2003 GENERAL RATE APPLICATION

FINAL ARGUMENT

An application to the
Board of Commissioners of Public Utilities

Proposed Power Rates
To be charged by
Newfoundland & Labrador Hydro
To
Newfoundland Power,
Island Industrial Customers
and
Rural Customers

January 2004

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A. INTRODUCTION

A.1 General

On May 21, 2003, Newfoundland and Labrador Hydro ("Hydro") filed an Application (the "Application") under the *Public Utilities Act, R.S.N.* 1990, c. P-47, seeking approval of the following:

1. Under Section 70 of the Act, changes in the rates to be charged for the supply of power and energy to its Retail Customer, Newfoundland Power, its Rural Customers and its Industrial Customers, to be effective January 1, 2004; and

2. Under Section 71 of the Act, the Rules and Regulations applicable to the supply of electricity to Rural Customers.

Hydro's Application included proposed rates for its Rural Customers to commence the phase-out of preferential rural rates as directed by Order No. P.U. 7 (2002-2003) ("P.U. 7"). In July 2003, the Lieutenant Governor-in-Council gave direction to the Board of Commissioners of Public Utilities (the "Board") under Section 5.1 of the *Electrical Power Control Act*, 1994, S.N. 1994, E-5.1 ("*EPCA*") to maintain the preferential rates charged Rural Customers. This direction was slightly revised by a subsequent Order-in-Council dated August 14, 2003 and was filed in the hearing as Information Item I #1 ("I #1").

On August 12, 2003, Hydro filed an Amended Application to reflect the direction received by the Board from the Government with respect to the rates to be charged to Rural Customers as set out in I #1 and to reflect the June 20, 2003, decision of the Board on Newfoundland Power's General Rate Application (Order No. P.U. 19 (2003)) insofar as it affected Hydro's Application. The Amended Application proposed the continuation of the preferential rates charged to Rural Customers as directed by the Lieutenant Governor-in-Council, reduced the rate

of return on equity requested by Hydro in consideration of the decision of the Board in Order No. P.U. 19 (2003), and reflected the changes in rates for Newfoundland Power's customers as approved by the Board by Order No. P.U. 23 (2003).

Subsequently on October 31, 2003, Hydro filed a revision to its Application to update relevant forecasts (No. 6 fuel prices, load, interest rates, foreign exchange rates, etc.) and expenses used in the Revenue Requirement to reflect actuals to August 31, 2003.

Based on the October 31, 2003 Revision, Hydro is proposing to:

1. Increase rates charged to Newfoundland Power by 12%, which will result in an increase of approximately 6.5% to Newfoundland Power's customers;

2. Increase rates charged to Hydro's Island Industrial Customers by 12.2% for firm service;

3. Continue with the existing policy for setting rates for Rural Customers on the Island Interconnected system and the L'Anse au Loup system that these customers pay the same rates as Newfoundland Power's customers. The rates for these customers will, therefore, increase by approximately 6.5%.

4. Continue with the policies for setting rates for Isolated Rural Customers as directed by the Lieutenant Governor-in-Council. The proposals with respect to the rates for Isolated Rural Customers are set out in the Rates Section of this Argument; and

5. Commence the five-year phase-in of uniform rates for Labrador Interconnected Rural Customers as described in the Rates Section of this Argument.

In addition, Hydro is proposing to decrease the rate for wheeling energy for Abitibi-Consolidated Company to 4.37 mills per kWh, that the rate charged Industrial Customers for non-firm service be as set out on p. 3 of the Amended Rates Schedules, dated October 31, 2003, that the firming up charge for energy supplied by Corner Brook Pulp and Paper Limited ("CBPP") be 6.45 mills per kWh and that the specifically assigned charges for Industrial Customers be as set out on p. 2 of the Amended Rates Schedules, dated October 31, 2003.

