Newfoundland & Labrador

BOARD OF COMMISSIONERS OF PUBLIC UTILITIES

REASONS FOR DECISION:
ORDER NO. P. U. 43(2009)

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

AND IN THE MATTER OF
a general rate application by Newfoundland Power Inc. for approval of, *inter alia*,
rates to be charged its customers.

BEFORE:

Andy Wells
Chair and Chief Executive Officer

Darlene Whalen, P.Eng.
Vice-Chair

Dwanda Newman, LL.B.
Commissioner

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I. APPLICATION AND PROCEEDING

1. Application

Newfoundland Power Inc. ("Newfoundland Power") filed a general rate application (the "Application") with the Board of Commissioners of Public Utilities (the "Board") on May 28, 2009 for an Order of the Board approving, among other things, the rates to be charged as of January 1, 2010 for the supply of power and energy to its Customers.

2. Application Proposals

In the Application Newfoundland Power proposed that the Board approve:

1. discontinuance of the use of the Formula for setting the allowed rate of return on rate base for Newfoundland Power;

2. the adoption of the accrual method of accounting for other post employment benefits and for income tax related to other post employment benefits with effect from January 1, 2010;

3. establishment of a Pension Expense Variance Deferral Account with effect from January 1, 2010;

4. amortizations, with effect from January 1, 2010, to:

   (a) amortize the recovery over a four year period of certain 2009 conservation costs associated with implementation of the Conservation Plan; and

   (b) recover over one year an estimated $750,000 in Board and Consumer Advocate costs related to the Application;

5. that the next depreciation study relate to plant in service as of December 31, 2009;

6. continued use of the Energy Supply Cost Variance clause beyond 2010, and the Demand Management Incentive Account until further Order of the Board;

7. an overall average increase in current customer rates of 6.1 percent, with effect from January 1, 2010, based upon:

   (a) a forecast average rate base for 2010 of $867,396,000;
   (b) a rate of return on average rate base for 2010 of 9.15 percent in a range of 8.97 percent to 9.33 percent; and

(c) a forecast revenue requirement for 2010 of $545,312,000 to be recovered from electrical rates;

8. rates, tolls and charges effective for service provided on and after January 1, 2010, which result in average increases in current customer rates by class as follows:

Rate Class	Average Increase
Domestic	6.8%
General Service 0-10 kW	4.1%
General Service 10-100 kW (110 kVA)	4.1%
General Service 110-1000 kVA	5.1%
General Service 1000 kVA and Over	6.1%
Street and Area Lighting	6.1%

3. Notice and Pre-Hearing Conference

Notice of the Application and Pre-hearing Conference was published in newspapers throughout the Province beginning on June 3, 2009. The Pre-hearing Conference was held on June 17, 2009 at the Board's hearing room in St. John's.

Following the Pre-hearing Conference the Board issued procedural Order No. P.U. 24(2009) on June 17, 2009 which identified registered intervenors, established procedural rules and set the schedule for the proceeding.

Registered intervenors for the proceeding were the Government appointed Consumer Advocate, Mr. Thomas Johnson, assisted by Mr. Randell Earle, Q.C., and Newfoundland and Labrador Hydro ("Hydro"), represented by Mr. Geoff Young. Hydro advised in its Intervenor Submission that its participation in the proceeding would be limited. Newfoundland Power was represented by Mr. Ian Kelly, Q.C. and Mr. Gerard Hayes.

The Board was assisted at the hearing by Mr. Daniel W. Simmons, who acted as Board Hearing Counsel, Ms. Jacqueline Glynn, Board Counsel, Ms. Cheryl Blundon, Board Secretary, and Ms. Barbara Thistle, Assistant Board Secretary. The Board's financial consultants, Grant Thornton LLP, also completed a review of the Application and filed a report on July 31, 2009.

4. Settlement Agreement

During the Pre-hearing Conference the Board set aside the period from August 24 to September 18, 2009 for negotiations, with the hearing scheduled to begin on October 14, 2009. On September 23, 2009 a Settlement Agreement was filed with the Board which set out the terms of an agreement between Newfoundland Power and the Consumer Advocate on certain issues contained in the Application. Hydro did not participate in the settlement process and Mr. Young confirmed in opening comments that Hydro was largely an observer in this proceeding.

5. Application Amendments

On September 28, 2009 Newfoundland Power amended the Application incorporating the terms of the Settlement Agreement and updating other aspects of the Application, including 2010 test year customer, energy and demand forecasts. Supplemental evidence and exhibits were also filed as part of the amendments.

Newfoundland Power proposed that the Board approve:

1. discontinuance of the use of the Formula for setting the allowed rate of return on rate base for Newfoundland Power;

2. the adoption of the accrual method of accounting for other post employment benefits and for income tax related to other post employment benefits with effect from January 1, 2010;

3. establishment of a Pension Expense Variance Deferral Account with effect from January 1, 2010;

4. amortizations, with effect from January 1, 2010, to:

   (a) amortize the recovery over a four year period of certain 2009 conservation costs associated with implementation of the Conservation Plan; and

   (b) recover over one year an estimated $750,000 in Board and Consumer Advocate costs related to the Application;

5. that the next depreciation study relate to plant in service as of December 31, 2009;

6. continued use of the Energy Supply Cost Variance clause beyond 2010, and the Demand Management Incentive Account until further Order of the Board;

7. an overall average increase in current customer rates of 7.2 percent, with effect from January 1, 2010, based upon:

(a) a forecast average rate base for 2010 of $869,241,000;

(b) a rate of return on average rate base for 2010 of 9.13 percent in a range of 8.95 percent to 9.31 percent; and

(c) a forecast revenue requirement for 2010 of $545,917,000 to be recovered from electrical rates;

8. rates, tolls and charges effective for service provided on and after January 1, 2010, which result in average increases in current customer rates by class as follows:

Rate Class	Average Increase
Domestic	7.9%
General Service 0-10 kW	5.2%
General Service 10-100 kW (110 kVA)	5.2%
General Service 110-1000 kVA	6.2%
General Service 1000 kVA and Over	7.2%
Street and Area Lighting	7.2%

Grant Thornton reviewed the amended Application and filed a Supplementary Report on October 8, 2009.

6. Hearing

Notice of the Revised Application, Hearing and Invitation for Public Participation was published in newspapers throughout the Province beginning on October 3, 2009. Pursuant to Order No. P.U. 24(2009) the public hearing began on October 14, 2009. Oral testimony was heard on October 14, 15, 19, 20, 21, 22, 26 and 27, 2009. Written submissions were filed by Newfoundland Power and the Consumer Advocate on November 6, 2009. Final arguments were presented by Newfoundland Power and the Consumer Advocate on November 10, 2009. Consistent with its expressed intention to participate in the hearing in a limited way Hydro did not file a written submission or make a final argument as part of this proceeding.

During the hearing the following witnesses testified:

<u>Newfoundland Power:</u>

Mr. Earl Ludlow	President and Chief Executive Officer
Ms. Jocelyn Perry	Vice-President, Finance and Chief Financial Officer
Mr. Gary Smith	Vice-President, Engineering and Operations
Mr. Lorne Henderson	Manager of Rates and Regulation
Ms. Kathleen C. McShane	President, Foster Associates, Inc.
Dr. Karl Aboud	National Director, Reward Consulting Practice, Hay Group Ltd.

Consumer Advocate:

Dr. Laurence D. Booth	Professor of Finance, University of Toronto
Mr. John D. Todd	President, Elenchus Research Associates Inc.

The Board:

Mr. Mark A. Cicchetti	Senior Consultant and Project Manager, C. H. Guernsey & Company

As set out in the Notice interested persons and organizations were given the opportunity to submit a letter of comment or make an oral presentation to the Board. On November 10, 2009 the Board heard an oral presentation from Ms. Kelly Heisz, Executive Director, Seniors Resource Centre. The Board expresses its appreciation to Ms. Heisz for her presentation which was well prepared and presented and was very informative. This submission formed part of the evidentiary record considered by the Board in rendering its decisions on this Application. The Board also received three letters of comment.

II. BOARD DECISIONS

1. Settlement Agreement

The Settlement Agreement recommends that the Board implement the consensus proposals of the parties on the following matters:

- 2010 customer, energy and demand forecasts;
- amortization of 2009 conservation costs;
- continued use of the Energy Supply Cost Variance and the Demand Management Incentive Account;
- creation of a Pension Expense Variance Deferral Account;
- timing of the next depreciation study;
- capital structure for rate-making purposes; and
- schedule for the Retail Rate Review.

In considering the Settlement Agreement the Board must be satisfied that the proposals are consistent with the existing regulatory framework, with particular reference to the power policy of the Province as set out in Section 3 of the *EPCA.*

The Board notes that the negotiation process involved both the Consumer Advocate and Newfoundland Power and followed significant information exchange. Hydro chose not to participate in the Settlement Agreement and did not object to the consensus. The Board's financial consultants Grant Thornton reviewed the calculations, methodologies and assumptions in the Application and the amendments following the Settlement Agreement to verify the accuracy and completeness of the proposals and to ensure compliance with Board Orders. The Board is satisfied that the record is sufficient to enable a complete review of the Application, including the issues outlined in the Settlement Agreement. The Board's findings on the issues addressed in the Settlement Agreement are set out below.

i. <u>2010 Customer, Energy and Demand Forecast</u>

Newfoundland Power provided a 2010 Customer, Energy and Demand Forecast with its Application. As part of the Application amendments Newfoundland Power revised its 2010 Customer, Energy and Demand Forecast to reflect the most recent economic forecasts and the elasticity impacts of the higher proposed rate increase. Lower forecast energy sales decreased Newfoundland Power's forecast power purchases for 2010 by 28 GWhs and 9 MWhs of demand, resulting in a decrease in purchased power expense of $2,933,000. (Grant Thornton, Supplementary Report, pg. 2/15-16)

The parties to the Settlement Agreement agreed that the Board may accept and rely on the revised 2010 Customer, Energy and Demand Forecast which was filed with the Board as part of the amendments to the Application.

The Board notes that, while the revised 2010 Customer, Energy and Demand Forecast was updated to reflect more recent data, the overall methodology was not changed and is similar to the methodology accepted by the Board in recent general rate applications. Grant Thornton confirmed that the changes to the 2010 Customer, Energy and Demand Forecast were appropriately incorporated into the 2010 forecast of revenue requirement, forecast average rate base and forecast return on equity. (Grant Thornton 2nd Report, pgs. 2/8-10; 3/13-15)

The Board accepts the revised 2010 Customer, Energy and Demand Forecast to be used in calculating the 2010 forecasts of revenue requirement, rate base and return on rate base for the purposes of determining customer rates, incorporating the determinations set out in this Decision.

ii. <u>2009 Conservation Costs</u>

Newfoundland Power forecasts 2009 conservation costs associated with programming under the 5-year Energy Conservation Plan to be approximately $1.5 million. (Application, 1st Revision, pg. 3-38/10-16) The Application proposed that these costs, charged to the Conservation Cost Deferral Account approved by the Board in Order No. P.U. 13(2009), be amortized over the remaining four years of the 5-year Energy Conservation Plan, beginning January 1, 2010.

The parties to the Settlement Agreement agreed that this proposal should be approved. The Board is satisfied that this proposal should be approved.

The Board accepts the proposal to recover the 2009 conservation programming costs of approximately $1.5 million over the remaining four years of the 5-year Energy Conservation Plan through the Conservation Cost Deferral Account.

iii. <u>Energy Supply Cost Variance and Demand Management Incentive Account</u>

In Order No. P.U. 32(2007) the Board approved the recovery, through the Rate Stabilization Account, of the Energy Supply Cost Variance incurred up to the end of 2010. This mechanism is intended to reflect the current supply cost dynamics on the system and allows Newfoundland Power to recover the variance in energy supply costs related to the difference between purchasing energy at the 2nd block energy charge in the wholesale rate and the test year energy supply cost reflected in customer rates. The Energy Supply Cost Variance was approved to be recovered through the Rate Stabilization Account for the period 2008 to 2010.

In the Application Newfoundland Power provided a report on the operation of the Energy Supply Cost Variance for 2008 and a forecast for 2009. The parties to the Settlement Agreement agreed that the Board should approve the continued use of the Energy Supply Cost Variance until a further Order of the Board.

In Order No. P.U. 32(2007) the Board approved the establishment of the Demand Management Incentive Account to replace the Purchased Power Unit Cost Variance Reserve. The intent of this account is to isolate the demand costs and, in conjunction with the Energy

Supply Cost Variance, provide Newfoundland Power with the ability to recover its costs associated with variability in purchased power costs inherent in the demand and energy wholesale rate.

As required by Order No. P.U. 32(2007) the Application included a report on the operation of the Demand Management Incentive Account. The parties to the Settlement Agreement agreed that no changes should be made at this time to the Demand Management Incentive Account. It was also agreed that Newfoundland Power will provide a further report to the Board on the performance of the Demand Management Incentive Account with its next general rate application. This report will include a summary of the amounts of transfers and savings and an examination of the incentive effects of: i) the Demand Management Incentive Account; ii) other existing regulatory mechanisms related to power purchase costs; and iii) possible alternative mechanisms with respect to the effectiveness and efficiency of the incentive to reduce power purchase costs.

The Board is satisfied that the Energy Supply Cost Variance as approved in Order No. P.U. 32(2007) should be continued. The Board is also satisfied that the Demand Management Incentive Account should be continued and that a further report to the Board on the operation of this account as proposed in the Settlement Agreement should be filed by Newfoundland Power as part of its next general rate application.

