NEWFOUNDLAND POWER INC.

DIRECT TESTIMONY OF JOHN T. BROWNE

AUGUST 2001

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1. INTRODUCTION

Q. Please state your name.

A. My name is John T. Browne.

Q. Have you previously given evidence before this Board?

A. Yes, I previously appeared before this Board in June of this year. At that time, I testified on regulatory issues related to Newfoundland Power's proposed purchase of Aliant's poles.

In addition, as a partner with Deloitte & Touche, I was jointly responsible with Keith Boocock for two reports that were submitted to this Board. One dealt with general expense capitalization and was dated September 20, 1993 while the other dealt with inter-corporate charges and was dated March 18, 1996.

Q. Please summarize your professional background.

A. I established my own costing and regulatory consulting practice two years ago. Prior to this time, I was a consultant with Deloitte & Touche LLP for 16 years – the last seven years as a partner. Prior to that time, I was an auditor, a financial administrator and a lecturer in the School of Business at Queen's University where I taught courses in accounting and finance.

Over the last 17 years, I have directed and worked on a wide range of studies dealing with methods of regulation and their interpretation, the implications of regulation for the operations of a utility, accounting and cost allocation principles, cost of service determination, product costing/pricing, management reporting, issues of rate base determination, cost of capital (rate of return and capital structure), and special studies involving financial analysis and analysis of industry trends.

I hold a Bachelor of Commerce degree and a Master of Arts (economics) degree from Queen's University. I also completed the course work and comprehensive exam requirements of the doctorate program in economics. I am a Chartered Accountant and a Certified Management Consultant.

I co-authored the Deloitte & Touche publication "Basics of Canadian Rate Regulation" and authored the Deloitte & Touche monograph "The Contractual Pitfalls of Relying on GAAP". I am currently Chairman of the Canadian Institute of Chartered Accountants ("CICA") Study Group "Financial Reporting By Rate Regulated Enterprises".

A copy of my resume is attached as Exhibit JTB-1.

Q. What is the purpose of your evidence in this proceeding?

A. I have been asked by Newfoundland Power to address the following issues:

(1) regulatory control;

(2) regulatory reporting;

(3) return for a public sector utility; and

(4) two specific accounting issues, namely inter corporate charges and employee future benefits.

2. REGULATORY CONTROL

Q. In your view, what is the primary objective of a regulatory board such as the Newfoundland & Labrador Board of Commissioners of Public Utilities (the "Board")?

A. Consistent with normal regulatory practice, the primary objective should be to establish and approve allowed rates that are just and reasonable.

A key consideration in determining whether rates are just and reasonable is the cost of service standard. This requires that a utility have an opportunity, but not a guarantee, to recover its cost of providing regulated service, which includes a fair return on the investment required to provide regulated service – no less, no more. However, a utility should be allowed to recover only its prudently incurred costs

Q. What are the implications of this objective for a regulatory board?

A. A regulatory board has a responsibility to exert regulatory control and manage the risks to the regulatory objectives. This includes the risk that rates will be higher tha n required because costs are in excess of what is required to provide regulated service.

Regulatory control is exerted through approval of the rates that the utility is allowed to charge, although some regulatory boards may also have other options. Regulatory boards have disallowed costs that, in the view of the board and based on the evidence, were not adequately supported, not required to provide regulatory service or not prudently incurred. In some cases, boards have deemed either an appropriate amount of costs or an appropriate amount of revenues to offset costs.

It should be emphasized that a regulatory board has a control function, not a management role. It should give the management of a utility the freedom to manage the utility. For example, a regulatory board should not tell a utility how to manage its costs, but it normally has the right, and the obligation, to determine if the resulting costs should be recoverable through allowed rates.

This is consistent with statements made by The Supreme Court of Newfoundland Court of Appeal in a 1998 decision dealing with questions of law affecting the jurisdiction of this Board (Docket: 96/141):

> "… Accordingly, the power to determine reasonable rates necessarily requires supervision of operating costs" [para. 117]

> "… the Board is not the manager of the utility and should not as a general rule substitute its judgment on managerial and business issues for that of the officers of the enterprise" [para. 118]

> "…As emphasized earlier the powers of the Board should generally be regulatory and corrective, not managerial…." [para. 136]

A necessary input to regulatory control is information. In carrying out its regulatory control responsibilities, a regulatory board normally has the right and the obligation to gather adequate information. This would include information to support a rate application. It would also include reporting on compliance with its directives and orders. For example, a critical step in ensuring that its directives are followed is a requirement that a utility report on compliance with its directives within a reasonable time frame.

Q. What should be the focus of regulatory controls?

A. The key focus should be the attainment of regulatory objectives. Regulatory controls are imposed to support regulatory objectives by managing the risks to achieving those objectives.

