Board of Commissioners of Public Utilities
2001 Annual Financial Review of
Newfoundland and Labrador Hydro

Grant Thornton

Contents

	Page
Introduction	1
Accounting System and Code of Accounts	3
Return on Rate Base and Equity, Interest Coverage and Capital Structure	4
Other Costs	9
Revenue Requirement	28
Depreciation	29
Rate Stabilization Plan (RSP)	31
Deferred Charges	32
Cost Control/Productivity Initiatives	33
Contribution in Aid of Construction (CIAC's)	34

Schedules

1	Balance Sheet
2	Statement of Earnings and Retained Earnings
3	Reconciliation of Net Income to Revenue Requirement
4A	Comparison of Total Cost of Energy to kWh Sold and Used
4B	Comparison of Costs as a Percentage of kWh Sold and Used
4C	Comparison of Other Costs by Breakdown
5	Rate Stabilization Plan Summary

Introduction

This report to the Board of Commissioners of Public Utilities ("the Board") presents our observations, findings and recommendations with respect to our 2001 Annual Review of Newfoundland and Labrador Hydro ("the Company")("Hydro").

Scope and Limitations

Our analysis was carried out in accordance with the following Terms of Reference:

1. Examine Hydro's accounting system and code of accounts to ensure that it can provide information sufficient to meet the reporting requirements of the Board.

2. Calculate the return on rate base, return on equity, capital structure and interest coverage ratio.

3. Conduct an examination of operations and administration expenses, fuels, power purchased, depreciation, and interest to assess their reasonableness and prudence in relation to sales of power and energy. The examination of the foregoing will include, but is not limited to, the following:

   a) salaries and benefits,
   b) system equipment maintenance,
   c) insurance (including director's liability),
   d) transportation,
   e) building rental and maintenance,
   f) professional services,
   g) miscellaneous,
   h) capitalized expenses,
   i) intercompany charges,
   j) office expenses and membership fees,
   k) equipment rentals
   l) fuels,
   m) power purchased,
   n) depreciation,
   o) interest.

4. Verify Hydro's reconciliation of Net income to Revenue Requirement for 2001. Review and assess the reasonableness of adjustments in the calculation of revenue requirement.

5. Review Hydro's rates of depreciation and assess their compliance with the 1986 Peat Marwick Depreciation Policy Study. Assess reasonableness of depreciation expense.

6. Conduct an examination of the changes to the Rate Stabilization Plan to assess compliance with Board directives.

7. Conduct an examination of the changes to deferred charges and assess their reasonableness and prudence in relation to sales of power and energy.

8. Review Minutes of Board of Directors' and Management Committee meetings.

9. Review Hydro's initiatives and efforts with respect to productivity improvements, rationalization of operations and expenditure reductions. Obtain update on current activities and inquire as to any future initiatives currently being evaluated.

10. Review a sample of Contribution in Aid of Construction (CIAC) calculations for accuracy and compliance with approved policy.

The nature and extent of the procedures which we performed in our review varied for each of the items in the Terms of Reference. In general, our procedures were comprised of:

- enquiry and analytical procedures with respect to financial information included in the Company's records;
- examining, on a test basis where appropriate, documentation supporting amounts included in Company's records; and,
- assessing the Company's compliance with Board directives.

The procedures undertaken in the course of our financial review do not constitute an audit of Hydro's financial information and consequently, we do not express an opinion on the financial information as provided by Hydro.

The financial statements of the Company for the year ended December 31, 2001 have been audited by Ernst and Young LLP, Chartered Accountants, who have expressed their opinion on the fairness of the statements in their report dated February 8, 2002. In the course of completing our procedures we have, in certain circumstances, referred to the audited financial statements and the historical financial information contained therein.

Accounting System and Code of Accounts

Scope: ***Examine Hydro's accounting system and code of accounts to ensure that it can provide information sufficient to meet the reporting requirements of the Board.***

Section 58 of the *Public Utilities Act* states that the Board may prescribe the form of all books, accounts, papers and records to be kept by Hydro and that Hydro shall comply with all such directions of the Board.

The objective of our review of Hydro's accounting system and code of accounts was to ensure that it can provide information sufficient to meet the reporting requirements of the Board. We have observed that the Company has in place a well-structured, comprehensive system of accounts and organization / reporting structure. Hydro was able to meet all our requests for information and reports on a timely basis during our Annual Review.

In regards to Section 58 of the *Public Utilities Act*, the written order of the Board P.U. 7 (2002-2003) on June 7, 2002 indicated that Hydro's current code of accounts was approved but Hydro was required to file written policies and procedures for the accounting of all intra and inter-corporate transactions. These policies and procedures should detail what is considered regulated and non-regulated activities.

Our review indicates that Hydro did file these written policies and procedures with the Board in 2002. We will review them as part of our 2002 annual financial review.

Return on Rate Base and Equity, Interest Coverage and Capital Structure

Scope: ***Calculate the return on rate base, return on equity, capital structure and interest coverage ratio.***

Return on Rate Base

The average rate base for 2001, 2000 and 1999 has been calculated using the approach and methodology approved by the Board for the forecast 2002 rate base in P.U. 7 (2002-2003).

In addition to the new approach and methodology utilized by Hydro, the 1999 net income and interest expense have been restated to reflect the adjustments made by Hydro to the calculation of the profit contribution from the Hydro Quebec recall. These adjustments, which are consistent with the adjustments incorporated in the 2002 forecast test year are described in more detail in the revenue requirement section of our report.

Based on this approach, we have calculated the return on rate base for 2001 at 7.89% as compared to 7.69% for 2000 and 6.88% for 1999. Details with respect to the calculation of average rate base and return on rate base are as follows:

(000)'s	**2001**	**2000**	**1999**
Plant investment	$ 1,719,700	$ 1,678,600	$ 1,640,900
Less: Accumulated depreciation	(407,100)	(380,500)	(351,700)
CIAC's	(88,600)	(89,000)	(89,800)
	1,224,000	1,209,100	1,199,400
Balance previous year	1,209,100	1,199,400	1,219,300
Average	1,216,550	1,204,250	1,209,350
Cash working capital allowance	3,265	2,947	2,940
Fuel inventory	17,280	20,005	10,238
Supplies inventoy	20,720	21,251	21,933
Deferred realized foreign exchange loss	86,300	87,300	88,300
Average rate base	$ 1,344,115	$ 1,335,753	$ 1,332,761
Net income (as adjusted per Schedule 3)	$ 13,237	$ 5,850	$ (3,647)
Hydro net interest expense	92,788	96,868	95,327
Adjusted net income	$ 106,025	$ 102,718	$ 91,680
Return on rate base	**7.89%**	**7.69%**	**6.88%**

In February 2000, the Board issued P.U.5 (2000 - 2001) authorizing Hydro to abandon the woodchip fired thermal generating station located in Roddickton. This resulted in a write-down of capital assets of $16.7 million, which Hydro has reflected in the 1999 financial statements. The return on rate base for 1999 would be 8.99% excluding this write-down of capital assets.

Based upon our review, we did not note any discrepancies in the calculation of average rate base and rate of return on rate base.

Return on Equity

The return on equity for 2001 has been calculated at 4.92% as follows:

(000)'s		2001	2000	1999
Shareholder's equity				
	2001	$ 270,900		
	2000	$ 267,600	$ 267,600	
	1999		$ 289,700	$ 289,800
	1998			294,300
Average equity		$ 269,250	$ 278,650	$ 292,050
Net income (as adjusted per Schedule 3)		$ 13,237	$ 5,850	$ (3,647)
Return on equity		**4.92%**	**2.10%**	**-1.25%**

The above calculation excludes the profit contribution from the Hydro Quebec recall of approximately $27.4 million in 2001, $11.6 million in 2000 and $35.5 million for 1999. Also, the net income indicated above for 1999 includes a write-down of capital assets of $16.7 million. The return on equity would be 4.34% if this transaction were normalized in the net income calculation.

The shareholder's equity of Hydro has been adjusted to eliminate the portion of the equity of Hydro, which is attributable to subsidiary/non-regulated operations. These adjustments to Hydro's equity are as follows:

(000's)	2001	2000	1999
Equity per non-consolidated financial statements	$ 568,720	$ 568,600	$ 626,280
Less: Contibuted capital			
- Lower Churchill Development	(15,400)	(15,400)	(15,400)
- Muskrat Falls Project	(2,165)	(2,165)	(2,165)
Share capital issued to finance investment in CF(L)Co.	(22,500)	(22,500)	(22,500)
Net retained earnings attributable to CF(L)Co. (income recorded minus dividends flowed through to government)	(231,470)	(228,500)	(247,700)
Net retained earnings attributable to the sale of recall power to Hydro Quebec (income recorded minus allocation of dividends)	(26,290)	(32,427)	(48,708)
"Regulated Equity"	$ 270,895	$ 267,608	$ 289,807

The adjustment to regulated equity relating to the net retained earnings attributable to the sale of recall power to Hydro Quebec is based on Hydro's revised calculation of profit from the sale of recall power and incorporates an allocation of dividends between the regulated versus non-regulated earnings.

Based upon our review, we did not note any discrepancies in the calculation of average equity and rate of return on average common equity.

Interest Coverage

Interest coverage for 2001 has been calculated at 1.42 times as follows:

(000's)	2001	2000	1999
Total interest	**$ 94,121**	$ 96,034	$ 94,288
Less: CF(L)Co	**(2,523)**	(1,841)	(1,109)
Hydro net interest	**91,598**	94,193	93,179
Less: Guarantee fee	**(10,900)**	(10,610)	(10,849)
Add: Interest earned and IDC			
Power bills	**1**	16	85
RSP	**4,361**	3,217	3,217
Sinking funds	**6,382**	5,323	8,689
IDC	**5,151**	3,694	1,984
Gross interest	**$ 96,593**	$ 95,833	$ 96,305
Net income (per Schedule 3)	**$ 40,431**	$ 17,296	$ 31,715
Gross interest	**96,593**	95,833	96,305
Adjusted income	**$ 137,024**	$ 113,129	$ 128,020
Interest Coverage	**1.42**	**1.18**	**1.33**

Since 1997 gross interest costs have been steadily declining for varying reasons, however in 2001 this trend was reversed when Hydro issued two new bonds in August and December for a total of $250 million. This was the primary cause for the increased gross interest costs in 2001 of $760,000 over 2000. The increase in net income in 2001 is largely attributed to Hydro amending its purchase and sale agreement with Hydro Quebec in February 2001. Beginning March 9, 2001, Hydro received a new revenue cap set at $97.5 million. This new agreement increased Hydro’s energy sales and contributed to an increase in net profit of $27.4 million.

