Newfoundland and Labrador Hydro
2003 General Rate Hearing
Grant Thornton LLP
Supplementary Evidence

December 5, 2003

The purpose of this supplementary evidence is to provide additional commentary with respect to the following topics:

- Key Performance Indicators
- Rate Stabilization Plan
- Range of Rate of Return on Rate Base
- Automatic Adjustment Formula
- Revised Revenue Requirement

Key Performance Indicators

During this hearing there has been considerable evidence put before the Board through pre-filed evidence, reports, RFIs and through the examination of witnesses with respect to the topic of Key Performance Indicators (KPI) and a number of related topics including operating efficiencies, business process improvement initiatives and a productivity allowance. In some instances these topics were linked together while at other times they appear to have been examined as separate issues. It is our observation that all these topics are related and should be viewed that way from a regulatory perspective.

In Mr. Wells pre-filed evidence (pgs. 19-21) he has clearly articulated at a conceptual level how Hydro's goal of optimizing performance is operationalized through the assessment of business processes and measured through the development and implementation of key performance measures. However, while there has been discussion of business process improvement projects undertaken by Hydro (ref. Roberts pre-filed pgs.23-24; Transcript October 16th, pgs 137-145; Transcript October 27th, pg 87; NP-258 NLH) it may not be clear in the evidence how these all tie together and what they mean in terms of improvements in operational efficiency.

Hydro has presented evidence on the recommended KPIs in U-Hydro #17. However, it is our understanding that the 2004 KPIs are based on the revised October GRA filing but, as indicated in the undertaking, targets for 2004 have not been established. A more transparent linkage between process improvement initiatives and the key performance measures may assist the Board in effectively monitoring Hydro's operating performance and efficiency.

The objective is to establish an effective regulatory framework and process for monitoring Hydro's operational efficiency on a go forward basis. With a view to achieving that objective, we recommend that Hydro be asked to submit annual targets (or objectives) with respect to each KPI being reported to the Board for regulatory purposes, together with the background support or rationale for the targets. We would expect the targets to be supported by or linked in some manner to certain business process improvement initiatives or arise from certain benchmarking analysis or inter-utility comparisons of performance.

The second item we wish to comment on with respect to the topic of KPIs is the issue of external benchmarking or inter-utility comparisons of performance. As stated in our Report on Regulatory Performance Measures, we believe that there is value to the Board, and also Hydro, from external benchmarking of performance. In Consent #1 (pg. 4, para. aa) all parties agreed that "Hydro will propose a peer group of utilities and measures upon which to compare its performance…". We support this statement and suggest that the measures to be compared should include the KPIs identified in our report as being appropriate from a regulatory perspective.

Rate Stabilization Plan

On November 13, 2003 Hydro filed Consent #2 and Consent #3. Both of these documents detailed changes to the existing Rate Stabilization Plan ("RSP") as negotiated by representatives for Hydro, Newfoundland Power Inc., Industrial Customers and the Consumer Advocate. In supplementary evidence filed on November 21, 2003, and in testimony of December 2, 2003, Mr. Sam Banfield explained the proposed changes to the various components of the RSP. He also confirmed that the proposed changes were a result of negotiation involving give and take by all parties (Dec. 2, 2003 Transcript, Pg.147, lines 20-25).

Consent #2 describes the details and calculations of a revised RSP that, pending Board approval, will commence January 1, 2004. Consent #3 addresses the balance accumulated in the plan from September 1, 2002 to December 31, 2003 and will, pending Board approval, commence December 31, 2003. We have reviewed the changes as detailed in both consent documents and advise that we have not identified any concerns with the approach and methodology proposed. The changes described in both documents will have the following impacts:

- Reduce the overall impact of rate changes in 2004 by deferring the recovery of the September 1, 2002 to December 31, 2003 accumulated balance over four years as opposed to the two years currently required in the existing plan.

- Provides for 25% recovery of future hydraulic variation (excluding financing charges) as compared to a 100% recovery over two years under the existing plan.

- Provides for a timelier price signal to end consumers with regards to the impact of fuel price changes. This is the result of two changes in the proposed RSP: the addition of a fuel rider and the recovery of the accumulated balance, including forecast financing charges, over a one year period. The fuel rider calculation for each customer class is based on the PIRA forecast of fuel costs for the following twelve month period and a current foreign exchange rate.

- "Forward looking" mechanisms such as the forecast fuel costs used in the calculation of the fuel rider and the inclusion of the forecast finance charges during the recovery period in the rate adjustment calculation, along with the one year recovery period should reduce the potential that significant balances will accumulate in future years.

- Both components of the load variation, revenue and fuel, will be fully assigned to the customer class that caused the load variation. Previously, the fuel component was treated as common costs and shared proportionately among the customer classes.

