Q. **On page 2, line 19, you state that you have been asked by Newfoundland Power to address, *inter alia*, inter-corporate charges.**

(i) **Have you reviewed Newfoundland Power's policies and procedures pertaining to inter-corporate charges?**

(ii) **Please provide a copy of Newfoundland Power's practices and procedures in reference to the same.**

A. (i) Along with Keith Boocock, Mr. Browne reviewed Newfoundland Power's inter-corporate charges in 1996. Their work was summarized in a report that was titled "Newfoundland Light & Power Co. Limited, Report on Inter-corporate Charges" dated March 18, 1996. This report was subsequently submitted to the Board as part of Newfoundland Power's 1996 general rate review.

(ii) In Newfoundland Power's 1996 general rate review, the Board heard evidence on the issue of inter-corporate transactions. In P.U.7 (1996-97), the Board issued orders relating to inter-corporate charges. Newfoundland Power uses the guidance of P.U.7 (1996-97) in accounting for and reporting transactions with related entities. A copy of the pertinent pages (75 through 82) of the Order is attached for reference.

The Order referred to the Deloitte and Touche report referenced in response to CA- 188 (i). On page 81 of the Order, the Board accepted the guidance of the principles presented in the conclusions of the Deloitte and Touche Report. A copy of the conclusions from the report are attached.

The Board notes that the 1996 capital expenditure forecast has been adjusted to reflect what is known to be a reduced distribution expenditure for 1996. However, there is no indication in the evidence that the 1997 capital expenditure forecasts have been adjusted in any sense to reflect what is often a normal deferral process during a particular year. This omission is of concern to the Board. This was considered a necessary part of the 1991 financial model used by the Applicant. The Board views the capital expenditure amount for 1995 of $30.8 million as reflective of a very low level capital budget. The years 1996 and 1997 continue to be very low dollar value capital budgets. Therefore, it does not seem reasonable to apply a reduction for possible deferrals during the year in the order of 20% without a risk of impairment in quality service and reliability. However, the Board believes that a 4% reduction in the value of the capital expenditure budget for the year 1997 would be reasonable to reflect what has been the regular deferral process. This would result in a reduction to the depreciation expense of 1997 of approximately $40,000.

Board Determination

The Board orders that for rate setting purposes the 1997 capital expenditure budget be reduced by 4% and that the 1997 depreciation expense be reduced by $40,000.

Inter-corporate Transactions and Charges

The Applicant is one of the wholly owned subsidiaries of Fortis Inc. and is the largest subsidiary of the group. As a result, it is incumbent upon the Applicant to document fully all transactions with its parent company as well as with any of the subsidiary group. Due to the absence of arms length negotiation in any inter-corporate transaction, measures must be put in place to guide

the transaction, ensure fair prices that protect the ratepayers and provide transparency so that all stakeholders are able to follow each transaction.

To monitor such transactions among related companies, the Board directed in Order No. P.U. 6 (1991) that a quarterly reporting mechanism be put in place, that the code of accounts be modified to identify all inter-corporate transactions and that the Applicant conduct a study into the financial policies of regulated Canadian utilities with respect to mark up percentages on related party transactions. While a quarterly reporting mechanism was put in place, the reports were not always timely. The 1991 Board Order did not specify deadlines. This Order will rectify this matter.

While the code of accounts was expanded to identify all Fortis Inc. transactions, specific codes were not used to identify transactions with other Fortis Inc. subsidiaries, such as Unitel Communications Inc. (Unitel). The Board believes that such codes are necessary and requires the Applicant to begin tracking inter-corporate transactions for all subsidiaries of Fortis Inc., by account codes similar to Fortis Inc.'s codes. The Applicant filed its study by Deloitte and Touche into the financial policies of regulated Canadian utilities with respect to inter-corporate charges as of March 20, 1996.