Interest coverage has been calculated at 1.13 times when the profit contribution from the Hydro Quebec recall is also excluded from net income.

The Company’s interest coverage for 2001 is more comparable to 1999 and has improved significantly in comparison to 2000.

Capital Structure

The capital structure of Hydro, excluding its subsidiary companies, can be determined from Schedule 1. The debt and equity numbers as referenced in Schedule 1 have been adjusted to reflect the removal of the non-regulated energy sales to Hydro Quebec for the years 1999 to 2001. The capital structure with these adjustments is as follows:

(000)'s	2001	%	2000	%	1999	%
Debt	$ 1,206,813	80.4%	$ 1,119,395	79.4%	$ 1,106,068	79.2%
Employee benefits	24,059	1.6%	22,851	1.6%	-	0.0%
Equity	270,895	18.0%	267,608	19.0%	289,807	20.8%
	$ 1,501,767		$ 1,409,854		$ 1,395,875	

In comparison to 2000 and 1999, Hydro's debt:equity ratio for 2001 continues to deteriorate. The equity component of the capital structure declined to 18.0% in 2001 from 20.8% in 1999, while the debt component increased to 80.4% from 79.2% in 1999.

For 2001 Hydro declared and paid dividends totaling $53.3 million to the provincial government which included a $10 million dividend based on a partial flow through of CF(L)Co revenue and a $33.5 million dividend from the sale of recall power to Hydro Quebec. The dividend policy approved by the Board of Directors of Hydro on May 12, 2000 provides for the payment of dividends annually up to 75% of net operating income before net recall revenue for that year plus 100% of net recall revenues received provided such payment shall only be made after due consideration has been given by the Board of Directors of the impact the payment will have on the debt to equity ratio.

Other Costs

Scope: ***Conduct an examination of operations and administration expenses, fuels, power purchased, and interest to assess their reasonableness and prudence in relation to sales of power and energy.***

Other costs for the years 1999 to 2001 are as follows:

	2001	2000	1999
Salaries	61,733	61,374	57,128
System equip. maint.	17,453	18,977	14,957
Insurance	949	1,037	1,068
Transportation	2,332	2,892	3,481
Office supplies	1,872	2,081	2,858
Bldg. rentals and maint.	704	998	2,897
Professional services	5,530	3,815	3,756
Travel	2,779	2,835	2,459
Equipment rentals	1,369	1,400	1,602
Miscellaneous	5,221	4,891	4,341
Loss on disposal	1,839	2,186	923
Customer costs	395	420	495
Sub-total	102,176	102,906	95,965
Other	-		(49)
Hydro capitalized	(9,567)	(7,852)	(8,537)
C.F.(L) Co.	(1,766)	(1,774)	(2,109)
Sub-total	(11,333)	(9,626)	(10,695)
Total	90,843	93,280	85,270

The above table shows that the total other costs (before transfers to capital and cost recoveries) have decreased in 2001 relative to 2000 by $730,000 ($102,176,000 - $102,906,000). This 0.71 % decrease in 2001 is a reversal of the upward trend, which began in 1998.

On a net basis, other costs show a similar trend with a decrease in 2001 relative to 2000 of $2,437,000 ($90,843,000 - $93,280,000). The additional decrease on a net basis is attributable to the higher transfers to capital in 2001 as compared to 2000.

The most significant expense variances in 2001 relate to an increase in professional fees of $1.7 million and a decrease in system equipment maintenance of $1.5 million. The variances in these two categories almost net each other, however it is a combination of this change plus other smaller variances noted throughout other costs that make up the small decrease of $686,000. The increase in professional fees is largely tied to the cost of the rate hearing that was held during 2001, however a rise in software acquisitions and maintenance also contributed to the increase. The decrease to system equipment maintenance is largely attributed to non-recurring extra maintenance requirements in the

Transmission and Rural Operations division for 2000; mainly repairs to gas turbine and diesel plants in the central and Labrador regions. However this decrease was partially offset by additional maintenance requirements in the production division created by a major overhaul performed on unit #3 at the thermal plant in Holyrood. The other smaller net variances, occurring during 2001 can be partially attributed to the introduction of a restructured code of accounts for all inventory and non-inventory items during the spring of 2000.

In early 2000, a steering committee was created and allocated the task of assigning object codes to all purchases both inventory and non-inventory items. There were four object codes developed and assigned to commodity groups with items currently in inventory and commodity groups with no items currently in inventory. Three of the four codes, maintenance material, tools and operating supplies, and gases lubricants and chemicals are recorded within system equipment maintenance, the final code, safety equipment and supplies is recorded within building maintenance and rentals. This cost code restructuring accounts for many of the variances in the operations and administrative expenses.

Schedule 4C of our report provides an analysis of the "other costs" on a kWh's sold basis for the years 1997 to 2001. The schedule reveals an overall decrease in total "other costs" and an increase in the amount of kWh's sold for 2001. The increase in the number of kWh's sold coupled with a decrease in total "other costs" creates a slight drop in the calculation of total "other costs" per kWh sold in comparison to 2000.

With the exception of professional fees, salaries and miscellaneous, the various expense categories in other costs showed a consistent downward trend in 2001. We have reviewed the various expense categories on an individual basis and our observations and comments are noted below for your consideration.

Salaries and benefits

Gross payroll costs for 2001 were $61,733,000, which was only slightly higher from 2000 levels by $359,000 or 0.6%. The salaries and benefits costs are summarized below by category:

(000)'s	2001	2000	1999
Salaries	**$ 41,502**	$ 41,169	$ 40,503
Directors fees	**35**	21	77
Hourly wages	**6,367**	6,482	5,727
Overtime	**3,987**	3,998	3,946
Employee future benefits	**2,411**	2,243	
Fringe benefits	**6,192**	6,205	5,514
Group insurance	**1,129**	1,129	1,289
Labrador travel benefit	**110**	127	71
	$ 61,733	$ 61,374	$ 57,127

While gross payroll costs have been consistently escalating from year to year, the smallest increase occurred from 2000 to 2001. This modest increase can be attributed primarily to two of the eight payroll categories: salaries - $333,000 and employee future benefits - $168,000. These two categories, which amount to a variance of $501,000, were partially offset by a decrease in hourly wages of $115,000.

Future employee benefits consist of two components: 1) the current service portion, and 2) an interest portion. The cost of the interest portion can vary depending on the average balance of the pension benefit obligation or liability. Due to poor market conditions in 2001, the liability exceeded the value of the plan's assets causing higher interest expense than in 2000. The adoption of new CICA recommendations for accounting for employee future benefits in 2000 explains the nil balance in 1999.

The breakdown of salaries only, by division, is as follows:

(000)'s	2001	2000	1999
Finance	**$ 3,332**	$3,901	$3,894
Human resources and legal	**3,161**	3,165	2,857
TRO	**18,132**	17,410	17,227
Production	**15,654**	15,344	15,057
Internal Audit	**252**	206	207
Management	**971**	1,143	1,261
	$ 41,502	$41,169	$40,503

The main contributing factors to the increase in the salaries is as follows:

- A general scale increase of 3% was provided to all union, non-union and management committee effective January 1, 2001.
- An additional general scale increase of 2% was provided to all union staff effective April 1, 2001 and non-union staff, including the management committee effective July 1, 2001.

While these wage hikes should have contributed to a more significant rise in permanent salaries, other mitigating factors as noted below largely offset these increases.

- Various vacancies caused by retirements, promotions, sickness and transfers to special projects.
- Mr. Collett, the Vice-President of Production retired in 2001 creating a vacancy for several months that was later filled by Mr. Haynes, the Director of Production, leaving, in the interim, his position vacant.
- A total reduction of 44 positions from the staff complement for the year. The elimination of 41 of these positions was announced in February 2001.

In February 2001, Hydro announced that it was realigning certain staff and 41 permanent staff positions would be eliminated. After this reduction the staff complement was 855 positions, down from 891 in 2000, and the filled positions was 826, down from 853 in December 2000. According to the Company, this reduction in staffing levels was expected to provide cost savings of approximately $1.3 million on an annualized basis. As noted in the tables below the staff complement and the number of filled positions has continued to decline throughout the year leaving a final complement of 847 and 814 filled positions.

In 2000, Hydro developed a system to report full-time equivalent employees by category. Unfortunately these figures are only available for April to December 2000, and consequently comparative data for prior years is not available. In the future as comparative data becomes available, this information will be very useful for analyzing the salaries and benefits cost category.

The staff complement at the end of each fiscal year for 1999 to 2001 is as follows:

	2001	2000	1999
Production	**309**	318	320
TRO	**376**	411	412
Finance	**84**	84	85
Internal audit	**4**	4	4
Management	**8**	8	9
Human resources and legal	**66**	66	71
	847	891	901

The figures above include both filled and vacant positions. A similar analysis of filled positions only is as follows:

	2001	2000	1999
Production	**298**	312	312
TRO	**356**	382	383
Finance	**82**	81	81
Internal audit	**4**	4	4
Management	**8**	8	9
Human resources and legal	**66**	66	70
	814	853	859

As noted above, the staff complement for 2001 has dropped considerably from 2000, with the changes occurring mainly in the production and TRO departments.

The breakdown of hourly wages by division is as follows:

(000)'s	**2001**	**2000**	**1999**
Finance	**$ 547**	$ 657	$ 667
Human resources and legal	**1,021**	1,181	604
Transmission and rural operations (TRO)	**3,069**	2,951	2,119
Production	**1,711**	1,653	1,752
Internal audit	**19**	40	13
	$ 6,367	$ 6,482	$ 5,727

The decrease in hourly wages is primarily attributable to the following items:

- In the Finance division, staff requirements for the customer service department were reduced allowing several part-time meter readers to be replaced with diesel system representatives in the Transmission and Rural operations division. In addition permanent employees in the Finance division replaced several term employees at head office.

- In the Human Resources and Legal division the decrease is more of a timing issue due to the delay in the recruitment of apprentices required for 2001.

- A decrease in the average number of temporary staff on hand throughout 2001. (See table below)

- Scale increases of 3% and 2% in January and April respectively, partially offset the above decreases.

The following is a schedule of the average number of temporary employees on staff for 1999 to 2001. The monthly numbers were taken at the end of each particular month.