The Board will approve the continued use of the Energy Supply Cost Variance and the Demand Management Incentive Account. Newfoundland Power will be required to provide a report on the operation of the Demand Management Incentive Account as part of its next general rate application.

iv. Pension Expense Variance Deferral Account

In the Application Newfoundland Power proposed the creation of a Pension Expense Variance Deferral Account to capture the difference between the annual pension expense approved for the test year revenue requirement and the actual pension expense computed in accordance with generally accepted accounting principles for any subsequent year.

The parties to the Settlement Agreement agreed with the creation of this account with the following definition:

"Pension Expense Variance Deferral Account

This account shall be charged or credited with the amount by which the annual pension expense computed in accordance with generally accepted accounting principles for any year differs from the annual pension expense approved most recently for the establishment of revenue requirement from rates for a test year.

Disposition of any Balance in this Account

Newfoundland Power shall charge or credit any amount in this account to the Rate Stabilization Account as of the 31st day of March in the year in which the difference arises.

If there is an application before the Board for rates based on a new test year that is anticipated to be outstanding as of the 31st day of March in a year in which the new rates are expected to become effective, then Newfoundland Power shall apply to the Board for determination of the amount to be charged or credited to the account for that year and the timing thereof."

The Board accepts that recent financial market conditions have increased the variability and unpredictability associated with forecasting pension expense for the 2010 test year. The impact of this uncertainty can be significant. As an example the 2010 forecast pension costs included in the amendments filed on September 28, 2009 increased by $2,495,000 from that filed in May, primarily as a result of a lowering of the discount rate from 7.5% to 6.5%. (Exhibit JHP-1, pg. 1, Footnote 2) This variability is not in the control of Newfoundland Power and can have a material impact on annual pension costs.

Grant Thornton concluded in its review that the use of the Pension Expense Variance Deferral Account will limit the variability of pension expense due to changes in assumptions, in particular discount rates. According to Grant Thornton the language of the Rate Stabilization Clause approved in Order No. P.U. 6(2008) allows for the adjustment of the Rate Stabilization Account to dispose of the balance in this deferral account.

Newfoundland Power confirms that *"It is not the purpose of the Pension Expense Variance Deferral Account to address pension cost variances that result from factors within the Company's control that impact pension expense, such as an early retirement program."* (Newfoundland Power, Written Submission, pg. E-5/14-16)

The Board is satisfied that this account should be approved as proposed and agreed in the Settlement Agreement. The account will capture the variances from test year annual pension expense as calculated in accordance general accepted accounting principles. Similar mechanisms to allow for recovery of actual annual pension costs are in place in other jurisdictions in Canada and the U.S. The Board will, however, monitor the use of this account to ensure that only variances arising from factors that are outside of Newfoundland Power's control are captured.

The Board will approve the proposed Pension Expense Variance Deferral Account, to be implemented as of January 1, 2010.

v. <u>Timing of the Next Depreciation Study</u>

In Order No. P.U. 32(2007) the Board ordered Newfoundland Power to file its next depreciation study relating to plant in service as of December 31, 2010. In its Application Newfoundland Power proposed that the next depreciation study relate to plant in service as of December 31, 2009. The reason for this proposal is the requirement to file financial statements in 2011 that are compliant with International Financial Reporting Standards ("IFRS"). According to Newfoundland Power, because IFRS requires the 2011 statements to include comparative results for 2010, a study relating to plant in service as of December 31, 2009 would provide detailed information that will be useful in the preparation of these comparative financial statements.

The parties to the Settlement Agreement agreed that the next depreciation study should be filed relating to plant in service as of December 31, 2009. The Board is satisfied that this proposal should be approved.

The Board accepts the proposal that Newfoundland Power file its next Depreciation Study relating to plant in service as of December 31, 2009.

vi. Capital Structure

In the Application Newfoundland Power forecasts an average capital structure for 2010 of 54.21% debt, 1.05% preferred equity and 44.74% common equity.

The parties to the Settlement Agreement agreed that the proposed capital structure presented in the Application should be approved by the Board to be used for ratemaking purposes. In the amended Application Newfoundland Power updated the forecast capital structure to reflect 54.27% debt, 1.04% preferred equity and 44.69% common equity. The Board notes the proposed capital structure is consistent with the capital structure established by the Board in Order Nos. P.U. 16(1998-99), P.U. 19(2003) and P.U. 32(2007).

The Board acknowledges the agreement of the parties to the Settlement Agreement in relation to the capital structure and will accept a regulated common equity component of no greater than 45%.

vii. Retail Rate Design Study

In Order No. P.U. 32(2007) the Board accepted a proposal that the parties would undertake a Retail Rate Review to evaluate the design of Newfoundland Power's rates. This review is ongoing and, according to Newfoundland Power, includes consideration of a number of changes in the customer charges that apply to each class, including new customer charges that better reflect differing customer cost attributes within a class and reduction in customer charges for the larger General Service customers to better reflect current metering practices.

The parties to the Settlement Agreement agreed that appropriate adjustments should be made to the schedule for the retail rate design study to account for delays arising from this Application.

The Board accepts the proposal to adjust the schedule for the ongoing retail rate design study and will require Newfoundland Power and the Consumer Advocate to file a revised schedule with the Board no later than March 31, 2010.

viii. Outstanding Issues

The outstanding issues which were not resolved as part of the negotiation process include:

(i) Cost of capital;
(ii) Automatic adjustment formula;
(iii) Adoption of accrual accounting for other post employment benefits (OPEBs) costs;
(iv) Executive compensation;
(v) Operational costs and efficiencies;
(vi) Inter-corporate transactions;
(vii) Amortization of hearing costs;
(viii) Disposition of proceeds from Kenmount Road Property; and
(ix) Mobile River Watershed dispute.

These issues are detailed in the following sections including the Board's findings on each.

2. Cost of Capital

As stated by the Board in Order No. P.U. 19(2003) regulated utilities are provided with the opportunity to earn a fair rate of return. To be considered fair the return must be commensurate with the return on investments of similar risk and sufficient to assure financial integrity and to attract necessary capital.

i. <u>Newfoundland Power and Risk</u>

In Order No. P.U. 19 (2003) the Board found that the overall investment risk for Newfoundland Power, including business, regulatory and financial risk, is average when compared to other Canadian utilities. In this proceeding Newfoundland Power argues that it remains an average or typical low risk Canadian utility and that this has not changed since the last cost of capital review. Ms. McShane concluded that the business risk profile of Newfoundland Power has not changed materially since its last general rate application in 2007. She further concluded that Newfoundland Power would be viewed by investors as an approximate average risk utility relative to its Canadian peers. (K. McShane, Pre-filed evidence, pgs. 33; 39) Newfoundland Power also points to the changing financial market conditions since 2008. (Application, 1st Revision, pg. 3-18/8-12)

The Consumer Advocate stated in relation to Newfoundland Power's risk:

> *"Newfoundland Power has been and will continue to be a very well protected, stable, predictable, conservative, low risk utility operating in a very supportive regulatory environment where the company enjoys moderate, yet fairly steady customer growth, free from any significant competition. With only a small amount of generation, Newfoundland Power is predominantly poles and wires. In essence, it is very low risk."*
> (Consumer Advocate, Transcript, Oct. 14, 2009, pg. 25/11-20)

In his written submission (pg. 4) the Consumer Advocate states that the proposed Pension Expense Variance Deferral Account is a new risk reducer for Newfoundland Power and asks that the Board ensure that customers benefit from the low risk environment in which Newfoundland Power operates. According to Dr. Booth Canadian utilities enjoy almost a complete absence of risk. (Transcript, Oct. 22, 2009 pg 95/11-18) Dr. Booth detailed the reasons for his conclusion that Newfoundland Power is a typical low risk utility, including both low cost uncertainty and very low revenue uncertainty, a low growth, stable operating environment, good financial market access, and the attitude of the regulator. Dr. Booth concludes by saying: *"There is nothing in NP's business risk to indicate any change in its allowed risk premium: on the contrary given its lower financial risk a case can be made for a smaller risk premium relative to its peer group."* (Dr. L. Booth, Pre-filed evidence, Appendix H, pg. 23)

Mr. Cicchetti characterized Newfoundland Power as a transmission and distribution utility, operating in a low risk market under supportive regulation. (M. Cicchetti, Pre-filed evidence, pg. 15) He characterized the regulatory regime in which Newfoundland Power operates as "exceptional". (Transcript, Oct. 22, 2009, pg. 228/1)

The evidence shows that Newfoundland Power operates in a low risk environment. It is accepted that the regulatory regime is supportive with a range of mechanisms in place to mitigate risk, including the Rate Stabilization Account, the Municipal Tax Adjustment, the Weather Normalization Reserve Account the Energy Supply Cost Variance Reserve Account, the Demand Management Incentive Account, and the new Pension Expense Variance Deferral Account. Mr. Todd commented in his evidence that, while these types of regulatory mechanisms are not unique to this jurisdiction, they seem to be used more extensively in this province. (Transcript, Oct. 27, 2009, pgs. 114/24; 25; 115/1) In addition, the automatic adjustment formula and the capital budget approval process reduce regulatory uncertainty.

Newfoundland Power's operating conditions combined with the supportive regulatory environment contribute to earnings stability and, given Newfoundland Power's favourable common equity component compared to its Canadian counterparts, it can be considered to have low financial risk. There was no evidence presented of an increase in the level of financial risk for Newfoundland Power relative to its Canadian peers. For the last number of years Newfoundland Power has generally earned within the approved range of return on rate base. Under questioning from Board hearing counsel with respect to the returns produced as a result of the operation of the automatic adjustment formula since its inception in 2000, Ms. Perry confirmed that the returns have allowed Newfoundland Power to maintain its creditworthiness, even though the actual cost of equity may have declined in some years. (Transcript, Oct. 19, 2009, pgs. 113-115) It was also acknowledged that Newfoundland Power can apply to the Board for an adjustment to its cost of capital if its revenues are forecast to be lower than required to maintain its return at a reasonable level to ensure continued creditworthiness. Indeed this is the circumstance in this Application as Newfoundland Power has forecast its return for 2010 to be below that required to maintain its financial integrity and has applied to the Board for an increase in its allowed return on rate base for 2010 as a result.

While the evidence supports categorizing Newfoundland Power as low risk there was little evidence of new circumstances supporting a change from the previous finding that Newfoundland Power is an average risk Canadian utility. The evidence shows that Newfoundland Power's business risk profile has not changed. Supportive regulation continues to be demonstrated with the establishment of another deferral account to capture increased variability in pension expense. Newfoundland Power's deemed equity component continues to be set at 45%, one of the highest for a Canadian utility.

The Board acknowledges that financial market conditions have been turbulent over recent months and that there are differing views as to how the recovery will progress. While there is some evidence that Newfoundland Power may be considered low risk even vis a vis its Canadian counterparts, in the absence of better evidence and given the current financial circumstances, the Board continues to believe that it is appropriate to consider Newfoundland Power's overall risk to be average in relation to Canadian utilities.

The Board finds that Newfoundland Power continues to be an average risk Canadian utility.

ii. Methodologies for Estimating Return on Equity for 2010

Newfoundland Power proposes that the Board allow a return on regulated common equity of 11% for ratemaking purposes. This compares to the return on equity of 8.95% used for establishing 2008 test year rates in Order No. P. U. 32(2007) based on the settlement of the parties, and also for establishing 2009 rates based on the operation of the automatic adjustment formula.

The three expert witnesses that provided cost of capital evidence in this Application employed a variety of estimation methodologies. While all relied on the equity risk premium test, both Mr. Cicchetti and Ms. McShane used the discounted cash flow test, and Ms. McShane also used the comparable earnings test. The following table summarizes the expert recommendations.

2010 Return on Equity Summary of Expert Recommendations			
Expert Witness	**McShane**	**Booth**	**Cicchetti**
Recommended Return on Equity	**11.0%**	**7.75%**	**9.6%**
Test Results:			
1. Equity Risk Premium			
Risk-Free Rate	4.25%	4.5%	4.625%
Market Risk Premium	6.75%	5.0%	6.4%
Beta	0.65–0.70	0.50	0.66–0.69
Utility Equity Risk Premium	-	2.5%	4.35%
Risk-Adjusted Equity Market	4.5%	-	-
DCF-Based	5.35%	-	-
Historic Utility	6.25%	-	-
Indicated Cost of Equity	8.75%-10.5%	7.0%	9.0%
Allowance for Financing Flexibility	0.50%	0.50%	-
Other Adjustments	-	0.25%	-
Indicated Fair Return on Equity	**10.25%**	**7.75%**	**9.0%**
2. Discounted Cash Flow			
Indicated Cost of Equity	10.5%-11.0%	-	9.6%
Financing Flexibility	0.50%	-	-
Indicated Fair Return on Equity	**11.0%-11.5%**	-	**9.6%**
3. Comparable Earnings	**11.50%-11.75%**	-	-
Equity Ratio	**45%**	**45%**	**45%**

(Newfoundland Power, Written Submission, Appendix A, pg. 1 of 2)

In written submission (pgs. C-10 to C-12) Newfoundland Power notes that estimating the fair return on equity is somewhat subjective and sets out the weaknesses of each of the methodologies used by the experts for determining a fair return on equity, including:

- The capital asset pricing model, a type of equity risk premium test, uses realized past returns to estimate a future market risk premium and it is difficult to estimate relative risk or beta.
- The discounted cash flow test requires an estimate of expected future cash flows which can be difficult if a utility is not publicly traded.
- The comparable earnings test requires the determination of comparable investments and the time period over which returns are to be measured as well as a determination of the adjustments which may be required to ensure comparability.