Managing risk does not mean prevention at any cost. In considering new controls, or in evaluating existing controls, a regulatory board must weigh the benefits against the associated costs. Since the focus is the attainment of regulatory objectives, this trade-off should be made within the context of these objectives, which should recognize the legitimate interests of both ratepayers and the utility. Therefore, the imposition of regulatory controls should consider the direct dollar costs to impose and comply with the controls, costs borne by both the utility and the regulator. It should also consider other costs of imposing the controls, including the loss of management flexibility.

Managing risk also means seeking out the most efficient manner for dealing with the risks to the regulatory objectives.

Q. What level of detail is required for regulatory reviews and controls?

A. Where possible, a regulatory board should avoid detailed reviews and controls and focus on policies and procedures.

For example, in dealing with the risk that costs will not be managed efficiently, a regulatory board should focus on the policies and procedures for managing the costs and the compliance programs to ensure that the policies and procedures are followed. Also, to the extent possible, a regulatory board should rely on the internal compliance procedures of the utility rather than imposing additional external controls. This will improve both the effectiveness and the efficiency of regulatory control.

Of course, this assumes that the utility has adequate policies and procedures.

A board may always require some detailed reviews to ensure that the policies and procedures are appropriate and effective. However, it can significantly reduce the extent of these detailed reviews.

Q. What are the implications of this being Hydro's first rate hearing?

A. In a first full rate hearing, or where a number of years have passed since the last full proceeding, it is reasonable for a Board to require more detail and to more closely scrutinize the utility's application.

As a practical manner, regulatory boards and intervenors focus on changes in costs in evaluating their reasonableness, at least to a large extent. Therefore, in a first full rate hearing, it is important to go into greater depth to develop a solid base for evaluating the utility's operations and costs.

More importantly, principles and precedents are established for determining both how the revenue requirement will be established and how that revenue requirement will be recovered through rates. These principles and precedents will tend to affect future proceedings, therefore it is appropriate to go into more detail to help ensure that the appropriate principles and precedents are set.

Also, before a regulatory board places reliance on a utility's policies and procedures and internal compliance procedures, it will want more detail to ensure that they are appropriate and effective.

Q. Would you please summarize your testimony on regulatory control.

A. The primary regulatory objective is to establish rates that are just and reasonable. A key consideration in determining whether rates are just and reasonable is the cost of service standard. A utility should have an opportunity to recover its cost of providing regulated service, including a fair return – no less, no more. However, a utility is allowed to recover only its prudently incurred costs.

Regulatory boards have a responsibility to manage the risk to regulatory objectives, such as just and reasonable rates. In this regard, a regulatory board has a control function and not a management role.

A regulatory board has an obligation to seek the information necessary to support just and reasonable rates.

In exerting regulatory control, the focus should be on managing the risks to regulatory objectives. This requires a trade-off between the benefits of the controls and the associated costs, including the impact on management flexibility. It also implies a requirement to seek out the most efficient controls.

Where possible, a regulatory board should avoid detailed reviews and controls and focus on policies and procedures. To the extent possible it should rely on the internal compliance procedures of the utility. This will improve both the effectiveness and the efficiency of regulatory control. However, in a first full rate hearing, or where a significant period of time has elapsed since the last full proceeding, it is reasonable for a regulatory board to have a more extensive review.

3. REGULATORY REPORTING

Q. Does Hydro maintain separate accounts for its regulated operations?

A. It appears that it does not. Moreover, it appears that Hydro has difficulty in producing financial results for its regulated operations.

In Information Request NP-2, Newfoundland Power asked Hydro to provide calculations for the actual and forecast interest coverage on its regulated assets for the period 1992 through 2002. In its Response to Information Request NP-2, Hydro indicated that for five of the seven years in the period 1996 through 2002, including 2001 and 2000, it could not produce the coverage ratios. For those five years, Hydro indicated that the following information for regulated operations was not available: “Gross interest, per Cost of Service”, “Cost of Service Margin” and “Cost of Service Gross Interest Coverage”.

Q. Should a utility maintain separate financial accounts for its regulated operations?

A. Yes. It should maintain separate accounting records and produce financial reports (e.g., rate base, income statement and balance sheet) for its regulated operations as if they were provided by a separate accounting entity.

Effective regulatory control requires that there be a clear definition of regulated operations and a separate financial reporting of those operations. This reporting is necessary to monitor the performance of the regulated entity and as a base for forecasting its revenue requirements.

Of course, the necessary first step is a clear definition of what is included in regulated operations. This includes not only a definition of what services will have rates approved by the Board but also what operations and ancillary revenues will go into the calculation of revenue requirements. Especially since this is a first hearing for Hydro, this definition should be reviewed by the Board.

Although the adjustments to produce financial reports for regulated operations may appear to be simple, it is easy to become confused if separate financial accounts are not maintained. For example, Schedule 1 attached to Mr. J. C. Roberts' evidence indicated a revenue requirement in 2002 of $322.3 million while on page 1 of Exhibit JAB-1, the revenue requirement for 2002 is shown as $318.8 million. Hydro's Response to Information Request NP-1 indicates that the major reason for the difference is that Mr. Roberts had not recognized the IOCC revenue adjustment.