	2001	2000	1999
January	**81**	99	94
February	**79**	115	93
March	**80**	110	115
April	**104**	123	134
May	**156**	133	168
June	**187**	187	240
July	**202**	195	231
August	**193**	212	235
September	**153**	174	207
October	**134**	161	183
November	**106**	119	150
December	**56**	88	100
Monthly average	**127.6**	143.0	162.5

The gross payroll costs for 1999 to 2001 were allocated to operations and capital as follows:

(000)'s	**2001**	2000	1999
Payroll charged to operating	**$ 52,756**	$ 54,155	$ 48,954
Payroll charged to capital	**8,977**	7,219	8,173
	$ 61,733	$ 61,374	$ 57,127

The payroll costs charged to capital reversed its downward trend in 2001. Capitalized salaries are made up of more than 21 separate projects, however 7 of these projects represent approximately 57% of total capitalized salary costs. Some of these projects are continuations of the larger projects capitalized in 2000 such as the Lower Churchill River project and upgrading in the Central Region. Other larger projects in 2001 included the Granite Canal development, upgrading work on TL237 and the east coast microwave system.

The Lower Churchill River project refers to the negotiations with Hydro Quebec relating to hydro electric development on the Lower Churchill River in Labrador. All costs associated with these negotiations are capitalized and are treated as non-regulated assets. Upgrading and service extensions includes the erection of new poles, upgrading existing transmission lines and providing services to new customers. The Granite Canal development relates to the new generation project started in 2000. The purpose of the east coast microwave system was to provide communication to terminal stations on the Avalon and at the Holyrood plant. This project will allow Hydro to monitor the equipment in the terminal stations and to remotely operate equipment at these sites from Hydro Place.

Executive salaries for the years 1999 to 2001 are as follows:

	2001	2000	1999
Total executive salaries and benefits	**$ 860,354**	$ 838,578	$ 811,139
Number of executives	**5**	5	5
Average salary	**$ 172,071**	$ 167,715	$ 162,230

The total executive salaries and benefits and the average salary per executive increased by 2.6% in 2001 in comparison to 2000. In the spring of 2001, the Vice-President of Production retired and his successor filled the position at a lower salary level. However, this potential saving was partially offset by salary increases for the four remaining executives of approximately $35,000 or 5.3%.

The Compensation Committee recommended a salary increase for the President and Vice-Presidents consistent with the increase provided for non-union staff. They also approved a step progression for the Vice-President of Transmission and Rural Operations after an evaluation was prepared by a consulting group on the current responsibilities of each vice president. The recommendations of the consulting group resulted in a significant change for the position of Vice-President, TRO and approved the job rate for this position to be equivalent to that of the positions of Vice-Presidents of Finance and of Human Resources.

In 2001 Hydro introduced a performance-based incentive system as a pilot project for the executive and senior management. The Board of Directors decision to introduce this pilot project was two-fold: 1) narrow the gap between the salaries paid at Hydro and those paid by comparable organizations; and 2) move the corporation to a performance-based culture. All payments related to the performance-based incentive system were paid in 2002. Based on the performance achieved in 2001 in relation to the established targets, a total of $119,500 was paid out to the seventeen individuals who participated in the project. These payments were not accrued in the 2001 fiscal year.

System equipment maintenance

In 2001, system equipment maintenance costs decreased from 2000 levels by $1,525,000 or 8.0%. This decrease is made up of several significant variances within the account groupings for this category. The changes in system equipment maintenance costs in 2001 as compared to 2000 are as follows:

• Lower maintenance costs for TRO	$(2,720,000)
• Higher maintenance costs for thermal generation	1,034,000
• Lower maintenance costs for hydro generation	(282,000)
• Higher maintenance and inventory costs for Human resources & legal	278,000
• Higher costs for lubricants, gases and chemicals	190,000
• Other miscellaneous variances – net	(25,000)
	$(1,525,000)

The costs for 1999 to 2001 for the system equipment maintenance portion of this expense only (excluding tools and equipment, freight and lubricants, gases and chemicals) are broken down by department as follows:

(000)'s	**2001**	2000	1999
Transmission and rural operations	**$ 5,946**	$ 8,666	$ 4,497
Production	**9,230**	8,439	9,544
Human Resources & Legal	**814**	536	
Finance	**156**	137	
Other	**4**	2	9
	$ 16,150	$ 17,780	$ 14,050

The decrease for the transmission and rural operations division for 2001 as compared to 2000 is primarily due to certain non-recurring extra maintenance requirements in the Central and Labrador regions of the province during 2000. The extra maintenance requirements in these regions included repairs to the gas turbine at the Stephenville plant for $1,800,000 and $300,000 for overhauls at the Nain Diesel Plant. Other smaller items contributing to the decrease relate to maintenance performed in the northern region of the province and the account code restructuring that took place in the spring of 2000. The decrease in northern operations occurred as a result of timing of credits (or core charges) relating to an overhaul done on a generating unit in Lance au Loup in 2000.

The overall increase of $791,000 experienced in the production division in 2001 is largely related to the costs incurred at the thermal plant in Holyrood.

The Holyrood thermal plant costs are as follows:

(000)'s	**2001**	2000	1999
Unit # 1 overhaul	**$1,199**	$1,433	$1,428
Unit # 2 overhaul	**1,048**	1,148	3,268
Unit # 3 overhaul	**3,175**	1,170	1,193
Annual routine maintenance	**2,132**	2,769	1,522
	$7,554	$6,520	$7,411

Maintenance costs at Holyrood can vary considerably from year to year depending on scheduling of overhauls. Based on information provided by the Company, Unit # 1 had a minor overhaul in 2001, 2000 and 1999; however the overhaul for Unit #1 in 2000 also included costs relating to work performed on the valves. The costs incurred in 1999 and 2000 when compared to 2001 are largely due to the scope of the overhaul, since the last major overhaul performed on Unit #1 was in 1997. Unit # 2 had a minor overhaul in 2001 and 2000 versus a major overhaul in 1999. The cost differential between a minor and major overhaul on Unit # 2 accounts for a majority of the variance when comparing 2001 and 2000 to 1999. Unit # 3 had a major overhaul done in 2001 and minor overhauls in 2000 and 1999. The cost of the major overhaul is fairly consistent with the cost of the major overhaul on unit #2 in 1999. This was the first major overhaul performed on unit #3 since 1994.

The annual routine maintenance includes the maintenance on Holyrood buildings and sites, common equipment, water treatment plant equipment and administration equipment. In 2001, the routine maintenance costs have decreased by approximately $637,000 from 2000. Costs relating to structures and equipment are incurred on a project-by-project basis, and costs incurred for regular routine maintenance can vary greatly depending on the type of maintenance projects that are completed, and, due to the age of the plant and the surrounding grounds, some years are much costlier than others.

Extra maintenance requirements had occurred at the Bay D’Espoir hydro plant in 2000. Since these projects were not part of the regular routine maintenance at Bay D’Espoir (i.e. non-recurring), costs overall for the hydro generation division in 2001 decreased by approximately $282,000.

Increases noted in the lubricants, gases and chemicals account are mainly attributed to the to the extra Bunker “C” consumption at the Holyrood thermal plant. When production at the thermal plant increases, the consumption of chemicals and lubricants also increases. In addition to these increases noted above, the account code restructuring which was introduced in the spring of 2000 was also a contributing factor to theses increases. All inventory and non-inventory items that fall under the object code “gases lubricants and chemicals” are now recorded to the “lubricants, gases and chemicals account”.

Under Hydro’s accounting system, the expenses relating to maintenance of Hydro Place are included in the Human Resources and Legal division. The increase in the Human

Resources & Legal division for 2001 is largely due to roof repairs at Hydro Place, which are expected to continue into 2002. The divisional increases are also the result of coding the office supplies group of expenses to system equipment maintenance for the full year.

Insurance (including director's liability)

Insurance costs decreased overall by $88,000 or (8.45%) in 2001 over 2000.

The All-risk (property) and Boiler and Machinery policies were marketed during 2001 and a combined policy was quoted and secured with a significant premium reduction of approximately $82,000.

Miscellaneous changes to other premiums and fees paid in the year net to a decrease of $6,000.

Transportation

Transportation expense is comprised of aircraft rentals, vehicle expenses (fuel, rental and allowances) and mobile equipment fuel. This expense category decreased overall by $560,000 (19.4%) in 2001 as compared to 2000. The majority of this decrease is due to lower vehicle repairs of $243,000, lower mobile equipment repairs of $92,000 and a reduction in aircraft costs and fuel of $179,000. Other miscellaneous variances such as decrease in vehicle fuel of $24,000 and vehicle rentals and allowances of $22,000 make up the remaining difference.

The combined reduction in vehicle and mobile equipment repairs is primarily a result of the introduction of the account code restructuring in the spring of 2000. These expenses were all coded to maintenance materials in system equipment maintenance for 2001.

The reduction in aircraft costs and fuel is largely attributed to a decrease in the utilization of helicopters mainly in the Labrador region. The decrease in aircraft costs and fuels is also reflective of the decrease in maintenance in the Transmission and Rural Operations division, the primary user of aircrafts.

Based on information provided by Hydro, in 2000 the Company had 395 vehicles and 387 mobile equipment units, and in 2001 the Company had 390 vehicles and 395 mobile equipment units.

Office expenses, including membership fees

Office expenses in 2001 (including heat and light, telephone, supplies, postage, advertising, cleaning, office equipment maintenance, books and subscriptions and membership fees) decreased by $209,000 or 10.0% over 2000. The large decreases were noted in the same cost areas as in the prior year, including printing forms and supplies of $147,000, cleaning and janitorial supplies of $78,000, and office equipment and maintenance of $62,000. This decrease was slightly offset by an increase in postage for $61,000. Other miscellaneous variances result in a net increase of $17,000.

The decreases within the account groupings of this category were primarily attributable to the method of allocating inventory and non-inventory items to account codes. These accounts, which were adopted during the spring of 2000, include costs for approximately the first four months of that year with costs for the remainder of the year coded to the object code maintenance materials in system equipment maintenance. In 2001 all costs are coded to material maintenance creating a total decrease to these accounts of $287,000.

Postage costs increased in 2001 by $61,000 over 2000 mainly due to the large quantities of mail outs during the 2001 rate hearing.

In 2001 membership dues reversed the upward trend it began in 1999. The decrease of approximately $34,000 is largely a result of additional initiatives undertaken in 2000 by the Canadian Electrical Association, which Hydro, as a member, shared in the cost.