According to Deloitte Touche, many of the items allocated by Fortis Inc. are transferred to non-regulated expenses. These included: directors' fees, annual report expenses for Fortis Inc., management fees, and any trustee fees and listing fees attributable to financing non-regulated operations. Deloitte Touche also stated that the Applicant allocates any costs considered to represent a duplication of amounts already incurred entirely to non-regulated operations. Non-regulated inter-corporate transactions represented 57.0% of 1993 inter-corporate costs, 35.0% of 1994 inter-corporate costs and 47.0% of 1995 inter-corporate costs.

Deloitte Touche concludes regarding the allocation of costs:

> "To summarize, in determining the principles to be followed in allocating costs to a regulated entity, the core principle is that the regulated entity should only be paying for costs which are undertaken on its behalf and which can be traced to it, or for which it can be identified as receiving a benefit. Similarly, an affiliate of a regulated entity should be charged for costs undertaken on its behalf and which can be traced to it, or for which it can be identified as receiving a benefit."

During final argument, intervenors still expressed concerns with respect to inter-corporate charges. These concerns included: timeliness of quarterly reports, early representations of the Applicant regarding costs of Fortis Inc. with respect to trustee fees and keeping time cards, executive salary allocations, alleged cross subsidization of capital structures, acquisition of excess fibre optic capacity, mark-up of services provided to related parties to avoid undue advantage given to affiliates and the Holiday Inns DSM commercial heat pumps project.

With respect to the timeliness of quarterly reports, intervenors took serious exception to the delays in their preparation from time to time. While the delay(s) may have been explained to the Board when they occurred, the Board believes mechanisms should be put in place to allow the generation of reports regardless of logistical problems that have arisen.

Board Determination

The Board orders that inter-corporate quarterly transaction reports be filed with the Board within 60 days following the quarter end. Since code of accounts changes were ordered in Order No. P.U. 6 (1991) 60 days is considered to be reasonable to facilitate such preparation.

The intervenors argued that the 1987 representations relating to trustee fees should bind the Applicant and Fortis Inc. to the practice of treating trustee fees as non-regulated. The Applicant stated, in its rebuttal, that these representations were made at a time when Fortis Inc. did not even exist. Further, since Fortis Inc's formation, the Board has allowed trustee fees. The Board notes that Deloitte Touche's survey of Canadian utilities shows no evidence that such fees should be disallowed in principle.

Board Determination

The Board concludes that trustee fees are justifiable inter-corporate transactions. The Board accepts the recommendation of Deloitte Touche that in allocating charges from Fortis Inc. to the Applicant for costs related to raising equity capital, equity, rather than net assets, should be used as the basis of allocation.

With respect to time sheets as the basis of executive salary allocations, the intervenors pointed to early representations by the Applicant that this would be done. There was direction provided by the Board on this matter, as well as the reports of NKHK Chartered Accountants, Deloitte Touche and Doane Raymond which indicated time support documentation was necessary.

The Board cannot accept as a regulatory cost any unsupported transactions. Salary allocations from another entity are essentially unsupportable without time and project records.

Board Determination

The Board orders the charges of Fortis Inc for Chairman's fees in 1996 be treated as non-

regulated. All future salary allocations must be supported by time records indicating the duty and time spent on the Applicant's business. Similarly, the Applicant's executive and staff must record time spent on duties for the benefit of Fortis and its subsidiaries.

Deloitte Touche stated that the Applicant's policy is that any costs considered to represent a duplication of amounts already incurred shall be treated as non-regulated. The Board notes that the Applicant has a full executive team and legal department with over eight years of experience since the creation of Fortis Inc. Hence, the Board views any executive time of Fortis Inc. as a duplication with the exception of time documented by the Corporate Secretary. Fortis Inc.'s executive time spent as the parent investor of the Applicant is fully to the benefit of Fortis Inc.'s shareholders, not to ratepayers of the Applicant.