Ms. McShane comments on these three tests:

"Each of the tests is based on different premises and brings a different perspective to the fair return on equity. None of the individual tests is, on its own, a sufficient means of estimating the fair return; each of the tests has its own strengths and weaknesses. Individually, each of the tests can be characterized as a relatively inexact instrument; no single test can pinpoint the fair return. Moreover, different tests may be more or less reliable depending on prevailing economic and capital market conditions." (K. McShane, Pre-filed evidence, pg. 40/993-999)

Newfoundland Power argues that Ms. McShane's evidence should be preferred given the depth of economic analysis, methodological scope, and breadth of comparative data underpinning her analysis. (Newfoundland Power, Written Submission, pg. C-32)

Dr. Booth stated that he believed that the most important thing is to use the right estimation technique and not necessarily a variety of techniques as suggested by Ms. McShane. (Transcript, Oct. 21, 2009, pgs 148/19-29; 149/1-16). Dr. Booth stated that the capital asset pricing model is overwhelmingly the most important model used by a company in estimating the cost of equity capital. Dr. Booth explained his preference for the capital asset pricing model in his pre-filed testimony (pg. 32):

"Why the CAPM is so widely used is because it is intuitively correct. It captures two of the major "laws" of finance: the time value of money and the risk value of money. I will discuss the third law of finance the tax value of money later, but the time value of money is captured in the long Canada bond yield as the risk free rate. The risk value of money is captured in the market risk premium, which anchors an individual firm's risk. As long as the market risk premium is approximately correct the estimate will be in the right "ball-park." Where the CAPM gets controversial is in the beta coefficient; since risk is constantly changing so too are beta coefficients. This sometimes casts doubt on the model as people find it difficult to understand why betas change. Further it also makes testing the model incredibly difficult. However, the CAPM measures the right thing: which is how much does a security add to the risk of a diversified portfolio, which is the central idea of modern portfolio theory."

The Consumer Advocate submits that neither the comparable earnings test nor the discounted cash flow test have been afforded weight by Canadian regulators for years. (Transcript, Nov. 6, 2009, pgs. 57/21-23; 91/20-21) Both Dr. Booth and Mr. Cicchetti suggested the comparable earnings test is not an acceptable measure of estimating fair rates of return. (Transcript, Oct. 22, 2009, pgs. 28/3-9; 149/13-17) Dr. Booth stated that, until the early 1990s, half of his testimony was based on the discounted cash flow analysis but using this test became problematic in Canada at that time and now he uses it largely as a reasonable risk check. He also notes that it is no longer the main methodology used by chief financial officers in the United States. (Transcript, Oct. 21, 2009, pgs. 193/24-25; 194/1-5; 149/22-25)

One of the most controversial issues raised in relation to the determination of an appropriate return on equity for Newfoundland Power was the use of U.S. comparables by both Ms. McShane and Mr. Cicchetti in both the discounted cash flow and comparable earnings tests and in some of the equity risk premium analyses. In relation to using U.S. data in the comparable earnings test Ms. McShane stated:

> *"Satisfying the comparable return standard requires consideration of returns available to comparable utilities in the U.S., given the similarity of operating and regulatory environments, the integration of the two capital markets, the small number of Canadian utilities with equity market data and the obvious circularity of comparisons limited to utilities that are all subject to similar ROE automatic adjustment mechanisms."* (K. McShane, Pre-filed evidence, pg. 2/47-52)

Mr. Cicchetti stated the U.S. comparables are similar and will provide the best estimate of the cost of equity. According to Mr. Cicchetti U.S. regulated utilities are proxies for Newfoundland Power since they have similar operating and regulatory environments, there is significant integration in the capital markets of the two countries, and rating agencies consider companies in these countries to be peers. (M. Cicchetti, Pre-filed evidence, pg. 19) In relation to the discounted cash flow test both Ms. McShane and Mr. Cicchetti acknowledged that there are no perfect comparables but that the selected U.S. companies represent reasonable proxies for Canadian utilities. Mr. Cicchetti says that each company will have its differences and you need to look at the entire picture. (Transcript, Oct 22. 2009, pg. 195/15-17) Ms. McShane stated:

> *"So no, it's not completely comparable to a Newfoundland Power. No individual utility will be. I mean, every company is unique. Newfoundland Power is unique. But if you look at the, you know, overall sample of companies and the average of the various risk measures, I mean, this is a sample that you could view as in—of comparable risk to a Newfoundland Power."*
> (Transcript, Oct. 21, 2009, pgs. 19/25; 20/1-8)

The Consumer Advocate spent a great deal of time in the hearing as well as in written submission challenging the U.S. comparables used by Ms. McShane and Mr. Cicchetti. In his written submission (pg. 49) the Consumer Advocate summarized the testimony of Dr. Booth on this issue, highlighting the important differences between the two countries, including the rate of inflation, the level of risk, regulation, event risk and macro-economic factors. Dr. Booth comments on the use of U.S. comparables:

> *"Just because US firms use the same technology as Canadian ones does* ***not*** *mean they are equivalent in risk as should by now be patently obvious. I would urge the Board to disregard recommendations based mainly on US evidence, and place primary weight on Canadian market experiences and policies that have worked rather than US policies that have not."*
> (Dr. L. Booth, Pre-filed evidence, pg. 4/15-19)

Dr. Booth said that it violates everything he has taught in international finance to accept evidence from the U.S. into Canada without making adjustments and stated specifically:

> *"The first basic rule in international finance is you cannot take interest rates or fair rate of returns for one market and of one country and apply them to another without making serious adjustments to those."*
> (Transcript, Oct. 21, 2009, pgs. 173/14-19; 174/1-5)

The Consumer Advocate argued that both Mr. Cicchetti's and Ms. McShane's evidence show why U.S. returns cannot be applied to Newfoundland Power without making adjustments. He states that Ms. McShane's comparables analysis is *"…the major factor in explaining why her*

ROE recommendation for NP is a gross overstatement." (Consumer Advocate, Written Submission, pgs. 29; 38)

The Board believes that, in this type of analysis, it is not enough that the chosen comparables are the best available. If this data is to be relied on it must be shown to be a reasonable proxy or that reasonable adjustments can be made to account for differences. The evidence showed significant differences in virtually all of the comparables including significant levels of non-regulated and non-utility business as well as riskier generation projects, earnings volatility, more competition and less regulatory support. While it was argued that, on balance, the U.S. comparables are reasonable proxies the Board notes the overwhelming evidence of a lack of balance as it was clear that on almost every measure Newfoundland Power would have to be considered less risky than the U.S. comparables. The Board heard evidence that the rating agencies consider U.S. companies to be peers for Newfoundland Power but the Board does not conclude from this that they are the same. Moody's comments acknowledge the differences in operations in the U.S. and Canada:

> *"NPI's Baaa1 issuer rating reflects the fact that the company's operations are exclusively based in Canada, a jurisdiction where regulatory and business environments in general are relatively more supportive than those of other international jurisdictions such as the United States, in Moody's view."* (Application, 1st Revision, Exhibit 4 - Moody's Credit Opinion, August 3, 2009)

The Board notes that the rating agencies make their own "adjustments" in these comparisons by considering the lower credit metrics to be "offsetting" factors. The Board notes that neither Ms. McShane nor Mr. Cicchetti made any adjustments to reflect differences between the U.S. and Canadian market. Ms. McShane testified that she did not see it as necessary to make any adjustments to reflect differences. (Transcript, Oct. 20, 2009, pgs. 37/25; 38/1-2) Mr. Cicchetti also does not recommend adjustments to the numbers that flow out of his discounted cash flow test using U.S. comparables although he does acknowledge that concerns in relation to the level of non-regulated business operations in some of the comparables could be taken into consideration in reference to the range of the return that was calculated. (Transcript, Oct. 22, 2009, pgs. 157/13-17; 159/9-19) Based on the evidence the Board is not satisfied that the U.S. comparables are reasonable proxies for determining an appropriate return on equity without appropriate adjustments.

While the Board acknowledges the difficulties with each of the estimation methodologies, Canadian regulators have been fairly consistent for the last ten years in using an equity risk premium model for rate setting purposes. This approach seems to have satisfied utility investor expectations as there is no evidence there has been a flight of capital in the industry. Dr. Booth was quite categorical in his opinion: *"I know of no regulatory decision in Canada over the past 20 years that has adversely affected a regulated utility."* (Transcript, Oct. 21, 2009, pg. 175/24-25) This is, in the Board's view, evidence of the protective nature of the Canadian regulatory environment and of the soundness of and even an empirical validation of the equity risk premium model. The equity risk premium test is, for the most part, based on Canadian data and, while it is necessary to forecast for the future in assessing both the market risk premium and the beta, this is the sort of exercise that the Board is accustomed to in the context of prospective regulation.

The Board principally relied on the equity risk premium test in determining a fair return for Newfoundland Power in the last two full cost of capital reviews. In addition the settlement agreement of the parties in the last general rate application proposed a return on regulated common equity for rate setting based on the equity risk premium methodology. Consistent with past practice of this Board and other Canadian regulators, and considering the evidence respecting the issues in relation to the comparable earnings and the discounted cash flow tests, especially in relation to the reliance on U.S. data without making adjustments, the Board will continue to rely principally on the equity risk premium test to estimate a fair return on regulated common equity for Newfoundland Power for ratemaking purposes.

iii. Capital Asset Pricing Model Analysis

An analysis of the appropriate return on equity for Newfoundland Power using the capital asset pricing model (CAPM) form of the equity risk premium methodology requires the determination of the:

- risk-free rate to reflect the time value of money;
- market risk premium to reflect the risk undertaken by an equity investor generally; and
- beta adjustment to the market risk premium to reflect the individual firm's risk.

a) Risk-free rate

The risk-free rates recommended by all three expert witnesses were similar with Ms. McShane recommending 4.25%, Dr. Booth recommending 4.5%, and Mr. Cicchetti recommending 4.625%. Dr. Booth commented that the risk-free rate is not an area of concern, saying that the risk-free rate is in the order of 4.25-4.5% with Ms. McShane's estimate of 4.25% having been determined earlier in the year (Transcript, Oct. 21, 2009, pg. 152/4-10). The Board is satisfied that 4.5% is a reasonable estimate of the risk-free rate.

The Board will utilize 4.50% as the forecast of the risk-free rate to be applied in the capital asset pricing model for the 2010 test year.

b) Market Risk Premium

Ms. McShane estimates the market risk premium to be 6.75% using the capital asset pricing model. She calculates the 1947-2008 historic arithmetic average risk premium in Canada to be 4.4% to 4.6% and in the U.S. to be 5.6% to 6.2 %. She concludes however that, because the Canadian historic bond returns are materially higher than the expected returns, the historic measured risk premium in Canada understates a reasonable estimate of the forward looking equity market risk premium. She determines her recommended market risk premium of 6.75% by subtracting the estimated long-term Canada bond yields from the long run Canadian and U.S. equity market return of 11-12%. Ms. McShane concludes that, after analysis of the trends in Price/Earnings ratios, equity market returns and bond returns, the historic equity market returns in both Canada and the U.S. provide a reasonable estimate of the forward looking equity market return.

Dr. Booth agrees with Ms. McShane's estimate of the historical earned risk premium between equities and bonds in the U.S. and Canada but does not agree with her as to the difference going forward. (Transcript, Oct. 21, 2009, pg. 154/9-14) Dr. Booth challenges Ms. McShane's assessment on the basis that there is a mismatch in the data used since she subtracts a forecast risk-free rate from the average historic long run equity returns. Dr. Booth notes that the average historic long run equity returns were in the context of inflation running at three to four percent which, on a forward looking basis, overestimates the market risk premium given the commitment by Bank of Canada to hold inflation to one to three percent. He stated:

> *"So I think her estimate of the market risk premium at 6.75 percent is high. It's high relative to what the typical person in the US and Canada, professors of finance, think that it is and I mean, it's high because there's a mismatch in the underlying inflation assumptions that reflected in historic experience versus the going-forward experience."*
> (Transcript, Oct. 21, 2009, pgs. 158/24-25; 159/1-7)

Dr. Booth estimates a market risk premium of 5%. In referencing an April 2009 survey of 884 finance professors from around the world on the market risk premium for 2008, he states:

> *"The critical number is the median, the middle guy. The middle guy in the US thinks the market risk premium is six percent. The middle guy in Canada thinks that it's 5.1 percent. The middle guy in Europe thinks it's five percent. The middle guy in the UK thinks it's five percent. I think it's five percent. So one important fact is that my estimate of the market risk premium is not a high ball, it's not a low ball. It's basically right in the middle of the pack."*
> (Transcript, Oct. 21, 2009, pgs. 155/21-25; 156/1-6)

The Board notes that the survey referred to by Dr. Booth captured market risk premiums used in 2008 but did not seek opinions as to the appropriate market risk premium moving forward into 2010. The Board also notes that, while the median was 5%, the average was 5.4%. Further, while Dr. Booth recommends 5%, he acknowledges that his recommendation may be at the low end of the range. (Transcript, Oct. 21, 2009, pg. 163/17-21) The Board finds that, in light of recent market conditions, it is reasonable to assume that the required market risk premium for 2010 will not be on the low end of the range. The Board does not believe that it is appropriate to adopt a market risk premium which is at the lower end of the historical range given that the risk-free rate has in recent years dropped well below historical averages. The Board believes that Ms. McShane's recommendation of 6.75% is high based on her use of unadjusted U.S. data, the fact that she discounted the Canadian data in reference to historic premiums, and that there is mismatching of the historical experience versus the going forward experience. Considering the circumstances the Board accepts that 6% is a reasonable market risk premium.

c) Beta

A beta is a risk measure of the sensitivity to the market and, as stated by Dr. Booth, is often the most controversial part of the capital asset pricing model. (Dr. L. Booth, Pre-filed evidence, pg. 32)

Ms. McShane states that the market risk premium needs to be adjusted to recognize the relative lower risk of utilities. She calculates the historic raw beta of the TSX Utilities Index to be 0.5, with considerable variability during certain periods. She then calculates the ratio of the standard deviation of the utility index to mean and median standard deviations of the 10 major sector indices and determines a relative risk adjustment for a Canadian utility of 0.55-0.85, which she reduces to a central tendency of 0.65-0.70. Ms. McShane also does an analysis based on the long run returns and estimates a beta of 0.70. Ms. McShane also looks to the approach of several investment firms to determine an adjusted beta of 0.67. Ms. McShane recommends a beta of 0.65-0.70. (K. McShane, Pre-filed evidence, pgs. 50-55)

Dr. Booth calculates the long run average beta for Canadian utility stocks to be 0.40-0.60 but reports that the betas have not been in the normal range for the last ten years. (Dr. L. Booth, Pre-filed evidence, pg. 41) He believes that this range is appropriate given that utility stocks are defensive stocks:

> *"Fortis barely never dropped more than 20 percent when the market was off 40 percent, and we could look throughout all of the utilities and we can see what comes through very, very clearly is they're simply not as volatile as the market as a whole. They just don't drop with the market. They don't increase with the market, which is what we call defensive stocks or low risk stocks. So there's absolutely no question that the price behavior of utility holding companies in Canada has demonstrated, yet again, that they're low risk. They're low beta stocks. They're defensive stock. So I have no problem looking at that. There are always problems with individual beta estimates because of unique things that are happening to firms, but overall what comes through clear as a bell is the low risk nature of utility stocks, the overall market risk premium, five percent, possibly six percent"*
>
> (Transcript, Oct. 21, 2009, pg. 162/5-25)

Dr. Booth concluded that, based on his judgment as well as the tendency of betas to revert to the long run average, it was appropriate to continue to use the normal beta range of 0.45-0.55 and assigned a beta of 0.50 to Newfoundland Power as a typical regulated utility.