Building rental and maintenance

Building and rental maintenance continued to decrease in 2001 as they did in 2000. The decrease of $294,000 or 29% is mainly attributed to restructuring the code of accounts. This category originally consisted of the accounts relating to building rentals, safety equipment & supplies and property costs. When the new object codes were introduced in the spring of 2000, the account "property costs" became inactive and all related expenses incurred after the restructuring were then recorded to system equipment maintenance. This resulted in a decrease to the account of $512,000 in 2001. This decrease was partially offset by an increase of $201,000 to the "safety equipment & supplies" account when items of protective clothing, originally part of miscellaneous expense, were coded to the new object code. Other miscellaneous variances result in a net decrease of $17,000.

Professional services

In 2001, professional services costs of $5,530,463 increased from 2000 levels by $1,716,000 or 45%. The changes in professional services costs in 2001 as compared to 2000 are as follows:

• Higher regulatory costs	$ 1,434,000
• Higher software acquisitions	322,000
• Lower professional fees	(40,000)
	$ 1,716,000

For 2001, regulatory related expenses totaled $2,470,000, an increase of 138% over 2000. This significant increase is primarily related to costs for the 2001 rate hearing. These costs were mainly disbursed to two major parties involved in the proceedings, the Board and Hydro's consultants. During 2001 and 2000, Hydro contracted consultants to help with the preparation of the rate hearing. The costs of these consultants for 2001 were $633,000, an increase of $233,000 over 2000. Actual costs expended to the Board for the rate hearing was $1,255,000 which includes an accrual of $1,000,000 for costs not paid as of December 31, 2001. In addition to these hearing costs, there were increased billings throughout the year from the Board totaling $569,000 for other regulatory reviews.

Additional costs incurred in 2001 for software acquisition and maintenance are the result of a broad range of software items purchased throughout the year. The purpose of some of the major software items was to assist Hydro with Internet security, budget planning, customer service/help desk and integration software to accompany the Microsoft suite of products.

The third variance noted above, which slightly offsets the overall increase to the professional services cost category, relates to the professional services account. Professional fees for 2001 did not materialize as expected because some services were performed internally, while other projects did not have the staffing commitment available, as significant attention was focused on the rate hearing. Some of the projects deferred due to the rate hearing included Environment Canada Weather forecasting, enhancements to the UCIS (budget billing and preauthorized payments) system, and EMS replacement study for savings of approximately $339,000.

With the exception of 2001, the professional services expense account has been exhibiting significant upward trends over the past number of years. Due to the rate hearing occupying the time of so many employees, the only department incurring increases in professional services was in production. Consequently, in order to obtain a better understanding of the nature of the items included in this department, we conducted a more detailed review. The significant consulting/professional services that have been contracted out by this department during 2001 are as follows:

Department	Professional Services	Cost
2001		
Production	• Monthly consulting services for unit 1, 2, and 3 at Holyrood Plant	182,000
	• Research and advisory services regarding Datapro and Dataquest	104,000
	• Redesign of Hydro's Intranet	90,000
	• Hydro's infrastructure project	82,000
	• Implemented Security Awareness Program	49,000
	• Business vision workshop	36,000
	• Training and implementation of the ACMS & Affiniti products	28,000
		$571,000

With respect to the variances in this expense category, we have obtained explanations and performed additional analysis where appropriate.

Travel and conferences

In 2001 the travel and conference expense category decreased from 2000 levels by $56,000 or 2.0%. Travel costs decreased from $2.643 million to $2.599 million and conference costs decreased from $192,700 to $179,400.

From 1997 to 2000 travel costs have been on the rise, however in 2001 Hydro experienced a minor decrease from 2000 of $43,000. Conference costs, similar to travel costs, also ceased its upward trend in 2001 resulting in a slight decrease of $13,000 from 2000. The decreased spending on conferences of approximately $30,000 was primarily attributable to the customer service and the treasury divisions of the finance department. In 2000, customer service employees attended a training session on the process of analyzing customer data. This session was not an annual event and therefore was not held in 2001. Also in 2000, several treasury employees attended conferences regarding management reporting and cash and risk management. In 2001, the treasury department only attended two conferences with only one employee per conference. The decreased spending in this department was slightly offset by an increase in costs of $12,000 within the transmission and rural operations department. This increase is a result of a Prime Power Diesel Inter-Utility Conference held in St. John's for the Bishop Falls division. Other smaller variances in the human resources & legal, production and management departments make up the net increase of $5,000.

Equipment rentals

Equipment rental expense decreased by $31,000 or 2.2% in 2001, as compared to 2000. This decrease is attributable to a decline in telecommunication computer processing of $48,000. Other miscellaneous variances make up a net increase of $17,000.

Telecommunication computer processing costs for 2001 have decreased to approximately $13,000. A very significant portion of this cost related to the billing process of Hydro's rural customers, which was handled by Newfoundland Power. Since Hydro has assumed this billing process internally, this cost amount has ceased to exist.

Miscellaneous

In 2001, miscellaneous expense increased by $330,000 or 6.75% from 2000. The major variances in this expense category are as follows:

Increase in inventory losses	$ 613,000
Decrease in sundry costs	(137,000)
Decrease in staff training	(100,000)
Decrease in employee expenses	(68,000)
Net increase in other variances	22,000
	$ 330,000

The large increase in inventory losses is a result of a corporate initiative to identify excess and obsolete inventory items to be removed from stock. This initiative resulted in an increase of $469,000 over the original budget for 2001.

The most significant factor contributing to the decrease in sundry costs is the reduction in the Wabush profit of $123,000 from 2000.

The decrease in staff training in 2001 is related to the training programs carried out in 2000 for diesel plant operators, Reliability Centered Maintenance, work protection code and JD Edwards. However this decrease was considerably less than expected due to additional training initiatives undertaken in 2001 that were not originally budgeted. Training for information system & technology, diesel system representatives and the central region of transmission and rural operations department resulted in additional costs of approximately $236,000 to the Company.

As noted previously in the report, the cost of personal protective clothing had been removed from “employee expenses” in the spring of 2000, and reallocated to the object code for “safety equipment and supplies which is grouped in the “Building Rentals” category”, and as a result employee expenses has further decreased in 2001.

With respect to the variances noted above, we have obtained explanations and performed additional analysis where appropriate.

Capitalized expenses

Capitalized expenses for 2001 were $9.567 million as compared to $7.852 million for 2000 and $8.537 million in 1999.

The breakdown of capitalized expenses for the three years is as follows:

	2001	2000	1999
Salaries	**$ 8,977,207**	$ 7,218,993	$ 8,173,343
Fleet expense	**473,546**	502,400	255,218
Travel direct work orders	**115,693**	131,110	108,145
	$ 9,566,446	$ 7,852,503	$ 8,536,706

Of the costs incurred in 2001 and allocated to capitalized salaries, 21 of the total projects make up 78.5% of the $8.977 million, and more than half of these allocations can be attributed to seven main projects: upgrading work on TL237, Granite Canal development, east coast microwave system, service extensions and upgrading in the central and northwest regions, the Lower Churchill River project, and construction of a new diesel plant in Nain. Four of these projects have been carried over from prior year(s). While the number of capitalized projects has decreased from 2000, the amount of capitalized salaries has risen by 24.3%. This increase in costs is primarily due to the following: 1) a higher involvement of internal forces in the Granite Canal Project, the upgrade of transmission line 237 and the east coast microwave system; and 2) an increase in departmental and non-departmental overhead for the upgrade of transmission line 237 and the east coast microwave system.

The methodology employed by Hydro with respect to capitalizing expenses is outlined below. This methodology has not changed during 2001.

Capitalized salaries include the salaries and benefits of Company employees whose time is charged directly to capital projects, as well as departmental and non-departmental overhead. The benefits component is determined by applying a pre-determined percentage to the gross salaries, which are capitalized directly. The departmental overhead component is allocated to the capital projects as a percentage of direct salaries and benefits depending on the employees' responsibilities. Finally, the non-departmental overhead component includes costs of departments which are not directly related to the capital program but which are considered necessary to support the various capital projects throughout the year. The non-departmental overhead charge is determined by applying a pre-determined percentage to the total cost of capital projects as per the work orders.

Fleet expense and travel direct work orders encompass fleet costs and costs associated with smaller work orders related to the Company's distribution system. These costs are capitalized using standard rates developed by the Company.

All categories of capitalized expenditures other than capitalized direct salaries are allocated to work orders using percentages or standard rates developed by the Company.

These allocations are intended to ensure that capital projects are adequately charged with the cost of support functions such as accounting and finance, engineering, and other such expenses which cannot be directly charged to specific capital projects.

For 2001, the percentages used to capitalize fringe benefits and overhead costs were as follows:

Benefits (% of direct salaries)	
Island	33.0%
Labrador	43.0%
Departmental overhead	
Non-field (% of direct salaries and benefits of engineers and office staff)	37.6%
Field (% of salaries and benefits of crews)	19.8%
Non-departmental overhead	
(% of work order total costs)	6.0%

Intercompany charges

Intercompany charges to CF(L)Co. for 2001 have only slightly decreased from 2000 by $8,000 or .45%. The breakdown of intercompany charges by department is as follows:

	2001	2000	1999
Production	$ 629,714	$ 231,806	$ 792,042
Finance	406,755	430,496	345,557
Transmission and Rural Operations	73,921	172,834	20,000
Internal Audit	36,211	10,670	87,055
Management	29,421	40,694	184,020
Human Resources and Legal	590,413	887,979	680,355
	$ 1,766,435	$ 1,774,479	$ 2,109,029

These charges are for the provision of services in accordance with a Services Agreement between Hydro and CF(L)Co. Based on a recommendation in our report for the 1999 Annual Review, Hydro reviewed and updated its methodology for allocating intercompany costs during the spring of 2000. The internal report prepared by Hydro on this issue documents the change in methodology as compared to the 1992 study. Under the new methodology, Hydro utilizes specific work orders in most situations to capture the actual costs of providing services to CF(L)Co. As per the report, costs recoveries such as salary and overhead charges are determined as follows using the JD Edwards integrated suite of applications and a Lotus Notes Time Reporting application:

a) Departments track salaries, overtime, temporary wages and employee expenses through time reporting.
b) Departments use the percentage calculated from the time reporting to allocate other costs such as membership dues and conferences.
c) Interest and depreciation costs for Hydro Place are based on the equivalent complement percentage. This percentage is used to allocate the costs of providing administrative services such as telephone, maintenance materials, janitorial, etc.

d) "Information Systems and Telecommunication" costs are allocated based on the ratio of personnel computers assigned to CF(L)Co. to the total number of personal computers corporate-wide. This percentage is applied to computer costs and software acquisition and maintenance cost accounts.
e) All specific costs are recorded directly into the CF(L)Co. accounting system.