Hydro acknowledges that these proposed increases are significant, however, they cannot be reviewed in isolation but must be viewed in the context of the reasons for the increases. Hydro's Revenue Requirement has increased by approximately $50.5 million from that approved by the Board for the 2002 test year for rate setting purposes in P.U. 7. This increase in Hydro's Revenue Requirement arises for a number of reasons as outlined below.

Since 2002, Hydro has added three new sources of supply to meet customers' load requirements and the costs of these new sources are not included in the current rates. Power purchase costs have increased by approximately $18.5 million as a result of two new power purchase contracts with Exploits River Hydro Partnership and CBPP. Financing costs solely associated with the development of Granite Canal, the third new source of supply, have increased overall financing costs by approximately $11 million. Thus, the three new sources of supply required to meet the forecast load of customers for the Island Interconnected System account for $29.5 million of the $50.5 million increase from the Board approved 2002 Revenue Requirement and are the primary reason for the current Application.

All expenses are updated in a General Rate Application ("GRA") to reflect experience and forecasts for the test year. Thus, in the Application there are adjustments in other categories of expenses, as well as, for new sources of supply. The second largest increase is in depreciation and financing costs unrelated to Granite Canal, totaling $12 million. Increases in depreciation costs of $2.3 million are a result of new assets coming into service and other assets being retired. The financing cost increase is $9.7 million, excluding those related to Granite Canal and including Hydro's request to earn a return on equity of 9.75%, which Hydro considers to be essential to its long-term financial integrity.

The third component of the increase is higher fuel costs which continue to be one of Hydro's largest expenses. The Holyrood Thermal Generating Plant supplies approximately 40% of Hydro's average energy capability and 31% of its capacity. Fuel costs for 2004 are forecast to be $91.7 million, an increase of approximately $3.1 million from the 2002 test year, due primarily to an increase in No. 6 fuel costs. This increase is net of the impact of the production from the new Granite Canal plant and the two new power purchases.

The fourth and last component of the increase in Revenue Requirement of $50.5 million from the approved 2002 test year is the increase in the category of "Other Costs" of approximately $5.9 million. This category of expenses covers such items as salaries, insurance, professional services and system equipment maintenance.

During its 2001 GRA, Hydro had indicated to the Board that new sources of supply for customers would be required and would be coming into service in 2003. The costs of these new sources of supply, Hydro's Granite Canal Project and the two new power purchase contracts, are not included in the current rates charged by Hydro and are the primary driver of the timing of Hydro's current Application. As well, the Board in P.U. 7 directed Hydro to submit a GRA no later than December 31, 2003.

A. 2 Legislative Framework

Hydro is a regulated public utility under the *Public Utilities Act* and is subject to the provisions of the *EPCA*. The most significant legislative provisions which must guide the Board in its review and consideration of the issues in this hearing include the following:

Public Utilities Act

1. Section 70

   Hydro's Application is filed under Section 70 which requires the Board's approval for the rates charged by Hydro to its customers.

2. Section 71

   Section 71 requires the Board's approval for the rules and regulations which relate to service to customers. Hydro is proposing minor amendments to its current rules and approval of these is required under Section 71.

3. Section 80

   Subsection (1) of Section 80 provides that a public utility is entitled to a "just and reasonable return" on its rate base as determined by the Board. Subsection (2) provides that the return shall be in addition to expenses that are allowed as reasonable and prudent.

EPCA

1. Section 3 (a)

   Section 3 of the *EPCA* states the power policy of the Province. Subsection (a) provides that the rates to be charged for the supply of power:

   (i) should be reasonable and not unjustly discriminatory;

(ii) should be established, wherever practicable, based on forecast costs for that supply of power for one or more years;

(iii) should provide sufficient revenue to the producer or retailer of the power to enable it to earn a just and reasonable return as construed under the *Public Utilities Act* so that it is able to achieve and maintain a sound credit rating in the financial markets of the world; and

(iv) should be such that after December 31, 1999, Industrial Customers shall not be required to subsidize the cost of power provided to Rural Customers in the Province.