Such confusion can result in errors in the revenue requirement calculation or in the historical information used in evaluating the revenue requirement. At the very least, it makes it difficult to follow Hydro's evidence, which hinders regulatory control.

Q. What would account for the differences between Hydro's annual financial reports and financial reports for its regulated operations?

A. Most, if not all of the differences would be accounted for by non-regulated operations and non-recoverable costs.

Unlike many Canadian utilities, Hydro's regulated operations are in the parent holding company. As a result there is a need to remove the financial impact of its investment in non-regulated affiliates. There is also a need to remove the non-regulated operations such as the recall sales to Hydro Quebec.

Even if Hydro had no non-regulated affiliates or non-regulated operations, there would still be a need for adjustments. There are costs that a regulatory board deems to be non-recoverable and must be removed. For example, the Board requires that donations be treated as a non-recoverable and excluded from the calculation of revenue requirements.

Q. If it produces separate reports for its regulated operations, should Hydro still provide its corporate reports?

A. Yes.

There should be reconciliation between Hydro's corporate financial reports and its financial reports for regulated operations. This reconciliation should identify separately each material reconciling item. It should also provide an explanation for each material item.

To the extent the reconciling item represents an allocation of costs or revenues, the allocation methodology should be set out. However, where the allocation methodology has been approved by the Board for that type of item and there are appropriate compliance procedures to ensure that the approved methodology is followed, a statement to this effect and reference to where the approved methodology could be found would be adequate.

This reconciliation is an important control feature to help ensure that the costs and any ancillary revenues have been properly allocated to regulated operations, that non-recoverable costs have been appropriately removed and that the revenue requirement for regulated operations is not overstated.

Q. Should a regulatory board be concerned with the revenues and costs of non-regulated operations?

A. Normally, a regulatory board only has jurisdiction over an enterprise's regulated operations. It does not concern itself with non-regulated operations, except to the extent that they affect regulated operations.

For example, where regulated operations provide management services to non-regulated operations, it is reasonable to ask for information on the amount of the inter-corporate charge and to see this charge in the reconciliation between the utility's corporate reports and its regulatory reports. This is a control feature that helps ensure that the inter-corporate charges have been correctly removed from the revenue requirement.

It may also be appropriate to ask for information on the nature of the services provided, the amount of the charges for those services and how the amounts were determined. This information would help ensure that there were charges for all services provided and the charges were appropriate.

Although a regulatory board may not have jurisdiction over non-regulated operations, it does have a responsibility to ensure that the rates of the regulated operations are just and reasonable and that its revenue requirement is adequately supported. Where this requires information on non-regulated operations or from a non-regulated affiliate, and the information is not provided, the regulator has the option to disallow all or a portion of the costs that are not adequately supported. Or where information is required on ancillary revenues or transfer prices, a regulatory board can normally deem an appropriate amount of revenue in establishing revenue requirements.

Q. Would you please summarize your testimony on regulatory reporting.

A. Hydro should maintain separate accounting records and produce financial reports for its regulated operations as if they were a separate reporting entity. It should also reconcile its annual corporate financial reports with its regulatory financial reports. All material reconciling items should be separately identified and explained. Especially since this is Hydro's first rate hearing, Hydro should provide an appropriate definition of regulated operations for Board review.

4. RETURN FOR A PUBLIC SECTOR UTILITY

Q. How has Hydro calculated its revenue requirements in the past?

A. My understanding is consistent with what was presented in Ms. McShane's evidence. The total revenue requirements were set equal to the sum of the operating and maintenance expense, deprecation expense, interest expense and a margin. In its last review, the Board recommended that Hydro be allowed the opportunity to earn a margin based on an interest coverage of 1.08 times gross interest, excluding the Rural Isolated Systems[1].

[1] In the "Report of the Board of Commissioners of Pubic Utilities to The Honourable Minister of Mines and Energy Government of Newfoundland & Labrador on a Referral by the Lieutenant-Governor in Council Concerning Rural Electrical Service" dated July 29, 1996, the Board recommended the elimination of interest margin on the Hydro rural interconnected system and that a rate of return not be allowed on rural electrical assets, as long as the rural system is operating on a deficit basis (page 35).

In her evidence Ms McShane stated that the margin was set "essentially to provide protection that helped ensure that Hydro would recover in rates adequate funds to pay the interest expense." However, it would appear that the margin has also been used to provide compensation to Hydro's owner, the Government of Newfoundland & Labrador. Between 1995 and 2000, Hydro paid out $58.4 million in dividends, which represents 49.2% of its earning of $118.6 million over that period. Based on Hydro's forecasts, the dividends over the period 1995 to 2002 will amount to $140.5 million or almost the entire amount of its earnings.[2]

Q. What change is Hydro proposing?

A. Hydro is proposing to use a return on rate base methodology. With this methodology, revenue requirements would include operating and maintenance expenses and depreciation expense as before. However, instead of including interest expense and a margin, an allowed return on rate base would be included in revenue requirements.