As noted above, the recovery of costs for services provided to CF(L)Co have decreased overall by $8,000 from 2000. However this decrease is made up of several significant variances within the account groupings for this category as indicated in the table above. The most notable variation is in the production department for an increase of $398,000. When Hydro began reviewing its methodology for determining intercompany charges in 2000, it was discovered that Hydro had been overcharging CF(L)Co on engineering services provided in 1999. The cost recoveries received from CF(L)Co had been based on the use of several engineers when in fact only one engineer was employed to cover all engineering disciplines on behalf of CF(L)Co. This refund of $193,000 for 1999 increases the variance between 2000 and 2001 as the credit was included in the production department for 2000. The remaining increase in the Production department of $205,000 is mainly attributed to the Information System and Telecommunications division. This division recognized that an inadequate amount of staff salaries was being allocated to CF(L)Co. once it began tracking salaries through time reports on the J.D. Edwards system.

The increase in the Production department is completely offset by the decreases in the Human Resources & Legal and Transmission and Rural Operations (TRO) departments. The decrease in the human resources & legal of approximately $298,000 in 2001 is largely attributed to Hydro's switch to blanket ordering to reduce purchasing efforts and additional recoveries in materials management from 1999 that were not reflected in intercompany charges until 2000. The remaining decrease of $99,000 in TRO is due to generation and distribution recoveries in 2000 for the island and Labrador interconnected and isolated systems.

Fuels

In 2001 fuel expense increased overall by $7,640,000 or 17.95% over 2000. The cost of Bunker "C" increased by approximately $49,207,000 over 2000, however net of RSP recoveries, the increase is approximately $6,241,000. Lower hydraulic generation resulted in higher thermal generation (2,095 GWhs in 2001 versus 966 GWhs in 2000) causing Hydro to consume approximately 3,316,000 barrels of oil in 2001 versus 1,593,000 in 2000.

The hydraulic production and load variation components of the Rate Stabilization Plan resulted in an increase of $17,829,000 in fuel costs in comparison to 2000. The adjustment for hydraulic production (or water variation) is consistent with the significant decrease in actual hydraulic production in 2001 of approximately 21%. The adjustment for load variation is consistent with the increase in energy sales. Energy sales (excluding Hydro Quebec Recall) were up 71 GWh (1.1%) in 2001 in comparison to 2000. The increase in energy sales in 2001 was the result of steady cold weather conditions from January to late May, which increased Newfoundland Power's need for more energy to meet consumer demand. However this increased demand was partially offset by a decrease in energy sales to the Iron Ore Company of Canada and Abitibi Price in Grand Falls and Stephenville. Two of the paper mills operated by Abitibi Price experienced significant down time throughout 2001 due to a saturated market for newsprint. The Iron Ore Company of Canada decreased production after experiencing a slow down in the mine during 2001. Sales to these companies decreased by a total of 130 GWhs in 2001. All variations relating to the Rate Stabilization Plan are calculated using actual results for the year in comparison to the 1992 cost of service data.

Diesel fuel for rural operations also experienced an increase in 2001 of $1,284,000. This was primarily due to a rise in the average cost per litre of fuel.

Power purchased

The Company's purchased power expense decreased by $608,000 in 2001 (excluding the Hydro Quebec Recall). This decrease is made up of wide fluctuations in costs with the most significant decreases occurring from a reduction in the amount of power purchased from the two non-utility generators and CF(L)Co. (net of recall) of $504,000 and $499,000 respectively. These decreases were partially offset by an increase of $459,000 in secondary energy and $344,000 in L'Anse au Loup. Other smaller decreases were incurred in deferred fuel for $227,000 and capacity expansion for $137,000.

The Company purchased 156 GWh's of power from two non-utility generators at a cost of approximately $10.4 million as compared to 161 GWh's of power at $10.9 million in 2000. The cost decrease of approximately $504,000 is primarily a result of lower production particularly at Algonquin Power however an increase in the average cost per GWh for Star Lake and Algonquin Power has slightly offset this decrease. Each generator charges a separate combined rate for the time periods December to April and May to November, and in 2001 the average cost per GWh for Star Lake and Algonquin Power increased $1.15 and $1.23 respectively.

Also, 822 GWh's was purchased from CF(L)Co. as compared to 888 GWh's in 2000. This decrease of approximately $499,000 is a result of lower energy sales in Labrador as well as a decrease in the cost per GWh from $2.7202 to $2.5426 effective September 1, 2001.

Secondary energy shows an increase of approximately $459,000, however $210,000 of this increase relates to accounting adjustments that resulted from an over-accrual and a payment allocated to an incorrect account. The net difference after these adjustments still leaves a variance increase of $249,000, which is primarily attributed to the purchase of surplus energy from Abitibi Consolidated. This energy was available due to significant down time experienced at both paper mills.

The power purchase costs at L'Anse au Loup were also significantly higher in 2001 because the rate per kWh in 2000 was pegged at 20 mills but in 2001 the rate was determined by the price per litre of diesel fuel as noted in the contract. This increase in rate per kWh also explains why the deferred fuel component of L'Anse au Loup decreased by $227,000.

The expense for capacity expansion at the Wabush Terminal Station decreased by $137,000 due to lower charges from the Iron Ore Company of Canada. An agreement in place between both companies permits IOCC to charge back 53% of the capacity expansion costs. However, in 2001 IOCC had not billed Hydro for all eligible costs.

We note that power purchased expense includes an amount of $1.3 million paid to Abitibi Price in Stephenville for the right to interrupt a portion of its power supply should Hydro need the power to meet its own demand. A ten-year contract has been signed between Hydro and Abitibi to this effect. This contract was signed in 1994 and has a cancellation clause, which requires a three-year notice.

Interest

Interest expense for 2001 decreased overall compared to 2000 despite the increase in gross interest and the debt guarantee fee. The decrease in interest expense of approximately $2.6 million or 2.8% is primarily attributable to an increase in the amount of interest earned on the rate stabilization plan and sinking funds, as well as the amount of interest capitalized during construction. The increase in these items of $4.8 million was partially offset by an increase in Canadian bond interest. Two new series of bonds were introduced during the year for $150 million and $100 million, Series AB (6.65%) and Series AC (5.05%) respectively. Series W with an interest rate of 10.75% was retired during the year.

The following is a summary of interest expense for 2001 to 1999:

(millions)	**2001**	2000	1999
Gross interest	**$96.7**	$95.0	$95.0
Debt guarantee fee	**11.2**	10.7	11.0
Amortization of debt discount and financing costs	**1.1**	1.1	1.3
Foreign exchange losses	**1.0**	1.0	1.0
	110.0	107.8	108.3
Less:			
Interest earned	**(10.7)**	(8.1)	(12.0)
Interest attributable to CF(L)Co share purchase	**(2.5)**	(1.8)	(1.1)
Interest capitalized during construction	**(5.2)**	(3.7)	(2.0)
	$91.6	$94.2	$93.2

Revenue Requirement

Scope: ***Verify Hydro's reconciliation of net income to revenue requirement for 2001. Review and assess the reasonableness of adjustments in the calculation of revenue requirement.***

Reconciliations of Net Income to Revenue Requirement for the years 1999 to 2001 have been provided in Schedule 3 of our report. Our review of the revenue requirement reconciliation for 2001 included examining support for the adjustments and assessing the reasonableness in comparison to prior years.

The largest adjustments to the revenue requirement were to eliminate $30.656 million in energy sales to Hydro Quebec, $1.19 million in interest avoided on regulated operations and $4.456 million in power purchased from Upper Churchill. These adjustments, are the result of Hydro Quebec and Newfoundland & Labrador Hydro amending and restating their 1998 purchase and sale agreement. The original contract was amended on February 19, 2001 to include the recall of power for the period March 9, 2001 to March 31, 2004. Under this amended contract Hydro can purchase power from Upper Churchill at the mil rate of $2.5425 per MWh and resell it to Hydro Quebec at $23.90/ MWh, up to a revenue cap of $97.53 million. The contract also stated that if the revenue cap was achieved before the end of the three year contract then all power sold above the cap would be for the same price that Hydro purchased the power (i.e. $2.5425/MWh).

For 2001, donations and management contributions of approximately $183,000 have been eliminated from revenue requirement as per the Board's direction. This elimination has increased by approximately $51,000 from 2000 largely due to the decision during the 2001 rate hearing, to eliminate the costs associated with Bay D'Espoir Street lighting.

In addition, costs of $13,000 related to Muskrat Falls have also been eliminated as they relate to the development of the Lower Churchill, a project that is non-regulated and therefore does not impact Hydro's revenue requirement.

These above noted adjustments combine to decrease the net earnings per Schedule 3 by $27.194 million.

Depreciation

Scope: ***Review Hydro's rates of depreciation and assess their compliance with the 1986 Peat Marwick Depreciation Policy Study. Assess reasonableness of depreciation expense.***

Our procedures with respect to depreciation were focused on reviewing the rates of depreciation used and assessing their compliance with the 1986 Peat Marwick Depreciation Policy Study and also on assessing the overall reasonableness of depreciation expense.

During 2001 Hydro reported depreciation expense of $32.2 million compared to $35.5 million in 2000. This decrease of $3.3 million is primarily related to units 1 and 2 at the Holyrood thermal plant being fully depreciated during 2001. The breakdown of depreciation expense for 2001 is as follows:

Location	Asset Class	Net Cost	Method	2001 Expense
Hydro	Hydraulic stations Terminal stations Transmission lines	$1,013.8 million	Sinking Fund	$9.8 million
Hydro	All other classes	212.4 million	Straight Line	22.4 million
		$1,226.2 million		$32.2 million

The majority of Hydro's high dollar value capital assets are depreciated using the sinking fund method. As noted above this method is applied to hydraulic stations, terminal stations and transmission lines which account for approximately 83% of the net cost of all capital assets. Depreciation on the remaining classes of assets is calculated using the straight line method.

Under the sinking fund method, depreciation is very low in the early years of an asset's life and increases with time such that it is very high in the final years. The underlying rationale in support of this methodology by Hydro is that the combined charge of depreciation plus interest on the long term debt required to finance the asset should be equal over the short and long term to minimize fluctuations in operating income. The straight line method results in equal amounts of depreciation being charged to each period/year over an asset's useful life.