The Board acknowledges that determining an appropriate beta is the most difficult aspect of the capital asset pricing model. While it is well accepted that the beta will change over time the data used by the experts is largely based on historical averages. The Board notes that the actual beta has not been within the historical average since 1998. (Transcript, Oct. 22, 2009, pg. 19/17-25) While the starting point is the historical average beta (which Ms. McShane refers to as a raw beta) the additional analysis performed by Ms. McShane provides other perspectives suggesting the historic average should be adjusted. The Board agrees with Dr. Booth that utilities are a low beta stock. However, given that betas have not recently been within historical norms and in light of the financial market conditions, the Board does not expect that the beta will be within historical averages for 2010. In this circumstance the Board relies on the evidence of Ms. McShane that there should be an upward adjustment. The Board believes that, based on the evidence, a reasonable beta for Newfoundland Power is 0.60.

d) Allowance for Financing Flexibility

The Board notes that all three experts include an allowance for financing flexibility in the equity risk premium analysis. Dr. Booth and Ms. McShane recommend 0.50% and Mr. Cicchetti recommends 0.20-0.25%. Ms McShane states that this allowance is intended to cover floatation costs, a margin for unanticipated market conditions, and recognition of the fairness principle. The Board did not include a separate allowance for financing flexibility in Order Nos. P.U. 19(2003) and P.U. 32(2007). The Board did include an allowance for financing flexibility of 0.50% in the allowed return on equity for ratemaking purposes accepted in Order No. P.U. 16(1998-1999). The evidence of all three cost of capital experts in this proceeding suggests that it is appropriate to include an allowance for financing flexibility and these recommendations were not challenged. The Board is satisfied, based on the evidence, that it is appropriate to add an allowance for financing flexibility of 0.50% to the allowed equity return for rate setting.

e) CAPM Calculation

Using the individual CAPM parameters accepted by the Board an appropriate return on regulated common equity for Newfoundland Power for ratemaking purposes can be calculated as follows:

CAPM Calculation		
Long term Canada Bond Yield		4.5%
Market Risk Premium	6.0%	
Beta	0.6	
Adjusted Market Risk Premium		3.6%
Allowance for financing flexibility		0.5%
Total allowed risk premium for Newfoundland Power		4.1%
Total		**8.6%**

iv. Contextual Considerations

While the Board relies primarily on the CAPM approach it acknowledges that this model has limitations and looks to the other evidence in the Application to determine if it is appropriate to make further adjustments. While the Board was not guided by the results of other methodological approaches in its determination of an allowed return on equity as discussed above, these results provide the Board another check on reasonableness. The Board notes the range of returns determined using the other approaches taken by the experts is 9.0% to 11.75%.

The Board also notes that the evidence provided by Dr. Booth in relation to other measures which can provide a check on reasonableness suggests that a return on equity in the 8.5-9.0% range is reasonable. Specifically, Dr. Booth states:

> ***"…For the whole period, 1988-2008 the average Statistics Canada ROE for Corporate Canada was 9.1% and the median 9.88%.*** *What this means is that the average firm in Canada does not earn the level of ROE requested by NP of 11.0%; yet as the chart shows there is considerable year to year volatility in the overall earned ROE that is not faced by shareholders in NP."* (Dr. L. Booth, Pre-filed evidence, pgs 29/14-16; 30/1-2)

Dr. Booth also noted the Mercer report on Newfoundland Power's pension plan:

> *"…that Mercer is assuming a long run equity market return of 8.50% compared to 4.40% for fixed income which presumably included GOC debt plus some corporate and provincial debt. This implies a market risk premium of 4.10%. In my judgment this under estimates the market risk premium since Mercer's long run equity return is probably closer to the geometric then the arithmetic return, and the fixed income probably includes some non-GOC debt. However, it indicates that the finance (actuarial) professionals hired by NP have views quite close to my own."* (Dr. L. Booth, Pre-filed evidence, pg. 78/2-7)

Table 1[1]
Long Term Expected Return

Asset Class	**Long Term Expected Return**
Canadian Equities	8.50%
US Equities	8.50%
Non-North American Equities	8.50%
Fixed Income	4.40%
Cash and short term	1.90%

[1]Dr. Laurence Booth, Pre-filed evidence, pg. 78

The Board acknowledges that looking to other return on equities allowed in Canada may have an aspect of circularity. As such the Board is not guided by these determinations. However the Board believes that the well reasoned recent decisions of other regulators in Canada can provide another check on the reasonableness of the determinations of this Board. The Board notes the November 12, 2009 decision of the Alberta Utilities Commission[1] which allowed a generic return on equity of 9.0% and the March 19, 2009 decision of the National Energy Board[2] reflecting a return on equity of 9.7% at a 40% common equity component.

v. <u>Credit Metrics</u>

The fair return principle requires that the Board ensure that the return on equity used for rate setting is sufficient to assure Newfoundland Power's financial integrity. It is accepted that the credit metrics of a utility provide useful information when making this assessment.

Newfoundland Power states that its current credit ratings from DBRS and Moody's are both investment grade with a stable outlook. Newfoundland Power notes that, primarily due to changes in rating methodology, Moody's upgraded Newfoundland Power's first mortgage bonds to A2 while maintaining a Baa1 issuer credit rating for Newfoundland Power. Newfoundland

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[1] Information # 8
[2] CA-NP-201

Power states that Moody's commented that it believed that 2008 improvements in the credit metrics are likely to be sustained and that while Newfoundland Power's credit metrics remain somewhat weaker than those of other Baa1-rated low risk utilities this is balanced by a supportive regulatory environment. (Newfoundland Power, Written Submission, pg. C-32) Ms. Perry testified in relation to credit ratings generally:

> *"I think we're always under the microscope with respect to rating agencies. Leading into the 2008 rate case, we were starting behind the eight ball with respect to financial metrics alone and we did make improvements during that particular proceeding. I still feel like we are under the microscope with respect to our financial metrics. I do not believe that we are in that much of a better place with respect to having to maintain the financial strength of Newfoundland Power."*
> (Transcipt, Oct. 15, 2009, pgs. 163/17-25; 164/1-2)

Newfoundland Power submits that it would not be able to issue First Mortgage Bonds with the pre-tax interest coverage of 2.0 times indicated in 2010 under existing conditions. (Newfoundland Power, Written Submission, pg. C-34) Article 6.2 of Newfoundland Power's First Mortgage Bond Trust Deed states that no bond issue will be certified and delivered unless the interest coverage is at least two times after the issue. (CA-NP-26) Ms. Perry explained in testimony that if Newfoundland Power were to issue bonds in 2012, as currently planned, the interest coverage calculation would be based on 2011 earnings before taxes plus total interest including the 2012 issue (Transcript, Oct. 19, 2009, pg. 13/11-21).

In his written submission (pg. 51) the Consumer Advocate raises a note of caution in relation to credit metrics and references PUB-CA-6 where Dr. Booth states that he is not aware of any financial theory or practice that determines the allowed return off the times interest earned that was found to be fair. The Consumer Advocate submits that we have to look at whether or not the firm can raise capital and provide service. The Consumer Advocate notes that the evidence shows that Newfoundland Power's next bond issue is not expected until June of 2012. The Consumer Advocate suggests that, based on the evidence, Ms. Perry may have been mistaken when she said that Moody's would not accept Newfoundland Power having lower financial metrics within its peer group. (Consumer Advocate, Written Submission, pg. 55)

The Board acknowledges that Newfoundland Power's credit metrics are weaker than its peers, which include U.S. utilities. DBRS notes at pg. 5 of its Rating Report for Newfoundland Power dated May 5, 2008 that, while Newfoundland Power's credit metrics appear weaker than those of its peers it is offset by more stable credit metrics and business risk profile. DBRS reports that Newfoundland Power had earnings before interest and taxes (EBIT) interest coverage of 2.00x for the 12-month period ending March 31, 2008 with coverages of 2.16x to 2.47x in the five prior periods. Cash flow/adjusted debt was 11.1% with range of 11.6% to 14.9% in the prior periods.

Moody's stated in its Global Credit Research Credit Opinion dated March 6, 2009:

> *"Moody's considers a downward revision in NPI's rating to be unlikely in the near term. However, NPI's long-term ratings could be negatively impacted to the extent that Moody's perceived a reduction it the level of regulatory support combined with weaker liquidity and a*

sustained deterioration in NPI's credit metrics such as CFO pre-WC to interest coverage of less than 2.5x, CFO pre-WC to debt in the low teens and a debt to capitalization in excess of 55%."

The Board notes that Moody's changed its established threshold for a downgrade of Newfoundland Power in 2009, suggesting that in the current circumstances Moody's will accept lower credit metrics before considering a downgrade of Newfoundland Power. Moody's does not report on EBIT but the differences in the other two measures are:

MOODY'S DOWNGRADE THRESHOLD	2007	2009
CFO Pre-W/C to interest coverage	3.0x	2.5x
CFO Pre-W/C to debt	15%	low teens

(Source: Information # 4; Application, 1st Revision, Exhibit 4)

As the Board stated in Order No. P.U. 19 (2003) the Board does not regulate interest coverage but rather looks to the credit metrics as an indicator of the extent to which a return will assure financial integrity as required by the fair return standard. In Order No. P.U. 16 (1998-99) the Board found that a reasonable range of interest coverage is between 2.4x and 2.7x given the interest rates and the level of Newfoundland Power's risk at the time, noting that the range of acceptable interest coverage may shift.

In Order No. P. U. 32(2007) the Board approved the cost of capital proposed by the parties in the settlement agreement. The Board determined that the proposals would provide Newfoundland Power with the opportunity to earn a just and reasonable return on rate base that will maintain creditworthiness. The Board concluded that the order of the Board would result in forecast credit metrics that were marginally below the bottom of the range recommended by Moody's with Pre-tax Interest Coverage of 2.5x; Cash Flow Interest Coverage of 2.9x; and Cash Flow Debt Coverage of 14.9% (pgs. 23-24). The Board notes that it did not hear evidence that this resulted in a downgrading by credit rating agencies. In fact evidence was led that Newfoundland Power was upgraded with a clear positive outlook.

The evidence shows that a return on equity of 9%, with allowed common equity of 45%, will yield credit metrics which are within the parameters set out by the Board and Moody's. As set out in Exhibit 5, 1st Revision a 9% return on equity will result in Pre-tax Interest Coverage of 2.41x-2.42x, Cash Flow Interest Coverage of 3.25x-3.38x and Cash Flow Debt Coverage of 17.1%-18.2%. Absent a dramatic change in circumstances there is no evidence to suggest that Newfoundland Power is in danger of being downgraded. The Board understands that it is appropriate for Newfoundland Power's Chief Financial Officer to be concerned with ensuring an appropriate return on equity for shareholders and a healthy credit rating to ensure access to financing but the Board is satisfied based on the evidence that a return on regulated common equity of 9.0% is adequate to assure the financial integrity of the company.

vi. Return on Equity

The Board is satisfied that 9.0% is an appropriate return on regulated common equity for Newfoundland Power, given a common equity component of 45%, and considering the CAPM calculation of 8.6%, the financial market conditions, and Newfoundland Power's credit metrics.

The Board notes that this finding is generally consistent with the experts' recommendations flowing from the other tests, recent Canadian return decisions, and the other calculations of returns, historical and expected, presented in evidence. The return on regulated common equity for Newfoundland Power for 2010 to be used for ratemaking purposes is set out below:

Newfoundland Power 2010 Test Year Allowed return on equity for ratemaking purposes	
Long term Canada Bond Yield	4.5%
Newfoundland Power Risk Premium	4.0%
Allowance for financing flexibility	0.5%
Total	**9.0%**

The Board is satisfied that for the 2010 test year a return on regulated common equity of 9.0%, with a common equity component of 45%, will provide Newfoundland Power the opportunity to earn a just and reasonable return on rate base that is consistent with the fair return principle and the provision of least cost reliable power.