In itself, this change should not have a material impact on revenue requirements. The methodology simply requires a return on rate base. Its application does not require a specific approach for establishing the return on equity used in calculating the return on rate base, or even for establishing the return on rate base.

Hydro may question whether a return that provides a margin equal to 8% of gross interest is an appropriate equity return; however this is a separate issue.

[2] This information is based on Hydro's Response to Information Request NP-72, which appears to have included some non-regulated operations.

Q. What is Hydro requesting in setting its allowed rate of return to be applied to rate base.

A. Hydro is proposing to use a weighted average cost of capital. This rate would be based on its forecast actual capital structure as reported by Hydro, its forecast debt costs as a percent of average debt and a return on equity of 3%. However, in his evidence, Mr Wells stated that, in the assessment of Hydro's financial position and the determination of its revenue requirement, Hydro should be viewed as a commercial entity.

According to Mr. Wells, it is Hydro's view that the normal financial targets for a utility operating as a commercial entity would be a debt / equity ratio of 60 / 40 and return on equity of 11.0% to 11.5%. Hydro is proposing to move to commercial debt / equity ratio, although it does not currently have a plan for how to achieve it. In its next hearing, Hydro is proposing to seek a commercial return on equity.

Q. Do you believe it is appropriate for a public sector utility to use normal commercial targets in determining its allowed return on rate base?

A. In principle, yes. However, consideration must be given to social and public policy objectives pursued by such a utility.

I believe that there is an opportunity cost associated with the investment of a government in a utility and the allowed return on rate base for a public sector utility should be determined on a stand alone basis, the same as an investor owned utility.

However, governments may own utilities for reasons other than earning a financial return. They often own them so as to assist in achieving social or public policy objectives. Accordingly, it may be appropriate for a public sector utility to seek a lower return or to incur costs that are not recoverable through rates and which effectively reduce the return to the owning government.

Q. Should all payments to the owner of a public sector utility be treated as part of the utility's return?

A. It depends on the nature of the payments.

I believe that there must be a separation between the role of the government as investor in the utility and the normal role of the government. For example, payments such as payroll taxes that would normally be paid by a privately owned utility should be considered recoverable costs and not be considered as part of the return to the owning government. This assumes the amounts are comparable to what a privately owned utility could be expected to pay.

Also, charges for services provided should be treated the same as where a privately owned company provides services to an affiliated utility. Where the service benefits regulated operations and is reasonable, the charges should be considered a recoverable cost. To the extent that it does not meet this test, it should be considered a non-recoverable cost and, in effect, reduce the return to the owner.

However, costs that would not normally be incurred by a privately owned utility and that result from government ownership should be excluded from recoverable costs and, in effect, should be applied as a reduction to the return to the owner.

It should be noted that the Board, like other regulatory boards, treats certain costs as shareholder costs and not recoverable through allowed rates. In effect, the return of the owner is reduced below the level that would otherwise be considered fair and appropriate by the amount of the disallowed costs.

This is how this Board treats charitable donations. A utility is allowed to make the donation but the amount is deemed to be a shareholder cost which effectively reduces the utility's allowed return.

Q. Are there cases where a regulatory board should accept charges that would not normally be incurred by a privately owned utility?

A. Yes. A regulatory board is required to conform with the legislation under which it operates or with directions provided in accordance with that legislation. In this regard, section 5.1 of the *Electrical Power Control Act, 1994* provides for an open and transparent process whereby the Province can give specific direction to the Board and the Board will hold a public hearing to address the directive and report back to the Province.

However, in the absence of specific direction, either through legislation or in accordance with the legislation governing the Board, the Board should disallow costs that would not normally be incurred or allowed if Hydro were a privately owned utility.

Q. Does Hydro have any costs related to social or public policy objectives?

A. It appears that there is at least the possibility of such costs.

In Response to Information Request NP-76, Hydro was asked to identify differences between the way it is intended to operate and the manner in which an investor-owned utility operates. As part of its response, Hydro stated that: "As a Crown Corporation Hydro may receive directions from its shareholder, the Government of Newfoundland & Labrador, which reflects social or public policy considerations, not in conflict with legislation, which Hydro will implement."

It is significant that Hydro referred to the directions coming from its shareholder. Where a utility is wholly owned by one owner, it is not unusual that a utility would follow directions from it shareholders. However, this Board should not be constrained by directives to Hydro from its shareholder, any more than it should be constrained by directives from Fortis to Newfoundland Power. It should determine what is just and reasonable without reference to social or public policy objectives of the government, unless there is specific direction provided to this Board either through the legislation governing the Board or in accordance with that legislation.