2. Section 3 (b)

Section 3 (b) of the *EPCA* provides a further statement of the power policy. It states that all sources and facilities for the production, transmission and distribution of power in the Province should be managed and operated in the manner (i) that would result in the most efficient production, transmission and distribution of power; (ii) that would result in consumers in the Province having equitable access to an adequate supply of power; and (iii) that would result in power being delivered to consumers in the Province at the lowest possible cost consistent with reliable service.

3. Section 4

Section 4 states that the Board, in carrying out its duties and exercising its powers under both the *EPCA* and the *Public Utilities Act*, must implement the power policy declared in Section 3 and apply tests which are consistent with generally accepted sound public utility practice.

The Newfoundland Court of Appeal in a stated case from the Board on a number of questions in the case of Newfoundland (Board of Commissioners of Public Utilities), attached in Schedule A, reviewed the relevant legislative provisions, including those set out above from paragraphs 13 to 36 of its judgement. In

paragraph 36 the Court set out general principles to be used in the interpretation and application of the relevant legislation which should guide the Board in the interpretation of the statutory provisions set out above. These include that the Board in carrying out its functions must balance the interests of the utility and those of the consuming public and that the relevant acts must be given a broad and liberal interpretation to achieve their purposes and the implementation of the power policy of the Province.

B. REVENUE REQUIREMENT

B.1 General

Hydro's proposed 2004 Revenue Requirement as of October 31, 2003, shown on Schedule II (2nd Revision – October 31, 2003) to the evidence of J. C. Roberts ("Schedule II") is $367.5 million.

The Newfoundland Court of Appeal in its decision attached in Schedule A also gave direction with respect to the Board's review of operating expenses. The Court recognized that the Board has a right to review expenses of a utility. However, in paragraph 118 at page 32 of the attached decision the Court states:

> "In defining the parameters of such supervisory power, however, the Board must account for a competing principle, namely, that the Board is not the manager of the utility and should not as a general rule substitute its judgement on managerial and business issues for that of the officers of the enterprise."

Further in paragraph 120 the Court stated:

> "There will normally be a presumption of managerial good faith and a certain latitude given to management in their decisions with respect to expenditures."

This general approach to the review of operating expenditures as outlined by the Court should guide the Board in its review of the proposed Revenue Requirement.

The proposed Revenue Requirement for 2004 is composed of the following major categories of costs: depreciation, fuel, power purchased, other costs, interest and return on equity. Each of these categories of costs will be addressed separately in this section of the Argument.

B. 2 Non-regulated Costs and Revenues

Non-regulatory costs have been excluded from the determination of the Revenue Requirement as has the revenue received from non-regulated activities.

The Board in P.U. 7, directed Hydro to file, on or before December 31, 2002, the written policies and procedures to account for all intra and inter-corporate transactions identifying what is to be included in regulated and non-regulated activities as a normal reporting function (paragraph 38 (iii), p. 182, of the Order). A report on non-regulated operations was filed in December, 2002 by Hydro as directed by the Board and was attached to the evidence of J. C. Roberts filed with the Application as Exhibit JCR-2. Exhibit JCR-2 provided a definition of all non-regulated operations and described the procedures used by Hydro to determine, manage and report non-regulated costs and revenues.

Hydro's Exhibit JCR-2 was reviewed by the Board's financial consultants, Grant Thornton, in its 2002 Annual Financial Review of Hydro which was filed as I #3. At page 33 of this report, Grant Thornton stated that they have reviewed the policies as submitted by Hydro and concluded that "Hydro has appropriately identified and defined its various non-regulated operations and has established appropriate procedures for recording and reporting on these activities". No issue was raised by Grant Thornton in its review of Hydro's 2003 GRA (I #9) with respect to non-regulatory costs or revenues. Similarly, no issues were raised in the hearing with respect to the appropriateness of Hydro's practices with respect to the reporting of non-regulated costs and revenues.