3. Automatic Adjustment Formula

In Order Nos. P.U. 16(1998-99) and P.U. 36(1998-99) the Board established an automatic adjustment formula for fixing and determining the rate of return on rate base for Newfoundland Power for 2000, 2001 and 2002. In Order No. P.U. 19(2003) the formula was again ordered to be used in setting rates for 2005, 2006 and 2007. In Order No. P.U. 32(2007) the Board approved the settlement of the parties which proposed that the formula be used in setting rates for not more than three years following the 2008 test year (i.e. 2009, 2010 and 2011). The Board specifically ordered that Newfoundland Power file a general rate application by June 30, 2010 with a 2011 test year. Newfoundland Power instead filed this general rate application in 2009 with a 2010 test year seeking a cost of capital review a full year earlier than ordered by the Board. Newfoundland Power also proposes in this Application that the use of the automatic adjustment formula be discontinued.

In Order No. P.U. 16(1998-99) the Board acknowledged the possibility that there may be circumstances which would render the use of an automatic adjustment formula inappropriate for Newfoundland Power. Specifically the Board said at pg. 104:

> *"The Board will call a hearing if circumstances change, so as to render the use of an automatic adjustment formula to be inappropriate. Without attempting to enumerate all of the circumstances which might result in a hearing being convened, the following are intended as examples:*
>
> *(a) deterioration in the financial strength of the Company, resulting in an inappropriately low interest coverage;*
> *(b) changes in financial market conditions which would suggest that the formula is not accurately reflecting the appropriate return on equity; and*
> *(c) fundamental changes in the business risk of the Company."*

Newfoundland Power proposes that the Board discontinue the use of the automatic adjustment formula given that material changes in financial market conditions have affected the fairness of the returns on equity yielded by the formula. Ms. McShane set out a detailed analysis of the operation of automatic adjustment formula in her pre-filed evidence, which is summarized as follows (pgs. 8-9):

- the extent to which the formula has moved away from a fair and reasonable level can be seen in a comparison of the allowed returns on equity of Canadian and US utilities - between 1998 and 2008 the allowed returns on equity of Canadian utilities were on average 1.4 percentage points lower than those of U.S. peers, whereas the average yield on government bonds in the two countries over the same period differed by less than .1 percent.
- an analysis of the returns on equity to the utility/Treasury bond yield spreads in the U.S. shows that the returns are positively related to the utility/government bond yield, whereas during 2008 the flight to quality pushed the actual yields and forecast yields on long-term government bonds lower while other indicators were signaling a higher cost of capital, resulting in a material narrowing of the spread between the cost of new utility long-term debt and the automatic adjustment formula return on equity.
- the increased volatility in the equity markets is an indicator of rising investor risk aversion and a rising market risk premium, with the Montreal Exchange Implied Volatility Index signaling an increase in the equity risk premium since mid-2008.
- a regression analysis of the returns on equity compared to long term treasury bond yields in the U.S. over the period 1994 to 2008 showed that the returns changed by approximately 55 basis points for every one percent change in long-term government bonds, suggesting that the cost of equity is significantly less sensitive to changes in long term government bond yields than the 80 basis points assumed in the formula.

In an exchange between Board Hearing Counsel and Newfoundland Power's Vice President of Finance and Chief Financial Officer the following comments were provided:

(Mr. Simmons)
Q. Okay. So if I could summarize what you've told me then about the automatic—the position of the company on the Automatic Adjustment Formula, the problem with the formula has not so much been its use historically, but the problem is the effect that its use will have under current market conditions. That's the first point.

(Ms. Perry)
A. That is correct, yeah.

Q. And the second point is that the company is not philosophically imposed(sic) in any way to the use of an Automatic Adjustment Formula in the future?

A. Absolutely.

Q. And the question is, is the current formula the appropriate one, and your view is that it's too early to be able to tell what changes would have to be made to improve the formula?

A. That's correct.

(Mr. Ludlow)
A. That's correct.
(Transcript, Oct. 19, 2009, pgs. 120/23-25; 121/1-23)

The Consumer Advocate supports the continued use of the automatic adjustment formula, and states in his written submission (pg. 62):

"Having regard to the fact that NP is low risk, having transferred nearly every conceivable risk to its customers, there is no basis to say that the AAF needs to be abandoned when it would provide an 8.4% ROE for ratemaking purposes, some 65 basis points higher than Dr. Booth's fair return recommendation."

Dr. Booth concluded that the formula has functioned appropriately since its introduction, stating:

"…So I think that the direction of the trend, as a result of the ROE Adjustment Formula, has been absolutely correct over the last fifteen years. That does not mean to say that its correct in a mechanical way on an annual basis, so I've never said that it's absolutely correct. No mechanical forecast can be absolutely correct, it's going to over and under predict slightly over the business cycle and that's why I have no objection to supporting the continuation of the ROE Adjustment Formula, even though its 40 or 50 basis points higher than what I think is a fair ROE. So I think overall the direction of the ROE formula has been absolutely correct, but it doesn't mean to say that it's absolutely correct on a year-to-year basis, given changes in the capital markets."
(Transcript, Oct. 21, 2009, pgs. 168/20-25; 169/1-17)

Dr. Booth believes that financial markets are now returning to normal with liquidity spreads coming down and the economies of the U.S. and Canada recovering. While he believes that credit spreads are still higher than expected he does not believe this justifies a change. (Transcript, Oct. 22, 2009, pgs. 57; 58) The Consumer Advocate notes that, while the credit spread in the spring of 2009 on Newfoundland Power's 2009 first mortgage bond was 2.75%, this had dropped to 1.87% by the fall of the year. The Consumer Advocate points to comparable credit spreads for bonds issued in 2002 of 1.85%, 2005 of 1.06%, and 2007 of 1.40%. (Consumer Advocate, Written Submission, pg. 60)

Mr. Cicchetti states in his report (pg. 4):

"Regarding the automatic adjustment formula, I believe recent changes in financial market conditions cause the formula to produce a return below the bottom of a reasonable range of the cost of equity for the Company. If the formula were to be implemented for Newfoundland Power as of August 14, 2009, it would produce an allowed return of 8.5 percent, or 50 basis points below the bottom of the range I have determined as a reasonable range of the cost of equity for the Company."

Mr. Cicchetti cites financial market conditions over the past year which have resulted in particularly low yields on Canadian long-term government bonds, relatively high yields on corporate bonds, and declines in equity values.

Newfoundland Power bears the burden of showing that it is appropriate to discontinue the use of the automatic adjustment formula, a well-established regulatory tool that was expected to be used to set rates for Newfoundland Power in 2010. The Board is not persuaded by the evidence of Ms. McShane as to the historical underperformance of the formula, especially given the evidence of both Ms. Perry and Mr. Ludlow that the automatic adjustment formula established appropriate rates of return on rate base for almost a decade until the extraordinary financial market conditions which developed late in 2008. (Transcript, Oct. 19, 2009, pgs. 114/21-25; 115/1-25; 116/1-8)

In support of discontinuing the use of the formula Newfoundland Power notes that the formula is being reviewed in other provinces and cites a recent decision of the National Energy Board where it discontinued the use of the formula. While the Board has regard for approaches taken by other Canadian regulators, the Board finds that the circumstances of this Application are substantially different, involving a single utility with a relatively small customer base and evidence that stability in financial market conditions may be returning. As such the Board will make its decision based on the evidence presented in this hearing without regard to the approach taken by other Canadian regulators.

In Order No. P.U. 16(1998-99) the Board established the automatic adjustment formula stating (pg. 103):

> *"The Board is of the view that there is merit to a formula, in light of the cost burden of a full cost of capital hearing and the potential savings to consumers which could be realized. The Board also believes that the adoption of an automatic adjustment mechanism will create greater predictability, which will thereby reduce the risk of regulatory uncertainty. In the opinion of the Board, a mechanism to facilitate an annual review at modest costs will be of benefit to the ratepayer and to the Company."*

The automatic adjustment formula is a mathematical expression of the equity risk premium methodology which is the approach favored by Canadian regulators and the one used by this Board to determine the appropriate cost of equity for rate setting purposes for Newfoundland Power in 2010 in this Decision. In years beyond the test year Newfoundland Power's return on rate base and customer rates are established by the formula which adjusts the risk premium determined by the Board in the general rate application by a factor to reflect the change in the risk-free rate.

The Board believes that the automatic adjustment formula is fundamental to the multi-year regime in place in this province and contributes to regulatory predictability and certainty. The Board supports the comments of Mr. Todd in his report (pg. 2):

> *"The existing multi-year regime serves two purposes that are similar to the incentive regulation and performance based regulation regimes that have been adopted in some other jurisdictions:*

they reduce regulatory cost by reducing the frequency of GRA's and they provide an incentive for the Company to pursue productivity gains in the non-GRA years."

A general rate application is a time consuming and expensive regulatory proceeding the cost of which is generally borne by consumers. The Board notes that Newfoundland Power has requested approval to include $750,000 in the test year revenue requirement to recover the costs of this application. The revenue requirement for 2010 also includes $200,000 of outstanding hearing costs associated with Newfoundland Power's last general rate application. In addition Newfoundland Power has proposed that $315,000 be included in the 2010 revenue requirement for regulatory costs intended to cover ongoing regulatory matters possibly including a future general rate application from Newfoundland Power. These regulatory costs are significant and, if approved, will be collected in rates each year until the next general rate application. The automatic adjustment formula has been a useful regulatory tool to effectively reduce these types of costs in the past.

The evidence before the Board shows that the operation of the formula for 2010 as ordered by the Board in Order No. P.U. 32(2007) results in a forecast cost of regulated common equity for Newfoundland Power of 8.48%. (Undertaking # 10, 1st Revision) In this Application each of the cost of capital experts provided an opinion as to the fair 2010 return on equity for Newfoundland Power, ranging from 7.75% to 11.75%. In evaluating these opinions the Board rejected the evidence presented in relation to the comparable earnings test and the discounted cash flows as they related to U.S. utilities. Absent these methodologies the evidence suggests a return on regulated common equity in the range of 7.75% to 10.25%. The return on equity accepted as reasonable by the Board for Newfoundland Power for 2010 is 9%. The return on rate base which would have been generated by the formula is in the range suggested by the evidence of the cost of capital experts and, while lower than determined by the Board, does not suggest that there is a fundamental issue with the application of the formula.

Formulaic approaches to the determination of a return on equity do not allow for the exercise of discretion based on a comprehensive review of all the relevant circumstances at the time. The Board believes that the benefit of a cost of capital hearing must be weighed against the significant costs to customers. While it is clear that financial market conditions were unstable in late 2008 and early 2009 Newfoundland Power did not demonstrate that the use of the automatic adjustment formula is inappropriate for future years. Discontinuing the formula at this time would in the Board's view, be an excessive response to financial market conditions which, while severe in the fall of 2008 and spring of 2009, appear to be settling. The Board believes that it is appropriate to continue to use a formula to adjust Newfoundland Power's return on rate base for several years following a full review in a general rate application. Therefore the Board will order the continued use of the automatic adjustment formula for 2011 and 2012.

In this Application Newfoundland Power sought the discontinuation of the formula and did not provide alternatives for consideration of the Board. Mr. Ludlow, Newfoundland Power's CEO, stated that Newfoundland Power is not yet ready to discuss alternatives. Ms. Perry, the CFO, stated that she believed it was too early to propose changes. The Board does not agree and will require the formula to be used for 2011 thereby allowing almost a year to determine and implement appropriate changes. Newfoundland Power will now have the opportunity to consider and propose changes to the formula to address any concerns.

There are a number of alternatives and modifications to the existing formula and the associated processes that can be considered, including the use of consensus forecast for the risk free rate or the adoption of a different market risk premium adjustment factor. Ms. Perry raised the timing of the determination of the risk-free rate as a concern with the operation of the formula as it relates to general rate application decisions. Ms. McShane suggested that the utility cost of equity is considerably less sensitive to changes in long-term government bond yields than the existing formula suggests. Mr. Cicchetti suggested some possible improvements to the formula such as adjustment of the risk premium to reflect more recent market data and the use of a consensus forecast for the risk-free rate. Now that the question of the use of the automatic adjustment formula has been settled the parties can put their efforts to identifying ways in which this regulatory mechanism can be improved.

Newfoundland Power may apply to the Board by March 15, 2010 proposing changes to the automatic adjustment formula mechanism. The Board encourages Newfoundland Power to involve the Consumer Advocate in its analysis well in advance of filing its application with a view to encouraging consensus proposals and timely decision making that will allow for implementation of any changes in the determination of rates for January 1, 2011. In the absence of an application to modify the existing automatic adjustment mechanism the current formula will be used to adjust rates for 2011.

Newfoundland Power may submit a proposal to the Board by March 15, 2010 for changes to the existing automatic adjustment mechanism. The Automatic Adjustment Formula will be used to set the rate of return on rate base for 2011 and 2012.

4. Other Issues

i. Other Post Employment Benefits

Newfoundland Power offers other post employment benefits (“OPEBs”) to its employees which include hospital care, prescription drugs, vision care, other medical, life insurance and retirement allowances.

On January 1, 2000 Newfoundland Power adopted for financial reporting purposes the accrual method of accounting for OPEBs as required under CICA 3461-Employee Future Benefits. The accrual basis of accounting requires Newfoundland Power to recognize expenses during the period to which benefits relate. Newfoundland Power uses the cash basis of accounting for OPEBs expenses for regulatory purposes, which recognizes expenses when benefits are paid.