In completing our procedures, we recalculated depreciation for both depreciation methods on a test basis and compared the estimated service lives used in the calculations to the 1986 Peat Marwick Depreciation Policy Study. We also reviewed the interest rates used in calculating sinking fund depreciation for reasonableness.

Hydro's proposed changes to its depreciation policies, which were based on the 1998 Depreciation Policy Study conducted by KPMG LLP was placed before the Board at its 2001 general rate application. The proposed changes were approved to come into effect January 1, 2002 per Board Order P.U. 7 (2002-2003).

As a result of completing our procedures, no significant discrepancies were noted and therefore, we report that depreciation expense for 2001 appears reasonable.

Rate Stabilization Plan

Scope: ***Conduct an examination of the changes to the Rate Stabilization Plan to assess compliance with Board directives.***

Our examination of the Rate Stabilization Plan (RSP) for 2001 included reviewing the adjustments and components of the Plan in 2001 and assessing their reasonableness and compliance with Board directives. We also assessed the reasonableness of the interest charged and credited to the Plan during the year.

Schedule 5 of our report summarizes the changes in the RSP for the three years from 1999 to 2001. Similar to 2000, the fuel variation adjustment for 2001 represents the most significant change in the plan. This variation of approximately $56.9 million is a result of the difference between the actual cost of No.6 fuel per barrel during 2001 and the cost of service price per barrel that is incorporated in the Plan. In 2001, Hydro consumed approximately 3.3 million barrels of No.6 fuel at an average cost of $29.69, in comparison to the average cost of service price per barrel of $12.50. The difference in the cost of fuel multiplied by the number of barrels consumed represents the fuel variation. Another significant change in 2001 is the recovery adjustment of approximately $11.1 million. This adjustment partially offsets the increase in the plan attributable to fuel cost variations. The recovery adjustment represents a portion of the RSP balance that was collected from retail and industrial customers during the year.

During 2001, the balance of the plan to be collected from the industrial customers was adjusted (decreased) by $2.67 million. As of January 1, 2000, the rates charged to industrial customers were reduced to reflect the fact that as of that date, Hydro was no longer permitted to allocate any of the rural deficit allocation to this group of customers. However, this change was not reflected in the operation of the RSP during 2000, and as noted during the 2001 General Rate Hearing an adjustment was recorded when this discrepancy was discovered.

During the 2001 General Rate Hearing, the Board ordered various changes to the RSP that became effective as of September 1, 2002. A review of these changes will be incorporated as part of our 2002 Annual Financial Review.

Based upon our review, we report that the adjustments made to the RSP in 2001 are appropriate and it has been operating in accordance with Board directives.

Deferred Charges

Scope: ***Conduct an examination of the changes to deferred charges and assess their reasonableness and prudence in relation to sales of power and energy.***

The following table shows the transactions in the deferred charges account from 1998 to 2001:

(000)'s	Balance Dec./98	Net Add.	Amort.	Reclass	Balance Dec./99	Net Add.	Amort.	Balance Dec./00	**Net Add.**	**Amort.**	Balance Dec./01
Studies and software	$597			($597)							
CF(L)Co.	293	1,564	(379)		$1,478	-2	(383)	$1,093	26	(382)	$737
Realized foreign exchange losses	96,278				$96,278			$96,278			$96,278
Discounts and issue costs on long term debt	13,959	10	(1,274)		$12,695		(1,140)	$11,555	1,995	(1,137)	$12,413
	$111,127	$1,574	($1,653)	($597)	$110,451	($2)	($1,523)	$108,926	**$2,021**	**($1,519)**	$109,428

Significant additions to deferred charges during 2001 related to the issue of two new bonds for an aggregate amount of $250 million. The sale of these bonds resulted in deferred charge additions of $1.995 million. Bond Series AB was issued in June with a coupon rate of 6.65% and maturity date of 30 years. The second bond, Series AC, was issued in October and has a maturity date of only 5 years at a coupon rate of 5.05%.

Foreign Exchange Losses

Total deferred foreign exchange losses remained unchanged between 2001 and 2000 at $96.278 million.

As noted in our previous reports, section 17(4) of the Hydro Corporation Act (as amended by Bill 35) states that for purposes of the Public Utilities Act (including Subsection 80(2)), the foreign exchange losses as at December 31, 1994 were considered to be reasonable and prudent expenses of Hydro and therefore properly chargeable to operating account. Section 17(3)(e) establishes the period of amortization for these losses to be 40 years commencing in the year when Hydro's rates are first altered under the Public Utilities Act. If Hydro was to commence amortizing the foreign exchange losses based on the 2000 balance noted above, the annual amortization to be included in the revenue requirement would be $2.4 million.

In 2001 Hydro accrued $1 million towards its foreign exchange losses consistent with prior years and in compliance with the Board's recommendation from the 1992 hearing. During the 2001 rate hearing, Hydro proposed that this accumulated provision be netted against the total realized foreign exchange losses of $96.278 million and amortization of these losses should begin in 2002 at a rate of $2.157 million per year. The Board accepted this proposed treatment in P.U. 7 (2002-2003).

Cost Control/Productivity Initiatives

Scope: ***Review Hydro's initiatives and efforts with respect to productivity improvements, rationalization of operations and expenditure reductions. Obtain update on current activities and inquire as to any future initiatives currently being evaluated.***

The Company has undertaken a number of initiatives to explore the possibility of future savings and increased productivity. In our 2000 report, we noted a number of initiatives that the Company was in the process of implementing. An update on the progress of these initiatives as provided to us by Hydro senior management is outlined below.

Reliability Centered Maintenance (RCM) Approach for Transmission and Rural Operations

This approach to maintenance places the emphasis on reliability, therefore not all of the systems would be treated the same with respect to the frequency of maintenance. It is believed that this approach would result in a more effective maintenance program and result in an efficient use of resources in the maintenance area.

Based on correspondence from Hydro officials, this initiative is in the analysis stage and should be fully implemented on schedule. It was also indicated that the cost savings and/or productivity improvements will not be realized until after full implementation.

Diesel Plant Operation Review

A review of the isolated diesel operation systems resulted in an initiative to move to a new classification called Diesel System Representative (DSR). This change should help enhance efficiencies and reduce costs in the rural operations. This initiative started in 1998 and according to Hydro officials, the training program was fully implemented for full DSR operations of the isolated diesel systems by December 31, 2001.

Based on recent correspondence from Hydro officials, the DSR initiative has provided employees with training to perform limited line work, meter reading and some mechanical/electrical work which has resulted in not having other employees travel to these communities to perform the various jobs. This initiative has also improved customer service by allowing the DSR to deal with the customer directly rather than having Company employees travel to these communities from other locations. The reduction in travelling has realized costs savings for this initiative.

Overall, Hydro states that the level of service has improved for the isolated diesel system customers as a result of this multi-skilled approach to maintenance.

Contributions in Aid of Construction (CIAC's)

Scope: ***Review a sample of Contribution in Aid of Construction (CIAC) calculations for accuracy and compliance with approved policy.***

Our procedures in this area included the following:

- review the implementation of the undertakings of Hydro in respect of the revised CIAC policy as ordered in P.U. 4 (1997-98); and
- review a sample of CIAC calculations for accuracy and compliance with approved policy.

As part of our review, we have held discussions with Mr. Barry Brophy, Customer Communications and Support Supervisor (Acting), of Hydro regarding the Company's CIAC policies and procedures and we have selected and reviewed documentation supporting a sample of five (5) CIAC calculations prepared during 2001.

Based on our discussions, we believe, as in the prior year, that the shortfalls in Hydro's procedures are partially due to the manual process. The onus is on the regional technicians who perform the fieldwork to ensure that they have their sketches precise and their line measurements exact. Also, it is the responsibility of the regional offices to ensure all CIAC quotes are documented, filed and reported to Head Office. The implementation of the computerized system in January, 2002 is intended to further improve the CIAC system for the future.

We recommend all CIAC quotes should contain a written request for service and documentation regarding refunds should be provided to all customers. Also, Hydro should ensure that, in cases where joint use of a line extension will occur with the telephone company and the cable company, the appropriate documentation is received from the respective companies.

Based on the results of our inquiry and review of documentation, we noted that the Board's requirements for the approval, review and calculation processes as specified in P.U.4 (1997-98), are being complied with.

Newfoundland and Labrador Hydro **Schedule 1**

Balance Sheet as of December 31

(Excluding CF(L)Co., LCDC and Contributed Capital - Muskrat Falls)

(000)'s

	2001	2000	1999
ASSETS			
Fixed assets	$1,312,204	$1,254,627	$1,241,103
Current assets	106,388	98,232	111,765
Rate stabilization plan	63,936	24,113	17,538
Deferred charges	109,428	108,927	110,451
Total assets	$1,591,956	$1,485,899	$1,480,857
LIABILITIES AND SHAREHOLDER'S EQUITY			
Long-term debt	$ 936,175	$ 808,004	$ 997,544
Current liabilities			
Accounts payable	67,818	57,943	66,256
Due to affiliates	4,030	4,016	3,967
Promissory notes	138,262	121,170	54,415
Long-term debt within one year	114,429	162,863	12,150
	324,539	345,992	136,788
Employee future benefits	24,059	22,851	
Unrealized foreign exchange loss provision	10,000	9,000	8,000
Shareholder's equity			
Retained earnings	297,183	300,052	338,525
Total liabilities and equity	$1,591,956	$1,485,899	$1,480,857

Newfoundland and Labrador Hydro **Schedule 2**

Statements of Earnings and Retained Earnings

For the Year Ended December 31

(Excluding CF(L)Co., LCDC and Contributed Capital - Muskrat Falls)

(000)'s

	2001	2000	1999
Revenue	$ 325,310	$ 303,192	$ 316,990
Expenses			
Fuels	50,207	42,568	35,110
Power purchased	20,057	20,385	18,927
Other costs	90,842	93,281	85,271
Depreciation	32,175	35,469	36,108
Interest	91,598	94,193	93,179
	284,879	285,896	268,595
Write down of capital assets			16,680
Net earnings	$ 40,431	$ 17,296	$ 31,715

	2001	2000	1999
Retained earnings, beginning of year	$ 300,052	$ 338,525	$ 318,810
Adjust future employee benefits		$ (19,169)	
Net earnings	40,431	17,296	31,715
Dividends	(43,300)	(36,600)	(12,000)
Retained earnings, end of year	$ 297,183	$ 300,052	$ 338,525