It would therefore be appropriate to ask Hydro to identify all cases of where it has pursued social or public policy objectives, whether on its own account or at the direction of its shareholder. It should also be asked to identify and support the associated impact on its revenue requirement. Since the increase in revenue requirement is incurred for the benefit of the shareholder and is not necessary for the provision of regulated service, the associated impact should be removed from revenue requirements.

Q. Should the Deficit on the rural electrical system ("Deficit") affect the return allowed to Hydro?

A. The Board should explore whether the Deficit should be viewed as a recoverable cost or as a shareholder cost and, in effect, reduce the return to the shareholder.

Just and reasonable rates normally mean rates that contain no undue discrimination. It can be argued that cross subsidization represents a form of discrimination. Some customers have to pay more than the cost of providing them with service while others pay less. However, in many jurisdictions, it appears that at least some cross-subsidization is not viewed as undue discrimination. Cross-subsidization has been common among utilities and telecommunications companies, although in the case of the telecommunications companies, there has been a significant reduction in the level of cross-subsidization over the last 10 to 15 years.

Although cross-subsidization is common, as this Board noted in its 1995 report on rural electrical service, the burden is significantly higher in Newfoundland than the corresponding burden borne by ratepayers in other jurisdictions, who cross-subsidize rural losses to a lesser extent.[3]

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[3] Report of the Board of Commissioners of Public Utilities to the Honourable Minister of Natural Resources, Government of Newfoundland & Labrador on a Referral by the Lieutenant Governor in Council Concerning Rural Electrical Service; October 10, 1995; pg. 13.

Until 1989, the Government funded the Deficit from the Consolidated Revenue Fund. In 1989 the Government began a three-year phase-out period, wherein the subsidy was transferred from taxpayers to ratepayers. It could therefore be argued that the Government, in its role as the government, has indicated that the subsidy should be recovered from ratepayers and not the taxpayers. However, at that time and until new rates are set, Hydro's allowed earnings have been determined as a by-product of an interest coverage margin of 8% (i.e., a return to produce an interest coverage ratio of 1.08).

Also, the Board has concluded that a margin should not be allowed on the interest expense associated with financing the rural assets. Consistent with this policy, Hydro is not seeking an equity return on the rural assets in these proceedings.

Therefore, there is a question whether the Government considered the cost of equity to be a cost recoverable through allowed rates at the time it decided to transfer funding for the Deficit from the taxpayer to the ratepayer. There is at least a question whether there was a recoverable cost in excess of the 8% margin.

Certainly, the Board will be required to follow explicit legislation or directives in accordance with its legislated mandate. However, in the absence of explicit direction, it can be assumed that the Board is expected to apply its judgment in determining rates that are reasonable and not unjustly discriminatory.

Therefore, the Board should exercise its judgment in determining what is just and reasonable and consider whether to continue setting the recoverable return on equity on the basis of on an interest margin of 8% (i.e., 1.08 times interest expense), or whatever margin it felt appropriate, so as to reduce the amount of the subsidy that must be funded by ratepayers. In effect, a portion of the deficit would be considered a non-recoverable cost and as part of the return to the owner, the same as donations.

Q. Is it appropriate for Hydro to pay a dividend that will reduce its equity ratio to 13%?

A. Not if that payment imposes unnecessary additional costs on ratepayers.

Although Hydro has stated that its dividend policy is to pay dividends equal to 75% of its earnings, it is planning to pay a dividend of $70 million in 2002, which represents 730% of its forecast earnings in that year (see Response to Information Request NP-72). With this dividend, it is forecast that Hydro will have paid out almost all of its income earned over the period 1995 through 2002[4] and its equity ratio will fall to 12.93% (see Response to Information Request IC-197).

Utilities often have high dividend payout ratios; however, they generally have equity ratios that are significantly higher than Hydro's.

Table 3 in Exhibit JTB-2 sets out the dividend payout ratio for major Canadian utilities over the five-year period ending with 2000, including 7 public sector electric utilities. For the private sector utilities, the five-year average payout ratio ranged from 54% to

[4] These amounts exclude CF(L) Co. and Recall.

144%. However, these companies have much stronger common equity ratios than Hydro as indicated for the privately owned electric utilities in Tables 1 and 2 in Exhibit JTB-2.

In most cases, the information on public sector electric utilities does not support Hydro's dividend payments. Of the seven public sector utilities in Exhibit JTB-2:

(1) Two did not pay dividends over the five year period: Manitoba Hydro and NB Power;

(2) Three paid dividends but had equity ratios in the range of 34% to 47%; EPCOR, SaskPower and Hydro One.

(3) The remaining utilities had restrictions on their ability to pay dividends: BC Hydro and Hydro Quebec.

Hydro Quebec cannot pay dividends that exceed approximately 75% of net income or would result in its equity ratio falling below 25% - almost twice the level that Hydro will have at the end of 2002. BC Hydro cannot pay dividends that would reduce its equity ratio below 20%; however, equity includes contribution, deferred revenue and the rate stabilization account.