In Order No. P.U. 19(2003) the Board approved Newfoundland Power’s proposal to continue to use the cash basis for recognizing OPEBs expenses for regulatory purposes. However the Board stated:

"The Board is concerned about the potential liability for employee future benefits and is of the view that NP should explore using the accrual method of accounting for these benefits. The Board recognizes that there are significant transitional obligations associated with this change in accounting policy but once the transitional obligation has been met these costs should decrease. NP should continue to monitor its obligations with respect to employee future benefits and corresponding regulatory practice. The Board will direct NP to propose a plan at its next general rate application for moving towards the accrual method of accounting for employee future benefits as recommended by the CICA. The Board emphasizes such a plan should be presented to the Board as an alternative to the existing method and should address the transitional impact with a view to fulfilling NP's obligation to its employees while at the same time moderating is impact on rates. The Board will then be in a position to consider this alternative accrual method and its specific impacts at the next hearing."

As part of its 2008 general rate application Newfoundland Power proposed the implementation of the accrual basis of accounting for OPEBs. The proposal to implement the accrual basis of accounting required an increase in revenue requirement of $7,200,000, or approximately 1.5%. The settlement agreement filed in that application set out the following agreement of the parties to continue with the cash basis of OPEBs:

- *"It is recognized that both cash and accrual accounting treatments are in accordance with GAAP and regulatory accounting principles.*
- *In applying regulatory rate making principles, the Parties agree that in considering the accounting treatment for OPEBs, it is appropriate at this time to give more weight to the rate impact on customers of increases in the cost of electricity than to the principle of intergenerational equity.*
- *NP should, therefore, maintain the cash accounting treatment for OPEBs until the next GRA at which time the matter will be further considered by the Board."*

In Order No. P.U. 32(2007) the Board approved the continued use of the cash basis for accounting for OPEBs as proposed by Newfoundland Power in accordance with the terms of the settlement of the parties.

In this Application Newfoundland Power proposes:

1. adoption of the accrual method of accounting for OPEBs costs for regulatory purposes commencing in 2010;
2. tax-effecting all of its employee future benefits costs represented by OPEBs expense for regulatory purposes commencing in 2010; and
3. deferring consideration of the transitional obligation of $46,200,000 until a further hearing to be determined by the Board.

Newfoundland Power states that the move to the accrual method of accounting for OPEBs is in accordance with generally accepted accounting principles ("GAAP") and is also consistent with existing regulatory practice in the rest of Canada. Newfoundland and Labrador Hydro moved to accrual accounting for its OPEBs expenses in January 1, 2000. [Order No. P. U. 7(2002-2003)]

a) Annual OPEBs Expenses

The financial impact of adopting the accrual method of accounting for OPEBs is an estimated increase in 2010 expenses of $6.7 million, which is the difference between the expense under the accrual basis of $8.4 million and the expense using the cash basis of $1.7 million. The change to the accrual method will also reduce Newfoundland Power's rate base. Under the Asset Rate Base Method used to determine rate base a liability equal to the difference between the expenses under the accrual method and the cash method is deducted from the rate base. The move to the accrual method for accounting for OPEBs will reduce income tax expense by $1.7 million. This balance will be recorded on Newfoundland Power's balance sheet as a future income tax asset partially offset by an increase in average rate base.

Grant Thornton reviewed Newfoundland Power's proposals with respect to OPEBs and concluded that Newfoundland Power's proposal to use the accrual method of accounting for other post employment benefits and to tax-effect its costs is in accordance with Canadian GAAP, is consistent with Newfoundland Power's treatment of pension costs, is consistent with Newfoundland and Labrador Hydro's treatment of OPEBs, and is consistent with the treatment of income tax related to pension expense. In its report Grant Thornton also commented on the variability of the OPEBs expense, concluding that the accrued benefit obligation related to OPEBs is subject to variability due to uncertainty regarding assumptions, in particular discount rates. Grant Thornton noted (pg. 7):

> *"Under the accrual basis of accounting, OPEBs expense, like pension expense, is dependent on the discount rate used to calculate interest costs on accrued benefit obligations. Interest costs can be a major component of total OPEBs expense. For example, of the total forecast 2010 OPEBs expense of $7,414,000, $4,827,000 consists of interest cost."*

Grant Thornton also commented, however, that the total variability related to changes in the discount rate on OPEBs would not be as significant as it is with pensions due to the difference in the balance of the accrued benefit obligation.

b) Transitional Obligation

In addition to the increased expenses in the 2010 test year, the adoption of the accrual basis for accounting for OPEBs will result in a transitional obligation in the amount of the cumulative difference between accounting treatments up to the date of the full implementation of the accrual method. As of January 1, 2010 the balance of transition obligation is $46,172,000. Grant Thornton set out the components of this balance in its July 31, 2009 report (pgs. 5-6) as summarized below:

1. A transitional obligation existed when Newfoundland Power adopted the accrual method of accounting for financial reporting purposes on January 1, 2000 as required under CICA 3461. The balance was $25,133,000 and is being amortized over 17.6 years, which was the estimated remaining service life of covered employees at the time Section 3461 was adopted. As of January 1, 2010 the unamortized balance will be $10,857,000. This annual amortization is recorded as part of the OPEBs regulatory asset and not as an

expense because Newfoundland Power is using the cash basis to record OPEBs expense for regulatory purposes.

Newfoundland Power is proposing to continue to amortize the balance of $10,857,000 arising from the January 1, 2000 transition over the remaining 7.6 years, with the annual amortization amount of $1,428,000 included as part of its OPEBs expense.

2. As of December 2008 Newfoundland Power had recorded a regulatory asset of $41,074,000 on its balance sheet related to OPEBs. This represents the balance of what would have been expensed under the accrual method and what was expensed under the cash method from January 1, 2000 to December 31, 2008. This balance is estimated to be $46,172,000 as of January 1, 2010, including the $14,276,000 from above that has been recorded as a regulatory asset but not amortized for regulatory purposes.

   Newfoundland Power is proposing that the disposition of this balance be addressed at a subsequent hearing and submits that this would allow for an effective phase in of the recovery of accrued OPEBs liabilities which, in turn, will help moderate the immediate impact of the accounting change on customer rates.

Grant Thornton reviewed Newfoundland Power's calculations of the transitional obligation of moving to the accrual method and concluded that the calculations agree to the calculations of Newfoundland Power's actuary and will not change in years after the adoption of the accrual method.

The Consumer Advocate expressed concern with respect to the impact on customer rates of both the annual expense and the recovery of the transitional costs. In written submission (pg. 65) the Consumer Advocate stated:

> *"When one takes into consideration the transitional expense, the total annual revenue requirement imposed upon the rate payer is indeed very significant. It is reasonable to anticipate such expense as being in the range of 11 million dollars. What the actual amount will be is highly dependent on the period of amortization, if indeed that is the approach when dealing with the transitional expense."*

One specific concern identified by the Consumer Advocate is the variability of annual OPEBs expenses which, it is submitted, depends on various factors such as demographics, claims costs, aging, mortality assumptions, and actual benefit payment. The Consumer Advocate points out that, according to Newfoundland Power, the annual OPEBs expense will be adjusted annually on the basis of a best estimate by the company's actuaries.

The Consumer Advocate also takes issue with the overall costs of OPEBs, particularly with the fact that retirees over age 65 do not contribute to premium costs associated with their retirement benefits. The Consumer Advocate points out that a series of recommendations, made by Newfoundland Power's consultants in 2005 with respect to possible cost reductions but not implemented by Newfoundland Power, suggested that retirees bear a larger part of the burden of the cost of benefits. (CA-NP-293 Attachment A) According to the Consumer Advocate changing the group benefit program to require employees retiring after January 1, 2010 to pay one half of the cost of group benefits *"would reduce the annual OPEB accrual by 2.5 million dollars each and every year."* (Consumer Advocate, Written Submission, pg. 68/19-22)

It was also noted that Newfoundland Power provided evidence that it is commencing a review of its group plans with IBEW Local 1620. While the outcome of this process is uncertain, the Consumer Advocate points out that Newfoundland Power expects this review to conclude by the end of 2010, which means the actual results of the review would effectively be excluded from consideration in the 2010 test year. In written submission (pg. 69) the Consumer Advocate states:

> *"The evidence suggests that the OPEBs expense does not need to be as high as that asserted by Newfoundland Power. Rather, it is reasonable to anticipate that Newfoundland Power can implement some of those changes recommended to it in 2005 to bring this expense down by a significant amount."*

Mr. Todd recommended the following with respect to Newfoundland Power's OPEBs proposal:

> *"In any case, it may be prudent to reconsider this OPEBs issue in the context of an examination of the overall implications of the anticipated introduction of International Financial Reporting Standards (IFRS) which will almost certainly have potential impacts for the timing and approach used for the recognition of costs and revenues. The Board's consideration of the rate impacts resulting from OPEBs and IFRS-related accounting changes and the possible need for mitigation of the rate impacts can be pursued on a more informed basis once the implications of the transition to IFRS are known."*
> (Mr. John Todd, Pre-filed evidence, pg. 14/23-29)

Mr. Todd testified that it may be possible in the context of more evidence to adopt an approach that has *"known and appropriate rate impacts"* by using the inherent volatility of the OPEBs costs under the accrual method as a basis for handling the transitional obligations. (Transcript, Oct. 27, 2009, pg. 86/10-14)

The Consumer Advocate submits that, with respect to this matter, it would be reasonable for the Board to:

> *"i) defer accrual accounting of OPEBs until Newfoundland Power has made a reasonable effort to reduce the cost of OPEB expense; and*
> *ii) defer accrual accounting of OPEBs until the Board has had the opportunity to deliberate on the full impact upon rates of the accrual accounting of annual OPEB expense and transitional costs and to consider any mechanisms to smooth the impact of this volatile expense."*
> (Consumer Advocate, Written Submission, pg. 69/16-21)

In its written submission Newfoundland Power states that accrual accounting for OPEBs is mainstream Canadian regulatory practice and that the company's proposal to move to accrual accounting for OPEBs as of January 1, 2010 and to tax-effect accrued OPEBs costs at this time should be approved. With respect to the disposition of the transitional obligation of $46.2 million Newfoundland Power proposes that this matter be deferred and addressed at a later general rate application. According to Newfoundland Power this proposal is balanced since it will moderate the immediate impact of the accounting change on customer rates. Newfoundland Power does not agree with the Consumer Advocate's proposal to defer consideration of adoption of accrual accounting.

With respect to overall costs of OPEBs Newfoundland Power submits that its payment of the full cost of the premiums associated with current post age 65 retiree benefits is reasonable. It was noted that any modification of post-retirement benefits for future retirees, including modifications to provide for cost sharing of medical benefits, would require consideration of a number of factors, including the impact of the proposed modifications on overall post retirement benefits, provision of reasonable notice to employees, and whether transitional arrangements are warranted in the circumstances.

The Board notes that this is the third consecutive general rate application in which the issue of moving to the accrual method of accounting for OPEBs has been raised. The issue of future liability for customers of a delay in adopting accrual accounting for OPEBs was identified by the Board in 2003. The Board notes that, since the 2008 general rate application, the transitional obligation has increased by another $12.1 million and will be $46.2 million as of January 1, 2010. The Board acknowledges that accrual accounting for OPEBs costs is in accordance with Canadian GAAP and that Newfoundland Power should move to accrual accounting for OPEBs cost. However, the Board is now faced with the challenge of balancing fairness and stability in rates with the regulatory principle of intergenerational equity in the context of an outstanding liability of $46.2 million to be recovered from customers. This is a significant recovery balance and one that must be dealt with fairly and equitably.

In addition to concerns in relation to overall costs, the Board is also concerned about variations in the actual OBEBs expense from the forecast of 2010 test year expense. The Board notes the evidence in relation to the significant variables arising from changes in the assumptions underlying this calculation, especially discount rates. Newfoundland Power provided evidence that it will be conducting a review of group benefits costs in 2010, both for current employees and retirees. According to Ms. Perry the outcome of this review is uncertain but any changes in OPEBs annual costs as a result of this review will be factored into customer rates in the future. The Consumer Advocate is concerned that, since 2010 is a test year, any reductions in OPEBs expenses identified as a result of the review of OPEBs costs will not be reflected in customer rates but rather *"will go straight to Newfoundland Power's bottom line."* (Consumer Advocate, Written Submission, pg. 69/4-6)

Based on the above the Board believes that Newfoundland Power's proposal to move to the accrual method of accounting for OPEBs should be considered as part of a comprehensive proposal to deal with the transitional obligation to be recovered in rates. This is the process contemplated by the Board in Order No. P.U. 32(2007) when the Board agreed to defer the issue until the next general rate application, which was anticipated in 2010 with a 2011 test year. In addition the Board agrees with the evidence presented in this hearing that any consideration of this matter should also include sufficient information to address the impact of issues such as IFRS and the potential variability in OPEBs expense due to discount rates and changes in other costs that may arise from the ongoing review. Prior to any approval of the Board to move to accrual accounting for OPEBs costs Newfoundland Power will be required to provide a comprehensive proposal setting out recommendations and alternatives detailing associated rate impacts, as well as addressing potential issues such as variability in OPEBs expenses.