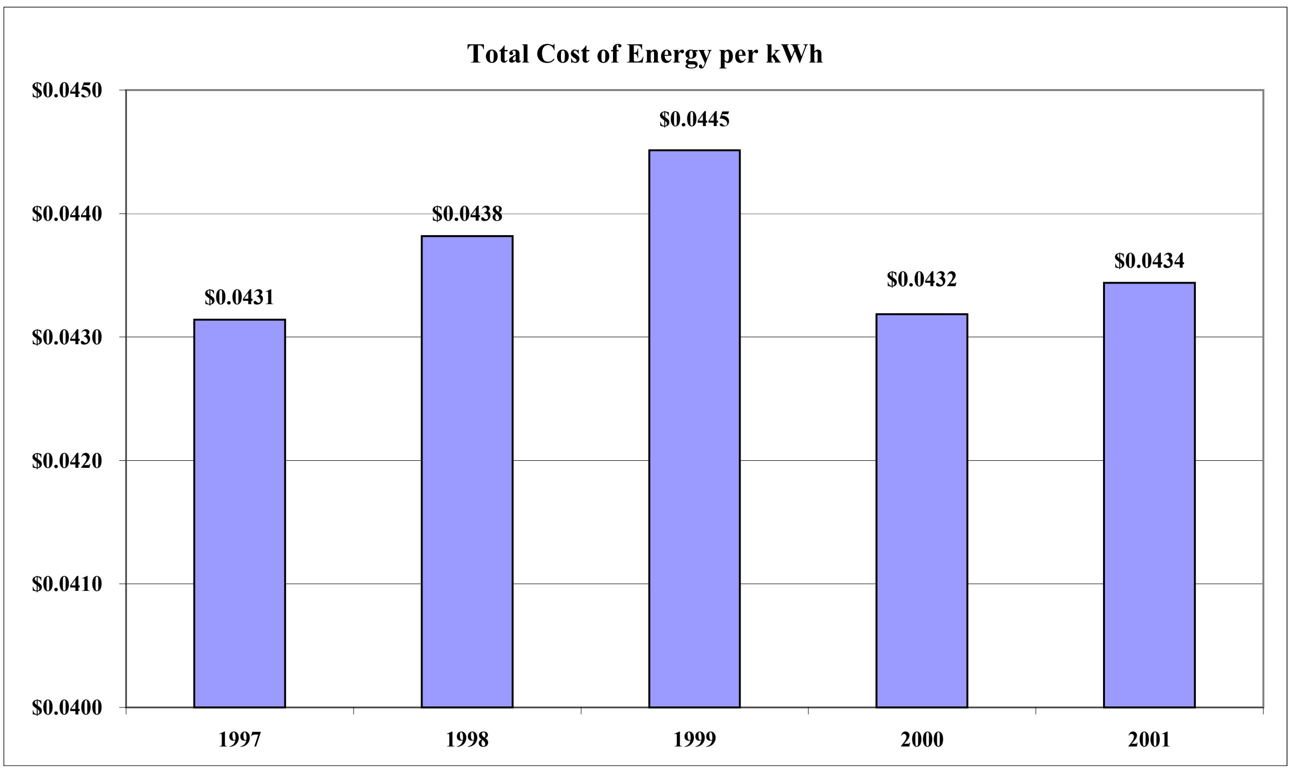
Newfoundland and Labrador Hydro **Schedule 3**
Reconciliation of Net Income to Revenue Requirement
1999 to 2001

(000)'s	2001			2000			1999		
	Financial Statement	Adjust.	Revenue Require.	Financial Statement	Adjust.	Revenue Require.	Financial Statement	Adjust.	Revenue Require.
Depreciation	$ 32,175		$ 32,175	$ 35,469		$ 35,469	$ 36,108		$ 36,108
Fuel	50,207		50,207	42,568		42,568	35,110		35,110
Power purchased	20,057	(4,457)	15,600	20,385	(4,424)	15,961	18,927	(5,142)	13,785
Other costs									
Salaries	61,733	(4)	61,729	61,374	(107)	61,267	57,128	(58)	57,070
System equip. maint.	17,453	(8)	17,445	18,977	(1)	18,976	14,957	(2)	14,955
Insurance	949		949	1,037		1,037	1,068		1,068
Transportation	2,332		2,332	2,892		2,892	3,481		3,481
Office supplies	1,872		1,872	2,081		2,081	2,858		2,858
Bldg. rentals and maint.	704		704	998		998	2,897		2,897
Professional services	5,530		5,530	3,815		3,815	3,756		3,756
Travel	2,779	(1)	2,778	2,835		2,835	2,459		2,459
Equipment rentals	1,369		1,369	1,400		1,400	1,602		1,602
Miscellaneous	5,221	212	5,433	4,891	288	5,179	4,341	388	4,729
Loss on disposal	1,839		1,839	2,186		2,186	923		923
Customer costs	395	(395)	-	420	(420)	-	495	(495)	
Sub-total	102,176	(196)	101,980	102,906	(240)	102,666	95,965	(167)	95,798
Allocations									
Hydro capitalized	(9,567)		(9,567)	(7,852)		(7,852)	(8,537)		(8,537)
C.F.(L) Co.	(1,766)		(1,766)	(1,774)	104	(1,670)	(2,109)		(2,109)
Other	-	-	-			-	(49)	49	
Sub-total	(11,333)	-	(11,333)	(9,626)	104	(9,522)	(10,646)	-	(10,646)
Total	90,843	(196)	90,647	93,280	(136)	93,144	85,319	(167)	85,152
Write down of capital assets			-				16,680		16,680
Interest	91,598	1,190	92,788	94,193	2,675	96,868	93,179	2,148	95,327
Net earnings	40,431	(27,194)	13,237	17,296	(11,446)	5,850	31,716	(35,363)	(3,647)
Revenue requirement	$325,311	($30,657)	$294,654	$303,191	($13,331)	$289,860	$317,039	($38,524)	$278,515

Schedule 4A

Newfoundland and Labrador Hydro
Comparison of Total Cost of Energy to kWh Sold and Used
(000)'s

Year	kWh sold and used	Depreciation	Fuel	Purchased Power	Other Costs	Interest	Adjusted Earnings		Total Cost of Energy		Cost per kWh
1997	6,784,000	$ 30,686	$ 43,900	$ 5,692	$ 74,152	$ 106,876	$ 31,351		$ 292,657		$ 0.0431
1998	6,254,000	$ 32,843	$ 26,880	$ 9,442	$ 80,827	$ 98,903	$ 25,132		$ 274,027		$ 0.0438
1999	6,257,000	$ 36,108	$ 35,110	$ 13,785	$ 85,152	$ 95,327	$ 13,033	1	$ 278,515	1	$ 0.0445
2000	6,712,000	$ 35,469	$ 42,568	$ 15,961	$ 93,144	$ 96,868	$ 5,850		$ 289,860		$ 0.0432
2001	6,783,000	$ 32,175	$ 50,207	$ 15,600	$ 90,647	$ 92,788	$ 13,237		$ 294,654		$ 0.0434



1 Both of these numbers have been restated for the writedown of the Roddickton chip plant

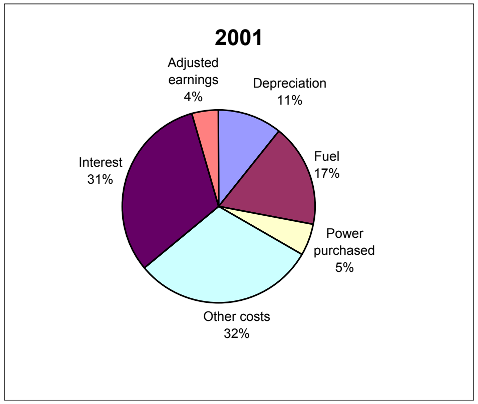
Schedule 4B

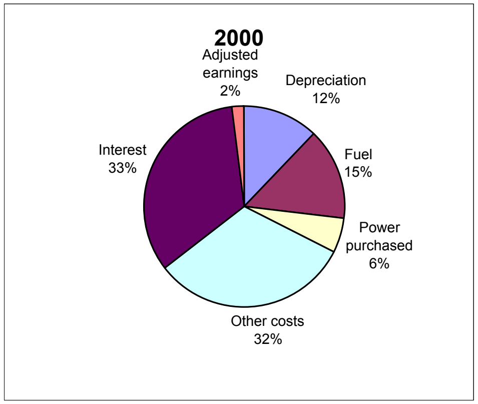
Newfoundland and Labrador Hydro
Comparison of Costs as a Percentage of kWh Sold and Used

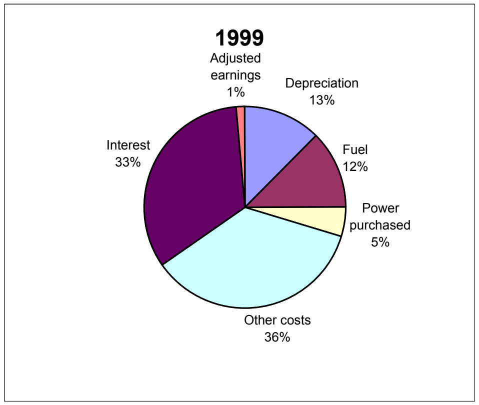
	1997			1998			1999			2000			2001		
kWh sold and used	6,784,000			6,254,000			6,257,000			6,712,000			6,783,000		
	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total
Depreciation	$ 30,686	0.0045	10.49%	$ 32,843	0.0053	11.99%	$ 36,108	0.0058	12.96%	$ 35,469	0.0053	12.24%	$ 32,175	0.0047	10.92%
Fuel	43,900	0.0065	15.00%	26,880	0.0043	9.81%	35,110	0.0056	12.61%	42,568	0.0063	14.69%	50,207	0.0074	17.04%
Power purchased	5,692	0.0008	1.94%	9,442	0.0015	3.45%	13,785	0.0022	4.95%	15,961	0.0024	5.51%	15,600	0.0023	5.29%
Other costs	74,152	0.0109	25.34%	80,827	0.0129	29.50%	101,832	0.0163	36.56%	93,144	0.0139	32.13%	90,647	0.0134	30.76%
Interest	106,876	0.0158	36.52%	98,903	0.0158	36.09%	95,327	0.0152	34.23%	96,868	0.0144	33.42%	92,788	0.0137	31.49%
Adjusted earnings	31,351	0.0046	10.71%	25,132	0.0040	9.17%	(3,647)	(0.0006)	-1.31%	5,850	0.0009	2.02%	13,237	0.0020	4.49%
Total	$ 292,657	0.0431	100.00%	$ 274,027	0.0438	100.00%	$ 278,515	0.0445	100.00%	$ 289,860	0.0432	100.00%	$ 294,654	0.0434	100.00%