Q. If the Board considers Hydro's dividends to be excessive, what should it do?

A. Where the dividend payments result in higher revenue requirements, one option is to deem a capital structure as if the dividends had not been paid.

With this option, the Board would set the margin in establishing the recoverable return on equity on the basis of the deemed amount of interest expense. It would also treat the debt guarantee fee related to debt deemed to be equity as a non-recoverable cost.

It should be noted that in the past the Board has recognized its ability to set a deemed capital structure. In a 1998 decision dealing with Newfoundland Power (P.U. 16 (1998-99)), the Board stated: "For purposes of setting interim rates utilizing 1997 test year data, pursuant to Section 75 of the Act, the Board will deem a common equity ratio of 45%. Common equity above this level will be treated as preferred equity." (pg.58)

Q. Would you please summarize your testimony on establishing the return for a public sector utility?

A. In principle, a public sector utility should be allowed to establish its cost of capital in manner similar to that of a private sector utility. However, governments often own utilities so as to assist in pursuing social or public policy objectives and may not seek a full return.

The role of an owning government as investor should be separated from its normal role as government. As an investor, it should be treated the same as any other investor, unless there is legislation or specific direction provided in accordance with the legislation governing the regulatory board. Accordingly, the customers of a public sector utility should not be required to pay more than they would if the utility were privately owned and the utility should not be allowed to recover costs that would not normally be borne by a privately owned utility.

Consistent with the above, Hydro should be required to identify the costs that it incurs to pursue social and public policy objectives. These costs should be treated as shareholder costs and removed from revenue requirements.

Cross-subsidization does occur with utilities. However, as previously recognized by this Board, the Deficit that Hydro passes on to some of its customers is unusually large. Given this, the Board should consider whether it is just and reasonable to change the basis for setting the return that Hydro can recover through allowed rates while retaining this unusually large subsidy. It should consider whether to effectively treat part of the Deficit as return to the owner.

The dividend that Hydro is planning to pay in 2002 is unusual, as are any dividends given its current equity ratio. Where the dividend policy results in a higher than necessary revenue requirement, the Board should deem a capital structure for rate setting purposes that assumes dividends are not paid.

5. ACCOUNTING ISSUES

Inter-corporate Charges

Q. Do inter-corporate charges pose a potential risk for regulatory objectives?

A. Yes.

By overpricing what a utility pays to acquire goods and services from an affiliate, or by under pricing what its provides to an affiliate, the amount recoverable through allowed rates can be increased with a corresponding increase to the return to the owner of the utility. This would be contrary to the cost of service standard.

Q. What are the standards that regulatory boards apply to the setting of inter-corporate charges?

A. The key standard, either explicitly or implicitly stated, is that the charges should reflect what would be established in an arms-length transaction. The best measure of this is market price.

Regulatory boards normally prefer that inter-corporate charges reflect market prices; however, this is often impractical. Where market prices are impractical, regulatory boards generally rely on cost-based pricing. These prices reflect the cost of providing the good or service, including a fair return.

Costs should be allocated on the basis of causality - that is, a cost should be allocated to what caused the cost to be incurred. Unfortunately, fixed common costs cannot be allocated on this basis. In developing inter-corporate charges, fixed common costs must be allocated and the preferred approach is usually relative benefits receive.

As a general rule, a cost allocation methodology that affects regulated rates should avoid the use of subjective judgment. It should be possible to objectively apply the methodology and verify the results. This helps to ensure that the results are appropriate and in accordance with the principles and procedures approved by the regulatory board.

It appears that this is an issue with Hydro. On page 22 of its 1999 Annual Financial Review of Newfoundland & Labrador Hydro, Grant Thornton made the following comment in relation to Hydro's allocations to CF(L) Co:

> "In reviewing the manner in which costs are allocated we observed that many of the methods of allocation are subjective and rely upon the judgment of Hydro management, consequently these allocated costs are not susceptible to proper verification"

It is difficult to avoid subjective judgment. It will be required in establishing the cost allocation methodology, in choosing the allocators and in establishing how the allocators will be determined. However, this subjective judgment should be an input to the development of the policies and procedures that the regulatory board approves. In this way the regulatory board has an opportunity to review the decisions based on the application of subjective judgment and review their appropriateness. To the extent practical, subjective judgment should be avoided in applying the policies and procedures.

As part of its obligation to ensure that rates are just and reasonable, a regulatory board should review inter-corporate charges to establish whether they are just and reasonable and it should ensure that there is adequate support for the charges.

The above issues are discussed in more depth in Exhibit JTB-3.

Q. Are inter-corporate charges (including charges to non-regulated operations) an issue in this proceeding?

A. Yes:

(1) According to Schedule I of Mr. Robert's evidence, allocations to CF(L)Co amounted to $2.4 million in 1992 and are projected to be $1.9 million in 2002.

(2) According to Exhibit JAB-1, page 8 of 94, $3.1 million will be allocated to the IOCC sales in 2002.