The Board will not approve Newfoundland Power's proposal to move to accrual accounting for OPEBs costs on January 1, 2010. Newfoundland Power will be required to submit no later than June 30, 2010 a comprehensive proposal for the adoption of the accrual method of accounting for OPEBs costs as of January 1, 2011. This proposal should include recommendations and alternatives in relation to a deferral mechanism to capture annual variances arising from changes in the discount rate and other assumptions, as well as for the recovery of the transitional balance associated with the adoption of accrual accounting for OPEBs costs.

ii. Executive Compensation

The Consumer Advocate challenged the recent salary increases for executives of Newfoundland Power and submits that these expenses should not be treated as regulated expenses. The Consumer Advocate argues that, since Newfoundland Power recruits its executives from within the Fortis group and does not compete for its executive resources with organizations in various business sectors across Canada, an executive compensation policy tied to the marketplace is not necessary or justified. In written submission (pg. 82) the Consumer Advocate states that Newfoundland Power failed to satisfy its obligation to justify the proposed executive compensation expense, stating:

> *"In the absence of evidence to support its executive compensation policy, the Commissioners should not allow as regulated expense the salary increases based in that policy. Shareholders in Newfoundland Power may wish to continue to reward its executive in accordance with the executive compensation policy. However, before rate payers can be expected to bear that burden, there is a burden on Newfoundland Power to show that such expenses are justified as reasonable and prudent expenses in the operation of the utility."*

Newfoundland Power states in its written submission that the basic structure of its executive compensation arrangements has not changed since 1998 and also that, over the past decade, the proportion of executive labor costs to Newfoundland Power's total labor costs has not materially changed. Mr. Karl Aboud, the National Director of Hay Group Canada Reward Consulting Practice, testified on behalf of Newfoundland Power on the issue of executive compensation. A report "Executive Compensation Review" prepared by Mr. Aboud, was filed in support of this testimony. This report concluded at pg. 2:

> *"In summary, Hay Group believes that:*
>
> *It is reasonable for NF Power to use comparative executive jobs within the broad Canadian Commercial Industrial market place as its comparator group;*
>
> *It is reasonable for NF Power to use the Median / 50th Percentile levels of comparator group compensation values as the basis by which to establish its own executive pay standards; and*

The NF Power incumbent-specific executive pay values are within the normal range of variance to its market pay standards that Hay Group typically experiences in these types of reviews."

The Board found Mr. Aboud to be knowledgeable and well informed and his evidence was supportive of these conclusions. The Board notes the absence of evidence which would contradict the testimony of Mr. Aboud or propose other approaches that should be taken by Newfoundland Power. Even if Newfoundland Power's executive compensation arrangements may seem to be generous based on the practice of hiring from within the Fortis Group, there is no evidence in this proceeding to ground the Consumer Advocate's suggestion that Newfoundland Power's forecast executive compensation expenses for 2010 are unreasonable and should be denied. The Board notes its comments in Order No. P.U. 19(2003) with respect to executive compensation:

"However, the Board in this case has not been provided with any evidence other than the assertion by the Consumer Advocate that compensation levels are too high. While the levels of individual compensation may be considered high by some measures, the Board does not have any information on the record which would enable it to evaluate other appropriate alternative comparators for NP's executive compensation."

The Board agrees that Newfoundland Power must provide support for proposed expenses and finds that, in this case, Newfoundland Power has provided the necessary support. The executive compensation arrangements are based on a previously approved approach, have been proportionally consistent over the last several years, and are supported with specific evidence from an expert witness. In the absence of contradictory evidence the Board finds that Newfoundland Power's executive compensation arrangements should be accepted.

The Board will make no order in relation to Newfoundland Power's proposed 2010 executive compensation expenses.

iii. Operational Costs and Efficiencies

The Consumer Advocate submits that Newfoundland Power has overstated its forecast operational costs for the 2010 test year.

With regard to Newfoundland Power's estimate of uncollectable bills for 2010 the Consumer Advocate states that the forecast of $963,000 for both 2009 and 2010 is approximately 15% higher than the 2008 actual expense. The Consumer Advocate argues that Newfoundland Power's methodology of using a three-year average (2006, 2007 and 2008) does not give appropriate weight to the most recent actual results, which were lower than previous years and as a result the forecast is high. He requests an adjustment be made to this operating cost item.

In its written submission (pg. D-5) Newfoundland Power states that its uncollectable bills for 2010 are forecast to be consistent with 2009, $129,000 more than 2008, and $130,000 less than 2007. The 2010 forecast for uncollectable bills is based on the average of actual results of the three most recent complete years.

The Consumer Advocate also questioned the reasonableness of Newfoundland Power's labour forecast assumption for numbers of retirees as well as the assumption that all the 2010 retirees will leave the company at the end of the year. The Consumer Advocate submitted that the evidence shows that Newfoundland Power has been experiencing higher actual retirements than forecast, as the forecast is based on the assumption that an employee will only retire upon reaching the age of 65, or age 60 with a combination of age and service years of 95 years (CA-NP-114).

With respect to the issue of retirement forecasting Newfoundland Power filed a Labour Forecast Report as required by Order No. P.U. 32(2007) which sets out how the company reconciles forecast work requirements and workforce options in the ongoing management of its labour requirements.

The Consumer Advocate also questioned the appropriateness of including forecast costs in 2010 in relation to a future general rate application. Newfoundland Power forecasts 2010 regulatory costs of $315,000 (Undertaking # 8). Newfoundland Power says that these costs are estimated in relation to several regulatory matters that are anticipated in 2010, including ongoing rate design reviews and possibly a general rate application for Newfoundland and Labrador Hydro or Newfoundland Power.

Newfoundland Power submits that the evidence shows that its cost management reflects an appropriate balance of cost and service in both the short term and the long term and that there is no basis in the evidence to indicate these costs are unreasonable.

The Board is not persuaded that an adjustment in 2010 operational costs is warranted based on the evidence. The averaging methodology for estimating the 2010 uncollectable bills expense is, in the Board's view, appropriate for estimating these costs and allows for smoothing of the impact of factors that may have affected the level of uncollectable bills in any given year, such as the economy and weather. On the issue of retirement forecasting and overall labour costs the Board finds that there is no evidence to indicate that Newfoundland Power's approach to forecasting these expenses is unreasonable. The Board notes that Newfoundland Power is forecasting a labour productivity improvement for 2010 of 1.1%, similar to what was achieved in 2008. In addition, the Board is satisfied given the outstanding regulatory issues and the probability of regulatory proceedings in 2010 the forecast regulatory costs are reasonable.

The Board will make no order in relation to Newfoundland Power's proposed 2010 operational costs.

iv. <u>Inter-Corporate Transactions</u>

The Consumer Advocate raised a number of issues with respect to Newfoundland Power's inter-corporate practices, and in particular with the at-cost charge-out rate for Newfoundland Power's personnel to Fortis affiliates for storm/hurricane repair/reconstruction work in the Caribbean areas and for secondments of its staff.

According to the Consumer Advocate the current arrangement of providing storm restoration assistance at-cost to Fortis owned affiliates benefits the shareholders of Fortis while shielding the ratepayers of these utilities from the full costs of these efforts. Newfoundland Power states that the company was compensated for the time spent by its field personnel on the basis of fully distributed costs, except for the time spent by Managers which was compensated at 1.2 times fully distributed costs. Newfoundland Power submits:

> *"Such assistance is provided when it does not negatively impact Newfoundland Power's customers. A primary benefit of participating in such restoration efforts is reciprocity. Because safety rules, work methods and practices, and equipment are standardized among Fortis utilities, crews from those utilities can be mobilized very safely and quickly in a storm restoration situation. The evidence indicates that Caribbean line crews have worked effectively in winter conditions and demonstrated knowledge of the proper work techniques and procedures."*
> (Newfoundland Power, Written Submission, pg. G-2)

With regards to staff secondments the Consumer Advocate submits that these secondments are *"one-way"* in that only Newfoundland Power's staff go to other Fortis companies and, since there is no reciprocity, *"there is no basis to continue charging at cost for such valuable employees."* (Consumer Advocate, Written Submission, pg. 75) Further he submits that there is no financial incentive for Newfoundland Power to charge more than the cost for these services since doing so will lessen the return to Fortis shareholders. The Consumer Advocate argues that Newfoundland Power should adjust staff charges to recover fair market value or an appropriate mark-up. In written submission (pg. 76) the Consumer Advocate states:

> *"A party in an arms length transaction would not fail to charge an appropriate mark-up on the grounds that the person being hired out was being exposed to a valuable learning experience. An arms-length party would be seeking to maximize its benefits from the transaction and that is what P.U. 19(2003) sets forth in its reasons and that is what consumers expect."*

In Order No. 19(2003) the Board identified the principles that Newfoundland Power would be required to observe with respect to all inter-corporate transactions:

> *(i)* *"All inter-corporate transactions between a utility and its affiliates shall be fully transparent and are subject to scrutiny by the Board.*
> *(ii)* *A utility shall have the right to manage its affairs but it must demonstrate to the satisfaction of the Board that all affiliate transactions are prudent.*
> *(iii)* *A utility shall ensure that inter-corporate transactions will not disadvantage the interests of ratepayers and furthermore that ratepayers and the utility will derive some benefit from such transactions.*
> (iv) *The onus is on the utility to show that it is in compliance with the guidelines and principles with respect to inter-corporate transactions."*

These principles continue to be valid and should govern all inter-corporate transactions between Newfoundland Power and Fortis and its affiliate companies. The Board's primary concern is to ensure that ratepayers are only paying for those costs necessarily incurred by Newfoundland Power to provide electrical service in the province. However, as stated previously, the Board recognizes that ascertaining demonstrable benefits requires a certain subjectivity on the part of utility, as not all benefits arising from these relationships are financial in nature. In the case of staff secondments, for example, the Board accepts that these types of assignments can provide opportunities to employees in terms of professional and technical skills development and therefore may benefit Newfoundland Power and its customers. The Board notes Newfoundland Power's position that the secondment of staff to other Fortis companies will only be permitted under circumstances where there is no operational or financial impact on the company.

In the case of the deployment of Newfoundland Power's personnel for storm/hurricane repair/reconstruction work in the Caribbean, there is no evidence to suggest that these deployments result in additional costs for Newfoundland Power's ratepayers. Under cross-examination by the Consumer Advocate Mr. Smith said that Newfoundland Power hired contract labour to do work while some of its line personnel were deployed to the Turks and Caicos restoration. Mr. Smith confirmed that this contract labour would have been billed at a market rate but his *"point of being comfortable is to make sure that labour is no more expensive than our own labour, and that way our customers wouldn't be in any way negatively impacted."* (Transcript, Oct. 26, 2009, pg. 12/14-17) Other than this statement there was no policy or further evidence provided to demonstrate specifically how Newfoundland Power can confirm that the deployment of Newfoundland Power's employees to other locations outside the province does not negatively affect Newfoundland Power's customers. It is noted that Mr. Smith said that the work that the contractors can do is generally limited in scope.

Under the current arrangement, Fortis and its affiliates benefit as a result of having access to Newfoundland Power's trained workforce. This access is made available by virtue of the fact that the companies are Fortis affiliates. If the Caribbean utilities to which Newfoundland Power's personnel were providing service were required to source these services outside the Fortis group of companies it is reasonable to expect that they would pay market rates.

The Board supports Newfoundland Power's willingness to provide assistance in emergency situations, such as hurricanes and ice storms. The Board would expect that Newfoundland Power would respond to a call from any utility, whether a Fortis affiliate or not, in such a situation assuming that its ability to continue to provide service in the province is not negatively affected. The Board does not believe that ratepayers would want Newfoundland Power to benefit financially in these emergency circumstances. However, in all non-emergency situations the Board would expect that the principle of *"demonstrable benefit"* be satisfied. As well, long-term deployment of Newfoundland Power personnel beyond the initiating emergency situation would not, in the Board's view, be in the best interest of Newfoundland Power's ratepayers. The evidence does not provide any indication as to whether any of the staff deployments to the Caribbean utilities extended beyond the emergency period. Newfoundland Power must be able to demonstrate that its customers will not be prejudiced in any way by the diversion of staff resources.

In the Board's view the issue raised by the Consumer Advocate with respect to the appropriate charge-out rate for deployment of Newfoundland Power's staff to affiliated companies is one that should be resolved in the context of the policy framework of the Inter-Affiliate Code of Conduct. The Board would like to see a clear policy statement with respect to Newfoundland Power's willingness and ability to respond to a request for personnel deployment both in emergency and non-emergency situations, and the criteria used to assess the impact and/or benefits for its customers in responding to these requests. As to the charge-out rate, as stated previously, the Board would not expect Newfoundland Power to benefit financially from providing emergency assistance but, where deployments extend beyond addressing emergency issues or are provided outside of an emergency, the Board would expect the charge-out rate to reflect the value of that service.

The Board will require Newfoundland Power to file a report no later than June 30, 2010, prepared in consultation with the Consumer Advocate, setting out alternatives and recommendations in relation to the policies for deployment of Newfoundland Power staff to affiliated or other companies for emergency requests.

v. Amortization of Hearing Costs

Newfoundland Power proposes that costs related to this Application in the amount of $750,000 be included in the 2010 revenue requirement. Newfoundland Power states in a footnote to the evidence filed with the Application that it is not currently expected that the rates set as a result of this Application will be in effect beyond 2010 and therefore proposes that the full $750,000 be recovered in 2010 rates. In final argument Newfoundland Power again notes that it is possible but currently not expected that the rates set as a result of this Application will be in effect beyond 2010. Newfoundland Power also notes the testimony of Ms. Perry wherein she said the revenue shortfall that is currently forecasted for 2011 will be larger if the full amount of hearing costs are not included in the 2010 rates. Newfoundland Power concludes that the appropriate amortization period for regulatory costs is a matter of judgment by the Board.

