact that Hydro's GRA will not conclude in 2015. They are not a result of Hydro management decisions and/or economic uncertainty, as submitted by NP.

Finally, and as stated previously, the Application is based on forecast 2015 Test Year costs. To the extent that costs other than supply costs have increased from the 2015 Test Year, they have not been included in the Amended 2015 Cost Deferral. Therefore, NP's assertion that if approved Hydro's application "will transfer the risks of 2015 management decisions already made and economic uncertainties already encountered from Hydro to its customers" is also incorrect.

NP's submission proposes recovery of only $20.0 million in 2015. NP's justification on page 8 appears to be, again, based on a misapprehension or mischaracterization of the two applications referenced, the Original and Amended 2015 Cost Deferral Applications:

> "On July 10, 2015, Hydro filed the original 2015 Cost Deferral Application seeking in the amount of $20 million. This filing, which exceeded 850 pages in length, can be taken as *Hydro's best estimate* in July 2015 of what was appropriate to address Hydro's forecast 2015 net income deficiency."

As noted previously, the Original and Amended Cost Deferral Applications are based on vastly different assumptions, primarily the expected completion date of Hydro's GRA. NP's assertion that the Original Application from July 2015 is directly comparable to the Amended Application of November 2015 is incorrect.

Further, while NP has recommended a lower level of recovery, it has not quantified the impact of this recommendation. If the Board were to only approve $20.0 million for deferral in 2015, this would result in a net loss for Hydro of $10.8 million, a return on equity of -2.84%, and a rate of return on rate base of 4.72%. Hydro submits that this level of return and corresponding net loss cannot be considered reasonable for 2015.

Hydro submits that NP's submission includes several incorrect statements and mischaracterizations of Hydro's Application. Further, Hydro submits that NP's recommended level of recovery would be unreasonable.

Consumer Advocate (CA)

The CA's ultimate recommendation is the same as NP's however, for different reasons. One of the main reasons that the CA opposes Hydro's Application is the granting of interim rates to Hydro effective July 1, 2015. Page 2 of the CA's submission states:

> "In the Consumer Advocate's submission, the interim rate increase granted by the Board effective July 1, 2015 fairly addresses Hydro's financial situation in 2015. Although effective only from midyear, the rate increase granted for Newfoundland Power, far and away Hydro's largest customer, is almost double what Hydro proposes in the Amended 2013 GRA."

While the CA states it believes the interim rate increase "fairly addresses Hydro's financial situation in 2015," no real justification for this conclusion is given. Hydro notes that the interim rates granted by the Board resulted in an additional $26.0 million in revenue in 2015. This level of recovery still results in Hydro incurring a net loss of $30.8 million in 2015.[10] Hydro is unsure by what measure the CA would consider a net loss of this magnitude to be a fair means by which to address Hydro's financial situation in 2015.

Ultimately, the CA recommends the same $20.0 million recovery as NP which Hydro submits is not a reasonable level of recovery for 2015.

[10] See Hydro's Amended 2015 Cost Deferral Application, Appendix A, Line 24.

Vale and Industrial Customer Group (IC)

Neither Vale nor the IC's Group oppose the creation of the account requested for deferral only. Vale submits that a number of issues need to be considered by the Board before determining how much of the requested deferral can be recoverable. However, Vale notes that they do not object to the creation of the account for deferral only.[11] The IC's state that should the Board grant the deferral requested by Hydro, they reserve their full rights to make future submission on the disposition of the account.

4.0 LEVEL OF RECOVERY

Hydro has requested Board approval of a 2015 cost deferral to offset 100% of the $60.5 million forecast 2015 Test Year net income deficiency. Based on Hydro's financial forecast for 2015 (reflecting actual results to the end of August), Board approval of a 2015 cost deferral to offset 100% of the $60.5 million forecast 2015 Test Year net income deficiency is required to provide Hydro the opportunity to achieve a rate of return on rate base at the bottom of the proposed range for 2015.

Hydro submits that because the deferral has been calculated based on the forecast 2015 Test Year, deferral to offset 100% of the forecast 2015 Net Income Deficiency is required to give Hydro the opportunity to earn a just and reasonable return in 2015.

Table 7 in Hydro's Amended 2015 Cost Deferral Application gave a range of recovery percentages and the corresponding financial impacts. This table has been restated to include the proposed level of recovery recommended by NP and the CA:

[11] Vale submission dated November 30, 2015 page 4, line 12.

Table 3

2015 Forecast Financial Results[12]

Line No.	Scenario	Deferred Recovery ($ Millions)	2015 Net Income ($ Millions)	2015 Return on Equity (%)	2015 Return on Adjusted Rate Base (%)
1	NP / CA Proposed	46.0	(10.8)	-2.84%	4.72%
2	70% Recovery	60.6	3.8	0.99%	5.25%
3	80% Recovery	69.2	12.4	3.27%	5.71%
4	90% Recovery	77.9	21.1	5.54%	6.17%
5	100% Recovery	86.5	29.7	7.82%	6.62%

It is unclear to Hydro how proposing an overall net loss for 2015 could be considered a "balanced approach" as NP has asserted. Hydro submits that such a level of return for 2015 is not reasonable. Hydro recognizes that approval of this deferral does not provide any certainty of recovery. However, Hydro submits the 2015 Test Year forecast costs reasonably reflect the cost of providing service to customers.

5.0 CONCLUSION

Hydro submits that the delay in completion of the GRA should not be the reason to deny Hydro the opportunity to earn a just and reasonable return in 2015. Approval of the Amended 2015 Cost Deferral Application will balance the interest of the utility and the customer, in that it (i) provides Hydro the opportunity to earn a reasonable return in 2015 and (ii) does not impact customer rates as customer rates will only be modified to provide recovery of tested costs for 2015 on conclusion of the GRA.

[12] Based on Hydro's August 2015 forecast.