(3) Officers of Hydro are also officers of the affiliated companies Twin Falls Power Corporation Limited, Lower Churchill Development Corporation Limited and Gull Island Power Company Limited, although no allocations were reported by Hydro.

(4) Hydro provides services to support the recall sales to Hydro Quebec, although no allocations to this non-regulated operation were reported by Hydro.

Q. What support should Hydro provide for its inter-corporate transactions?

A. Hydro should be required to identify the various types of goods and services that it provides to or acquires from its affiliates and non-regulated operations. For each type of transaction, it should develop policies and procedures for establishing a transfer price or for allocating the costs. The policies and procedures should be presented to the Board for review and approval. This is necessary for the Board to control inter-corporate charges and ensure that they are appropriately reflected in allowed rates.

Hydro should periodically report the aggregate amount of its transactions with affiliates and non-regulated operations by type and indicate whenever the nature of these transactions has changed. A material change in the size or nature of its transactions may require a review of its policies and procedures.

As part of the Board's review of its policies and procedures, Hydro should indicate the nature of the goods or services it provides to affiliates or receives from affiliates and the terms associated with the transactions. This will help the Board and interveners to better understand if the policies and procedures are appropriate.

The policies and procedures should be developed so that the resulting transfer prices or allocations can be verified. Also the policies and procedures should contain compliance procedures. For example, Hydro should have procedures for ensuring that all employees who might be involved with an affiliate, or non-regulated operations, are aware of the policies and procedures. This is necessary to help ensure that transfer prices and cost allocations reflect the policies and procedures approved by the Board.

Q. Would you please summarize your testimony on inter-corporate charges?

A. Inter-corporate charges should reflect what would be established in an arms-length transaction. The best measure of this amount is market price.

Regulatory boards normally prefer that inter-corporate charges reflect market prices. Where market prices are impractical, they generally rely on cost-based pricing. These prices reflect the cost of providing the good or service, including a fair return.
As part of its obligation to ensure that rates are just and reasonable, a regulatory board should review inter-corporate transactions and seek appropriate support for them.

Where costs are to be allocated, they should be allocated on the basis of causality – costs should be allocated to the cost object that caused them to be incurred. Fixed common costs cannot be allocated on the basis of causality but should be allocated where the cost allocation is used to support inter-corporate charges. Where they should be allocated, the fixed common costs should be allocated on the basis of beneficiality, which is often approximated by relative usage.

Hydro should be required to support its inter-corporate charges and cost allocations. As a first step, it should identify the goods and services it provides or acquires from non-regulated affiliates. It should then develop policies and procedures for determining the transfer prices or cost allocations to cover these transactions, or at least each type of transaction, and compliance procedures for ensuring that the policies and procedures are followed. Where appropriate, the procedures should include the cost allocation methodology. The policies and procedures should be developed so that the transfer prices and cost allocations can be objectively verified, at least to the extent practical.

Employee Future Benefits

Q. How does Hydro deal with post employment benefits other than pensions (“OPEBs”)?

A. It is my understanding that in the past Hydro employed the “pay-as-you-go” or cash method for both financial reporting purposes and for rate setting purposes. With this approach, the cost of the benefits is recognized when they are paid.

With the introduction of the new Section 3461 of the CICA Handbook – Accounting ("Handbook"), Hydro has moved to the accrual method for financial reporting purposes and is proposing to do so for rate setting purposes.

Under Section 3461, which became effective for financial years starting January 1, 2001 (although earlier adoption was encouraged), it is no longer acceptable for financial reporting purposes to employ the cash method. Instead the accrual method must be used. However, at the current time, if the cash method is required by a regulatory board, a utility could set up a regulatory asset to reflect the expected amounts that will be recovered through future allowed rates. Alternatively, it could continue to employ the cash method. In either case, the impact on net income and net assets would be the same.

Under the accrual method, the present value of the future obligation is expensed and recognized as a liability in the period that the service giving rise to the liability is rendered. In addition, interest on the liability is recognized each period so that, when the payments are made, the amount expensed (present value plus interest) will equal the cost of the benefits paid out.

Q. How do you deal with the transition from the cash to the accrual method?

A. The transition from the cash to the accrual method gives use to a transitional obligation. This obligation represents the present value of the liability for future OPEB payments at the time of the transition.[5]

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[5] That is, the present value of the future cash payments on account of past service at the time of the transition.

According to Section 3461, a company can deal with the transitional obligation either retroactively or prospectively.

(1) If applied retroactively, the company's financial reports are presented as if it had always employed the accrual method.

(2) If applied prospectively, an entity should amortize the transitional obligation in a rational and systematic manner over an appropriate period of time, which is normally the average remaining service period of active employees expected to receive benefits under the benefit plan.

Q. How has Hydro decided to deal with the transitional obligation?

A. Hydro decided to apply the change to the accrual method retroactively and reduced its opening retained earnings for 2000 by the amount of the transitional obligation. In effect, Hydro is saying that it will never attempt to recover this cost through allowed rates.