The Consumer Advocate opposes Newfoundland Power's proposal and states in final argument that the costs should be recovered over three years. The Consumer Advocate suggests that Newfoundland Power's proposal may result in the recovery of costs which were not actually incurred. He cites the opinion of Mr. Todd as setting out the appropriate approach to hearing cost recovery:

> *"The approach proposed by Newfoundland Power seems to be inconsistent with the desire to have GRAs on a three year cycle when possible. At the present time, the forecast 2008 regulatory costs are being amortized over years. That means that one-third of the forecast cost for 2008 will be included in 2010 rates. If 2010 GRA costs are also included in the 2010 rates fully, there will essentially be 133 percent of GRA costs included in 2010 rates, part of the cost from 2008, 100 percent of the costs from 2010. Second, if Newfoundland Power ends up not initiating a GRA for 2011, the rates in 2011 carrying forward will implicitly include the same 133 percent of the cost of a singe GRA, as well any subsequent years until there's another GRA. This recovery will correspond to costs that were not actually incurred. It would seem to make more sense to me to consistently amortize GRA costs over three years, as a matter of policy. If that approach is adopted, the recovery of GRA costs will be smooth and the cost of burden on rate payers will never exceed three-thirds of typical GRA costs."*
> (Transcript, Oct. 27, 2009, pgs. 78/11-25; 80/1-11)

The Board notes that if Newfoundland Power's proposal is approved the amount included 2010 rates in relation to general rate application regulatory costs would be $951,000 as set out by

Newfoundland Power in Exhibit 1 (1st Revision). This amount includes the costs of this Application in addition to the deferred costs to be recovered in 2010 flowing from Newfoundland Power's 2007 general rate application.

The Board agrees with the opinion of Mr. Todd that amortizing the costs associated with a general rate application over a period of three years promotes smooth and full recovery of these costs. The Board believes it is appropriate to determine the amortization period for regulatory costs on principle and consistent with recent regulatory practices rather than with reference to Newfoundland Power's overall revenue position for 2011. The Board will order that hearing costs of $750,000 will be recovered by Newfoundland Power over a three-year period beginning in 2010.

The Board will require the estimated costs of $750,000 associated with this Application to be amortized over three years beginning in 2010.

vi. Disposition of Proceeds from Kenmount Road Property

In 2009 Newfoundland Power sold a 3.334 hectare parcel of vacant land next to its offices on Kenmount Road with a book value of $234,000 to an adjacent landowner for $618,000. This land was acquired as five separate parcels with acquisitions occurring in 1961, 1965, 1973, 1986 and 1989. Newfoundland Power states that the land was assembled as a central location for additional Newfoundland Power offices and operations but was never used. The land remained vacant and unimproved at the time of sale.

The Consumer Advocate acknowledges that there is regulatory precedent for both including land acquired for future use in rate base and for transferring the proceeds of the sale of such land to the benefit of customers rather than shareholders. The Consumer Advocate cites Mr. Todd's testimony as follows:

> *"…The resolution of this issue should be consistent with regulatory principles espoused by the Board in Order PU-19 2003, pages 15 to 16, in particular, the sixth principle end result which is, in compliance with the legislation, the end result must be fair, just, and reasonable from the perspective of both the consumer and the utility. How you do that is not obvious, but in particular, it may be appropriate to remove from rate base an amount that is equal to the original cost of the property, plus all related costs, including the carrying costs that have been included in rates over the years, as reflected in the return on rate base since the land was acquired. Under the circumstances, this calculation may provide the appropriate approach to determine the sort of equity salvage value for this asset that would be removed from rate base."*
> (Transcript, Oct. 27, 2009, pg. 89/1-20)

Newfoundland Power states that its accounting treatment of the gain from the sale of the Kenmount Road land is in accordance with the historical regulatory practice in this jurisdiction of treating the financial impact of *ad hoc* land sales as miscellaneous revenue or expenses. Newfoundland Power reports that the gain of $345,000 on the sale of the land was recorded as miscellaneous revenue and included in Other Revenue in Newfoundland Power's books of account. Ms. Perry said in testimony that the land was bought for the consolidation of the St. John's offices but it became surplus land after the call center was located on Duffy Place in 1990 and the control center on Topsail Road in 1999. She stated that, when Newfoundland Power realized that the adjoining landowner was expanding, Newfoundland Power took advantage of the opportunity to sell the land.

The Board notes that there was no evidence presented to show that Newfoundland Power's acquisition and retention of the Kenmount Road land in rate base was unreasonable in the circumstances. It is clear that this land was acquired with a specific purpose and was sold when the opportunity arose. As such it would be difficult to argue that the Board should reach back in time to separate the costs associated with this property out of rate base and return the associated expenses to consumers as suggested by Mr. Todd.

As referenced by the Consumer Advocate many other jurisdictions have struggled with land speculation by utilities and with addressing large gains on a sale of land which flow to the benefit of shareholders only. These concerns do not apply here given that there is no evidence that Newfoundland Power has engaged in speculative real estate activities and also given the existence of an excess earnings account to capture earnings which are outside of the established range of return on rate base. The gain on the sale of the Kenmount Road land was included in income but was not so large as to cause the utility to earn outside of the established range. Newfoundland Power advises that the forecast regulated return on equity for 2009 including the gain on the sale is 8.62%, which is below the return on equity of 8.95% accepted for the purpose determining a rate of return on rate base.

The Board does not find that it is necessary to adopt special treatment for the proceeds of this sale or to establish general guidelines or precedents at this time in relation to the purchase, retention and sale of land as the Board accepts that Newfoundland Power's approach was reasonable and the treatment of the expenses and revenues appropriate.

The Board will make no order related to the proceeds from the 2009 sale of the Kenmount Road property.

vii) Mobile River Watershed Dispute

Newfoundland Power is presently involved in litigation in relation to the Mobile River Watershed lease with the City of St. John's. By lease dated October 21, 1949, the City of St. John's granted rights to Newfoundland Power within the watershed of the Mobile River. Newfoundland Power constructed hydroelectric generating facilities in the Mobile River Watershed which annually supply approximately 49 GWh of low cost hydroelectric energy to the Island interconnected grid.

The Mobile River Watershed lease was initially for a fifty-year term, renewing automatically thereafter for five-year periods, with the City having the right to terminate after year forty-seven with three years notice. On February 9, 2006 the City of St. John's, in accordance with the provisions of the lease, notified Newfoundland Power in writing of its intention to terminate the lease. The lease requires the City to pay Newfoundland Power the value of the hydroelectric assets on termination. An arbitration panel appointed pursuant to the terms of the lease to determine the value of the assets made a ruling and the City appealed this ruling to the Supreme Court of Newfoundland, Trial Division.

The Consumer Advocate states in his written submission that customers are funding this litigation through their rates. He notes Newfoundland Power's forecast litigation costs of $275,000 in 2009 and $100,000 in 2010 in relation to this litigation. He states that customers' rates in 2010 will specifically include the forecast 2010 costs of this litigation. The Consumer Advocate concludes that, if it should turn out that only Newfoundland Power's shareholders are entitled to any compensation that may arise from the resolution of this matter, Newfoundland Power's ratepayers will have funded the matter for the benefit of Newfoundland Power's shareholders. The Consumer Advocate requests that a deferral account be established to capture the liabilities and benefits associated with the litigation and ultimate resolution of the Mobile River Watershed litigation for appropriate disposition by the Board.

Newfoundland Power states in written submission that, until the litigation pertaining to the Mobile River Watershed is resolved, it is uncertain whether there will be any transfer of the Mobile River hydroelectric assets to the City. Newfoundland Power also states that before any transfer to the City of the Mobile River assets the matter will be submitted to the Board for consideration and approval in accordance with Section 48 of the *Act*. Newfoundland Power states that consideration of the need for a deferral account to capture the liabilities and benefits associated with the litigation and ultimate resolution of the Mobile River Watershed dispute with the City of St. John's is premature.

The Board believes that deferral accounts are unique regulatory tools which should be reserved for use where it is determined that the usual treatments are inadequate. The evidence is clear that the costs associated with the Mobile River Watershed litigation can appropriately be addressed in the ordinary course with the expense recorded in the year incurred. If the litigation ultimately results in a sale of the assets Newfoundland Power is required to apply to the Board and, consistent with past regulatory practice, absent an Order of the Board, any gain on the sale would be included in earnings in the year of sale and therefore would be subject to the provisions of the excess earnings account. The Board is not persuaded that it is necessary to set up a deferral account for the amount proposed to be included in the 2010 expenses which seems to reasonably reflect the limited activity that is expected in relation to this matter.

The Board will make no order with respect to the costs and liabilities associated with the Mobile River Watershed litigation.

viii. International Financial Reporting Standards

Effective January 1, 2011, all publicly accountable enterprises in Canada will be required to comply with International Financial Reporting Standards (IFRS). Grant Thornton states that Newfoundland Power's transition to IFRS represents a fundamental change in financial reporting and noted in its 2008 Annual Financial Review that Newfoundland Power is working towards meeting the IFRS conversion timelines and appears to have a robust implementation plan in place. Grant Thornton recommends that the Board require updates on the status of IFRS transition as a part of quarterly reporting requirements. Newfoundland Power accepts this recommendation as reasonable.

The Board agrees that Newfoundland Power appears to have a robust implementation plan in place. The Board also agrees that the transition to IFRS is a significant issue and one which may have significant impacts on Newfoundland Power's customers as well as the regulatory calendar of the Board in the coming months. Given that this transition is now imminent the Board believes that more regular updates are appropriate. The Board will require Newfoundland Power to report to the Board on a monthly basis as to the status of this transition beginning on February 1, 2010. In particular the Board would expect that Newfoundland Power will set out changes since the last update and the status of its implementation plan, specifically addressing the anticipated impact on Newfoundland Power's financial statements and key financial parameters as well as the anticipated regulatory processes.

The Board will require Newfoundland Power to file monthly updates on the implementation of International Financial Reporting Standards beginning on February 1, 2010 and until full implementation.

5. 2010 Forecast Rate Base, Return on Rate Base and Revenue Requirement

i. Forecast 2010 Rate Base

Newfoundland Power forecasts an average rate base for 2010 of $869,241,000. The components of the forecast 2010 average rate base are set out below. Grant Thornton reviewed Newfoundland Power's calculation of both the initial and revised forecast 2010 average rate base and concluded that the calculation is in accordance with established practice and follows the Asset Rate Base Method as approved by the Board. Grant Thornton also confirms that the proposed 2010 forecast average rate base accurately reflects Newfoundland Power's proposals with respect to OPEBs, including tax associated tax effects, as well as cost deferral accounts and updated calculations related to the rate base allowance. The Consumer Advocate did not raise any issues with respect to the forecast 2010 average rate base.

2010 Forecast Average Rate Base ($000s)	Forecast
Plant Investment	755,649
Add:	
Deferred Charges	102,935
Weather Normalization	4,377
Deferred Energy Replacement Costs	192
Cost Recovery Deferral – Depreciation	3,257
Customer Finance Programs	1,714
	112,475
Deduct:	
2005 Unbilled Revenue	2,309
Accrued Pension Liability	3,511
Accrued OPEBs Liability	3,350
Municipal Tax Liability	683
Future Income Tax	1,895
Purchased Power Unit Cost Reserve	224
Customer Security Deposits	602
	12,574
Average Rate Base Before Allowances	855,550
Cash Working Capital	9,230
Materials and Supplies Allowance	4,461
Average Rate Base At Year End	**869,241**

Source: Exhibit 11, 1st Revision, pg. 5

The Board heard no evidence contesting Newfoundland Power's proposed rate base calculations for 2010 but notes that, as a result of the findings of the Board in this Decision, the calculation of the forecast average rate base for 2010 will change.

Newfoundland Power will be required to file a revised calculation of the forecast average rate base for the 2010 test year to reflect the determinations of the Board.

ii. Forecast Return on Rate Base

The proposed 2010 forecast return on rate base and rate of return on rate base is set out below:

2010 Forecast Return on Rate Base ($000s)	
Forecast Average Rate Base	$869,241
Forecast Regulated Returns	
Debt	35,852
Preferred Equity	568
Common Equity	42,941
Return on Rate Base	**79,361**
Rate of Return on Rate Base (%)	**9.13**

Source: Exhibit 6, 1st Revision; Exhibit 8, 1st Revision

The Board notes that the forecast 2010 return on rate base will change as a result of the findings of the Board in this Decision.

Newfoundland Power will be required to file a revised calculation of the forecast return on rate base for 2010 to reflect the determinations of the Board.

iii. Forecast 2010 Revenue Requirement

Newfoundland Power forecasts a 2010 revenue requirement of $564,140,000 to be used to establish customer electrical rates, as set out below.

2010 Forecast Revenue Requirement ($000s)	
Return on Rate Base	$79,361
Other Costs	
Power Supply Cost	349,009
Operating Costs	52,189
Pension	8,196
Additional OPEBs Expense	6,841
Amortization of Depreciation Cost Recovery Deferral	3,861
Depreciation	43,383
Income Taxes	21,300
	484,779
2010 Revenue Requirement	564,140
Deductions:	
Other Revenue	(13,692)
2005 Unbilled Revenue	(4,618)
Other Adjustments	87
	(18,223)
2010 Revenue Requirement from Rates	545,917

Source: Exhibit 7, 1st Revision

The Board notes that the forecast 2010 revenue requirement will change as a result of the findings of the Board in this Decision.

Newfoundland Power will be required to file a revised forecast 2010 revenue requirement to reflect the determinations of the Board.

DATED at St. John's, Newfoundland and Labrador this 24th day of December 2009.

Andy Wells
Chair &Chief Executive Officer

Darlene Whalen, P.Eng.
Vice-Chairperson

Dwanda Newman, LL.B.
Commissioner

Barbara Thistle
Assistant Board Secretary