<u>Board Determination</u>

The Board orders that executive salary transfers from Fortis Inc. be treated as non-regulated expenditures unless sufficient evidence can be provided to support that the time was not a duplication of executive services expected to be provided by the Applicant's Executives.

With respect to cross subsidization of capital structure, intervenors and the Consumer Advocate's expert witness, Dr. Kalymon, argued that the capital structure of the Applicant can be manipulated to pass on a benefit to its parent company, which maintains a different capital structure. The Board has attempted to evaluate the capital structure necessary for the Applicant as a regulated utility. Since Fortis Inc. does not issue, and is not expected to issue, interest bearing long term debt, the capital structures will never be the same. The Board believes that rates should be set in a manner that reflects the optimum capital structure of the Applicant, at the time of the rate application. The

capital structure of the Applicant has not, in the Board's opinion, been modified to cross subsidize the parent company.

With respect to excess fibre optic capacity, NewTel Communications (NewTel) argued that the Applicant has no need for the excess capacity installed in its fibre optic network and that it has been engineered to a level that far exceeds the Applicant's operational requirements. NewTel indicated that the cost of the excess capacity is not used and useful, should not be part of rate base and could in the future be offered to the Applicant's affiliate, Unitel.

The Applicant could not provide any evidence to establish why it invested in this excess capacity, other than indicating that the incremental cost of acquiring additional fibres was not significant. For the fibre optic cables installed in the last five years, the incremental cost per cable was stated to be $5,600.

The Board has considered the cost of the additional excess capacity acquired during the last five years. The Board believes the overall cost of the excess capacity is too low to track independently in relation to rate base. However, the Board is not swayed by the view that because the magnitude of excess capacity investment is not material, it therefore should continue to be made. In the event of the fibre optic network being leased in the future to any telecommunication entity, the Board would equate such a lease to a pole attachment arrangement. It would be subject to a full rate review and establishment of proper cost allocation rules.

With respect to mark-up pricing of inter-corporate transactions, intervenors raised concerns that the ratepayers should be protected, through proper cost allocations. NewTel argued that if the Applicant recovered less than full cost, plus an appropriate mark-up, from an affiliated company receiving the Applicant's service, then the shortage would be recovered from ratepayers.

By the same token, NewTel argued that, when the Applicant acquires services from an affiliated company, then that affiliate must be the lowest cost supplier, based on a proper cost benefit analysis.

The Deloitte Touche study concluded that inter-corporate charges should be at market price, where market can be demonstrated to exist, and at cost, if there is no market. In a cost-sharing situation, a mark-up ought to be provided only to permit the recovery of overhead costs. In all cases where the costs are distributed, their allocation should be supported by a study. Mark-up to cover cost of capital would apply only where assets are utilized in generating the service or good provided.

In addition to this guiding policy direction, the Board noted that Deloitte Touche identified that postage and courier charges by the Applicant should include a charge for labour and a reasonable mark-up of overhead. Also, under pole attachment charges, the Applicant is using the same methodology as used for Terra Nova Telecommunications. The methodology identified in the more recent joint use agreement or the methodology used for CATV rates should be considered, since they represent current market rates.

The Applicant stated in rebuttal that services, specifically telecommunications services, are purchased on the basis of competitive bids. The Applicant does not see the necessity for any special rules in respect of dealing with competitive services purchased from an affiliated company.

Board Determination

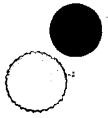
The Board continues to hold the position that inter-corporate transactions deserve special attention. The Board accepts the guidance of the principles established in the conclusions of the Deloitte Touche Report. The Board orders that inter-corporate transactions

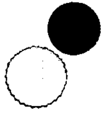
that can be obtained from a competitive market must be valued at market for regulatory purposes. In acquiring a competitive service from an affiliate, the allowed regulated expense shall be the lowest cost bid or tariff. In cost allocations from affiliates and the parent, transactions must be supported by documentation, for example time sheets. The mark-up on the cost must also be supported by reasonable documentation. A mark-up may include a return on capital only where the assets are used to deliver the service or good. Inter-corporate loans involving the Applicant must be valued at their opportunity cost and full documentation must support the rate. Pole attachment charges to Unitel should be valued at the same rates as offered to NewTel or CATV operators. Postage and courier charges must include labour and the standard overhead charge.