Q. Is it appropriate for a utility to write-off the transitional obligation for rate setting purposes?

A. Under the cost of service standard, a utility should have a reasonable opportunity to recover its cost of providing service. The transitional obligation represents the cost of the OPEBs that a utility has not had an opportunity to recover through allowed rates at the time of the transition to the accrual method. Therefore, under the cost of service standard, it should be allowed to recover the cost of transitional obligation through future rates. Of course, a utility should normally be allowed to exclude certain costs in determining its revenue requirements. This is especially true of public sector utilities that may be attempting to pursue social objectives of its owner. Therefore, I do not see a problem in Hydro writing off the transitional obligation.

Q. Must a regulated utility follow GAAP as set out in the Handbook?

A. No. The recommendations in the Handbook are designed to support good financial reporting. However, regulators are attempting to set just and reasonable rates.

In most cases, what is appropriate for financial reporting purposes is appropriate for rate setting purposes. However, differences can arise. For example, where a utility initiates an employee severance program, it would be required to expense the cost of the program in the period that the program was announced. However, for rate setting purposes, a regulator may decide that the cost should be recovered in rates over a five year period because, in its opinion, the resulting rates would be more just and reasonable. Another common example is the treatment of deferred income taxes employed by this Board[6].

Q. Should a utility apply the accrual method for OPEBs in setting allowed rates?

A. If a utility did not have a transitional obligation, I believe the accrual method would normally be preferable to the cash method.

[6] According to Section 3465 of the CICA Handbook-Accounting, companies must recognize the estimated amount of future income taxes that will be payable as a result of the operations in the period. The difference between this amount and the amount currently payable is set up as a future income tax liability. However, many of the energy utilities, such as Newfoundland Power, are required to use the flow through method for rate setting purposes in which only the taxes currently payable are recognized for rate setting purposes. Section 3465 does allow regulated utilities to use the flow through method if they use the method for rate setting purposes; however, this reflects the economic impact of the regulatory decision rather than providing guidance for a regulatory decision.

Under the accrual method, the cost of the OPEBs is expensed in the period that the services giving rise to the obligation are rendered. It is therefore consistent with the principle of intergenerational equity. The customers who receive the benefits of current employee services pay for the future costs that will result from those current services.

Q. What are the implications of a transitional obligation for adoption of the accrual method in setting rates?

A. Where there is a transitional obligation, a board may decide that it is more “just and reasonable” to retain the cash method. With this approach, rates reflect the cost of past service but not current service. If there is a switch to the accrual method, rates must reflect the cost due to current service plus a portion of the cost related to past service through the amortization of the transitional obligation.

In deciding on whether to change to the accrual method, there are two key issues that a regulatory board should consider:

(1) The first is the impact on rates due to recovering both the current obligation plus a portion of the past transitional obligation. Because of this impact, a regulatory board may decide that a utility should continue with the cash method. Alternatively, a regulatory board may decide to delay implementation of the transition until it can be accommodated with a smaller impact on rates.

(2) The other is the risk to the utility. The cash method results in a regulatory commitment to allow a utility to collect through future rates the amount of the future employee benefits when they become payable. However, with a changing environment, at some point in the future, it may become difficult to recover a cost related to the provision of past services.

Q. Will the impact of the switch to the accrual basis, as proposed by Hydro, have a material impact?

A. Not in itself, however, consideration should be given to the overall rate increase, including the impact of the RSP

According to Hydro, its OPEB expense in 2002 with the accrual method will be $2.2 million while the expense with the cash method would be $1.2 million. Therefore, the switch to the accrual method will represent 0.31% of Hydro's revenue requirement for 2002 (1.0 / 318 = 0.31%). If the difference were to stay in this range over the next few years it would not have a material impact on rates, in itself.

However, with the impact of the RSP, Hydro is proposing an increase in 2002 of 12.6% in the wholesale rate to Newfoundland Power, which will have an impact of 7.1%[7] on its customers. In light of these increases, the Board may question whether this is the right time to switch from the cash to accrual method.

Q. Would you please summarize your testimony on OPEBs?

A. Where a utility switches from the cash to the accrual method for dealing with OPEBs, it should be allowed to recover the transitional obligation through allowed rates. A public sector utility may choose not to seek this recovery and Hydro has chosen not to.

[7] Based on press release issued by Newfoundland & Labrador Hydro entitled "Newfoundland & Labrador Hydro Files General Rate Application" dated May 31, 2001.

Where the transitional obligation is not material, it is preferable to use the accrual method since it is consistent with intergenerational equity. However, where the transitional obligation is material, a regulatory board may deem that continuation of the cash method is more just and reasonable.

With Hydro proposing an increase of 12.6% to Newfoundland Power in 2002, there is a question as to whether this is the right time to switch from the cash to the accrual method.

Q. Does this complete your evidence?

A. Yes.