It was acknowledged by Mr. Banfield during cross examination that the proposed changes increase the level of complexity of the RSP and, as also indicated in his supplementary evidence, it is possible that the proposed changes may cause increased volatility in rates. In light of these comments we suggest that the Board consider the appropriate reporting requirements of the proposed RSP to permit effective monitoring of the plan, including the impact on customers.

Currently, Hydro is reporting on the activity in the RSP in its quarterly reports submitted to the Board. This report includes the accumulated year to date balance and the details for the last month of each quarter. During Mr. Banfield's testimony, he indicated that Hydro would have no difficulty in providing the monthly activity in its quarterly reports (Transcript Dec.2, 2003, pg. 153, lines 21-24). We recommend that Hydro be instructed to provide all monthly activity or summarized quarterly activity to the Board in its regular quarterly reports.

We considered whether a mechanism based on a maximum allowable balance should be included in the plan in order to trigger a review. However, based on a detailed review of the new plan including changes in the hydraulic variation, the use of a fuel rider and the one year recovery period, we do not consider such a mechanism to be necessary. However, we are recommending that Hydro be instructed to undertake a review of the new plan after a 24 month period. This review should assess the effectiveness of the new plan, assess the impact on and reaction of customers and determine whether any modifications are appropriate. As part of this review all stakeholders should be provided the opportunity to comment on the operation of the new plan.

Range of Rate of Return on Rate Base

In our report prepared for this hearing we suggested the Board consider establishing a range and upper limit of allowed return on rate base and an excess earnings account for Hydro (GT Report, pg.22, lines 21-23). It is our understanding based on a review of the evidence that Hydro's position on this issue is that they have not requested a range be set but that the Board has the jurisdiction to establish such a range if deemed appropriate (Transcript October 16th, pgs. 80-81; NP-234 NLH).

It has been the practice in this jurisdiction in the regulation of Newfoundland Power Inc to prescribe an allowed range for rate of return on rate base. It has also been the practice to prescribe that any earnings in excess of the upper limit of the prescribed range be placed in an excess earnings account with the disposition of any such amount being determined by the Board. Based on our review of Hydro's application and the evidence presented during the hearing we see no compelling reason why Hydro should be treated any different from Newfoundland Power Inc. with respect to this issue.

In the interest of regulatory consistency, we recommend the Board establish an allowed range and upper limit of rate of return on rate base for Hydro in its decision. In addition we recommend the Board instruct Hydro to establish an "excess earnings account" to deal with any earnings generated in excess of the upper limit as prescribed.

We do not have a position with respect to the specific range of rate of return for Hydro as the Board would need to assess the range in the context of its findings on other related financial matters. The range of rate of return prescribed for Newfoundland Power Inc. may be an appropriate starting point which could be adjusted, if necessary, to take into account the Board's decision on these other matters.

Automatic Adjustment Formula

Another matter related to rate of return on rate base is the issue of utilizing an Automatic Adjustment Formula (AAF) for adjusting the allowed rate of return on an annual basis. The use of such a formula is also an established practice in this jurisdiction which has been implemented with the objective of enhancing regulatory efficiency. The issue of regulatory efficiency would appear to be an issue equally relevant to Hydro and we see no reason why this regulatory practice would not apply. In the interest of regulatory consistency we recommend that the Board address whether implementation of an AAF is appropriate for Hydro at this time.

If the Board were to decide that implementation of an AAF was appropriate it should request that Hydro file a proposal detailing how implementation could be achieved for 2005.

Revised Revenue Requirement

On October 31, 2003 Hydro submitted its revised revenue requirement for the 2004 test year incorporating actual results to August 31, 2003, the impacts of the 2004 approved capital budget and the most recent forecast for matters such as No.6 fuel price, load, interest rate and exchange rates. The overall impact of these revisions resulted in a 2004 test year revenue requirement of $367.510 million in comparison to $371.841 million included in the August, 2003 filing; this represents a decrease of $4.331 million.

Schedule II (2nd Revision – Oct.31, 2003), Page 1 of 8 included in Mr. J.C. Roberts pre-filed evidence summarizes the changes in the 2004 revenue requirement from the August filing in comparison to the October filing. Pages 5 and 6 of 8 of the same Schedule also provide explanations to support the revisions. We have reviewed the revised revenue requirement as filed and can verify that Hydro has updated the 2004 test year data for the key assumptions as recommended in our report.

We have identified one issue related to the revisions which should be brought to the Board's attention. The increase in the loss on disposal of capital assets of $725,000 due to the projected discontinuation of service in the isolated community of Davis Inlet is unusual and not recurring in nature. We believe it is inappropriate to include an unusual item such as this in a test year revenue requirement that will be used to set rates until the next general rate hearing. We recommend that the cost associated with the discontinuation of service at Davis Inlet be amortized over a period of several years to normalize the forecast of 2004 test year revenue requirement. An amortization period of three to five years would be considered reasonable.