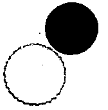
Heat Pump Project

During the hearing, the propriety and prudence of the Holiday Inns Heat Pump DSM Project was examined. The nature of the program was explained by Vice-President Erbland as a pilot project in supplying energy for large commercial water and air conditioning, using ground source heat pumps. Demand for Particulars DMB - 148 indicates some of the background of this specific project.

Ground source heat pumps were identified as potential DSM projects for a significant period before 1995. They are referenced in DSM Progress Reports of February 1991, December 31, 1992, December 31, 1993 and December 31, 1994. In the 1994 Report, a 1994 Domestic Heat Pump Project of $9,800 was identified.







CONCLUSION

Inter-corporate transactions occur extensively between Canadian utilities and related companies. It is generally recognized that inter-corporate charges should be at market where market can be demonstrated to exist, and at cost if there is no market. Where services are provided centrally for efficiency reasons, there is usually no acceptable basis for determining market, and the costs of the services are allocated among the entities using the service. In all cases where the costs are distributed, their allocation should be supported by a study.

In a cost-sharing situation, a mark-up will be provided only to permit the recovery of overhead costs; e.g., where salaries are allocated among entities, a mark-up may be provided to recover the costs associated with the salary such as benefits, space, etc.. The amount of such mark-up varies from company to company, and is specific to the costs of each company.

In addition to the previously-mentioned mark-up, there may also be a mark-up to cover the cost of capital if assets are utilized in generating the costs, and a mark-up for risk if there is a risk arising to one of the entities which is not present to all. An example of the latter occurs when employees are transferred between entities, or their costs are split between entities, but the risk of offering ongoing employment or incurring termination costs is with only one of the entities. In such a case, the CRTC has determined that a mark-up of 25% over causal costs is reasonable. Where operations are carried out on behalf of another entity in a group, the CRTC has also concluded that a 25% mark-up from cost is appropriate.

In the case of NP, market prices are used where they are available. The interest rate for loans is set to reflect market rates. The rental charges from NP to Unitel are based on market values. The charge from Unitel for telecommunication services is the result of a competitive bidding process. The charge to Unitel for the use of NP poles is based on the same methodology NP used when it dealt with an arms-length organization. Since market value is the preferred basis for establishing inter-corporate charges, these charges are consistent with regulatory theory and precedent.

Where market does not exist, inter-corporate charges from or to NP reflect either the direct costs or a share of the costs. Where there are normal loadings for materials, these are added to the charge. In the case of Fortis executive and staff costs charged to NP, an overhead rate of 25% is added to the charge.

This overhead rate lacks specific support but does not appear to be unreasonable. In the case of NP staff and labour costs charged to affiliates, an amount is added to cover employee benefits. A position could be taken that there should be an allocation of other related costs should as office space, etc., or a mark-up for overhead costs. Should these additional amounts be added to the inter-corporate charges, they should be applied both to the amounts charged by NP to its affiliates and the charges to NP from its affiliates. However, the amounts are relatively small and would likely not justify the amount of work required to estimate these additional allocations. Except for the situations noted below, the cost based charges are consistent with regulatory theory and precedent.

- In allocating charges from Fortis to the subsidiaries for costs related to raising equity, equity rather than net assets would be a preferable basis of allocation.
- The charge for the services of Dr. A.A. Bruneau is not adequately supported.
- In the case of NP's charges for postage and couriers, the charge covers direct costs only; there is no mark-up to for labour, use of space, etc. However, at current levels of service to NP's affiliates, it is unlikely that the amount of any mark-up would be significant.