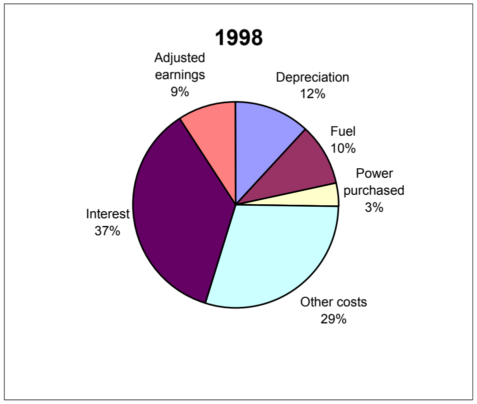
Newfoundland and Labrador Hydro
Comparison of Costs as a Percentage of kWh Sold and Used

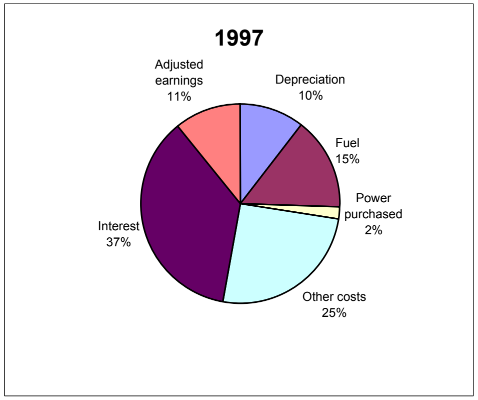
Schedule 4B











Schedule 4C

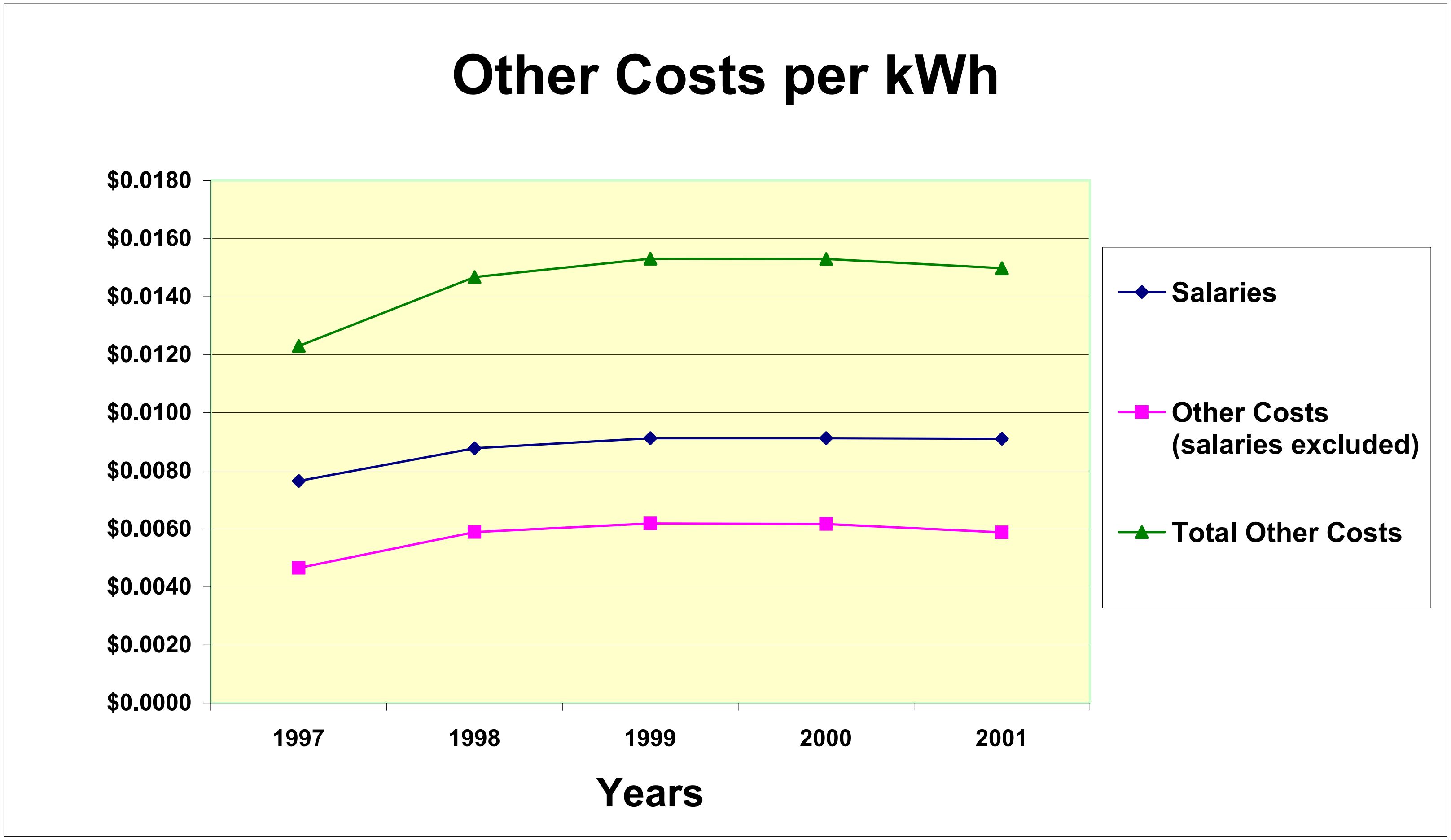
Newfoundland and Labrador Hydro
Comparison of Other Costs by Breakdown
1997 to 2001

	1997			1998			1999			2000			2001		
kWh sold and used	6,784,000			6,254,000			6,257,000			6,712,000			6,783,000		
	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total
Salaries	$ 51,863	0.00764	100.00%	$ 54,904	0.00878	100.00%	$ 57,070	0.00912	100.00%	$ 61,267	0.00913	100.00%	$ 61,729	0.00910	100.00%

	1997			1998			1999			2000			2001		
kWh sold and used	6,784,000			6,254,000			6,257,000			6,712,000			6,783,000		
	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total
System equip. maint.	$ 11,506	0.00170	36.46%	$ 11,323	0.00181	30.73%	$ 14,955	0.00239	38.62%	$ 18,976	0.00283	45.84%	$ 17,453	0.00257	43.77%
Insurance	1,224	0.00018	3.88%	1,056	0.00017	2.87%	1,068	0.00017	2.76%	1,037	0.00015	2.50%	1,037	0.00015	2.60%
Transportation	3,177	0.00047	10.07%	3,641	0.00058	9.88%	3,481	0.00056	8.99%	2,892	0.00043	6.99%	2,892	0.00043	7.25%
Office supplies	2,716	0.00040	8.61%	2,715	0.00043	7.37%	2,858	0.00046	7.38%	2,081	0.00031	5.03%	2,081	0.00031	5.22%
Bldg. rentals and maint.	2,210	0.00033	7.00%	3,226	0.00052	8.75%	2,897	0.00046	7.48%	998	0.00015	2.41%	998	0.00015	2.50%
Professional services	2,627	0.00039	8.32%	3,398	0.00054	9.22%	3,756	0.00060	9.70%	3,815	0.00057	9.22%	3,815	0.00056	9.57%
Travel	1,957	0.00029	6.20%	2,211	0.00035	6.00%	2,459	0.00039	6.35%	2,835	0.00042	6.85%	2,835	0.00042	7.11%
Equipment rentals	1,530	0.00023	4.85%	2,000	0.00032	5.43%	1,602	0.00026	4.14%	1,400	0.00021	3.38%	1,400	0.00021	3.51%
Miscellaneous	3,920	0.00058	12.42%	6,142	0.00098	16.67%	4,729	0.00076	12.21%	5,179	0.00077	12.51%	5,179	0.00076	12.99%
Loss on disposal	691	0.00010	2.19%	1,137	0.00018	3.09%	923	0.00015	2.38%	2,186	0.00033	5.28%	2,186	0.00032	5.48%
Total	$ 31,558	$ 0.00465	100.00%	$ 36,849	$ 0.00589	100.00%	$ 38,728	$ 0.00619	100.00%	$ 41,399	$ 0.00617	100.00%	$ 39,876	$ 0.00588	100.00%

Grand Total	$ 83,421	$ 0.01230	100.00%	$ 91,753	$ 0.01467	100.00%	$ 95,798	0.01531	100.00%	$ 102,666	0.01530	100.00%	$ 101,605	0.01498	100.00%

Schedule 4C



Other Costs per kWh
$0.0180
$0.0160
$0.0140
$0.0120
$0.0100
$0.0080
$0.0060
$0.0040
$0.0020
$0.0000
1997
1998
1999
2000
2001
Years
Salaries
Other Costs (salaries excluded)
Total Other Costs

Newfoundland and Labrador Hydro **Schedule 5**
Rate Stabilization Plan Summary
1999 to 2001

(000)'s	2001 Current Variation	2001 Current Interest	2001 Prior Interest	2001 Total	2000	1999
Balance, beginning of year				$35,606	$34,331	$48,786
Water variation	$ 5,243	$ (172)	$ 18,568	23,639	1,390	2,253
Load variation	(3,506)	(204)	231	(3,479)	762	5,074
Fuel variation	56,879	2,317	(18,326)	40,870	10,896	(9,896)
Recovery	(11,151)		2,289	(8,862)	(10,788)	(11,239)
Rural rate alteration	125	18	(213)	(70)	(1,046)	(482)
Labrador interconnected	34	2	4	40	61	(165)
Net change	$ 47,624	$ 1,961	$ 2,553	52,138	1,275	(14,455)
Rate adjustment for industrial customers				(2,671)		
Balance, end of year				$85,073	$35,606	$34,331

Comprised of:

Water variation	$244,204
Load variation	(737)
Fuel variation	(176,825)
Recovery	23,629
Rural rate alteration	(2,611)
Labrador interconnected	84
Rate adjustment for industrial customers	(2,671)
Balance, end of year	$85,073
Current receivable	$63,973
Long-term receivable	21,100
	$85,073