B. 3 Depreciation

The first major category of cost in the Revenue Requirement on Schedule II is depreciation which is forecast for 2004 to be $33.7 million. This amount reflects the 2004 capital budget as approved by the Board in Order No. P.U. 29 (2003). Hydro on November 21, 2003, applied for approval for additional 2004 capital budget items which, if approved, would need to be reflected in the depreciation expense in the 2004 Revenue Requirement.

The amount for depreciation was calculated in accordance with Hydro's depreciation policies as approved by the Board (P.U. 7, p. 58 and paragraph 37, p. 181). The Board further directed Hydro to submit its next depreciation study in 2005 (p. 58 of P.U. 7 and paragraph 8 (iv), p. 177).

Grant Thornton in its report on Hydro's 2003 GRA found no significant discrepancies in Hydro's depreciation expense and found that the depreciation expense forecast for 2003 and 2004 appeared "reasonable" (I #9, p. 34, commencing line 24). As well, Grant Thornton found that in forecasting depreciation expense, Hydro had complied with P.U. 7 (I #9, p. 35, lines 1-2). Grant Thornton raised no issues on Hydro's forecast 2004 depreciation expense in its supplementary evidence dated December 5, 2003, which was filed following a review of Hydro's revised evidence dated October 31, 2003. No Intervenor raised any issue about Hydro's depreciation policies.

Certain issues were raised with respect to the calculation of the actual depreciation expense used in the 2004 forecast Revenue Requirement. Grant Thornton in its report on Hydro's 2003 GRA (I #9, pp. 17-19) raised the issue of actual capital expenditures being lower than budget and the amount of capital retirements included in the 2004 Revenue Requirement and suggested that the depreciation expense should be adjusted to reflect both of these. Both these issues are addressed in sections B.10.2 and B.10.3 of this Argument. Subject to

any direction from the Board on these two issues and to its decision on Hydro's Application dated November 21, 2003 for additional 2004 capital projects, Hydro submits that the depreciation expense on Schedule II of $33.7 million should be approved by the Board.

B.4 Fuel

B.4.1 General

The second major category of expense in the Revenue Requirement for 2004 on Schedule II is fuel which is forecast to be $91.7 million. This category is made up of a number of elements, the most significant of which is the cost of No. 6 fuel used at the Holyrood Thermal Generating Plant ($84.2 million) and the cost of diesel fuel ($6.8 million).

The forecast cost for No. 6 fuel for 2004 depends on three principal factors: the forecast 2004 fuel price; the volume of fuel forecast to be consumed at the Holyrood Thermal Generating Plant; and the forecast fuel conversion factor for production at the Plant. The volume of fuel forecast to be used at the Holyrood Plant for 2004 is in turn dependant on the 2004 forecast load and the forecast hydraulic production for 2004 as the Holyrood thermal production accounts for the bulk of the difference between the forecast load and the forecast hydraulic production. Each of these three factors will be dealt with separately in this section.

B.4.2 No. 6 Fuel – Price

The price forecast for 2004 for No. 6 fuel (2.2% sulphur) used at the Holyrood Plant is based on forecast prices provided by an external consultant to Hydro. Hydro retains the services of the PIRA Energy Group of New York, an internationally recognized company, for its petroleum product market analysis and pricing forecasts. Hydro applies, to this forecast received from PIRA, foreign exchange rates which are calculated based on forecasts of major Canadian banking institutions. At the time of the May 21, 2003 filing, the forecast average price for No. 6 fuel for 2004 was $29.20 (Cdn.) (Pre-filed evidence J. R. Haynes, Schedule VII). This was revised with the October 31, 2003 Revision to a weighted average of $28.95 (Cdn.) per barrel (Schedule VII (1st Revision – October 31, 2003). J. R. Haynes, Schedule VIII (1st Revision – October 31,

2003) provided the updated 2004 monthly No. 6 fuel purchase prices forecast as of September 26, 2003. The underlying weighted average fuel purchase price increased from the August Revision to the October 31st Revision from $19.23 U.S. to $21.58 U.S. per barrel (Schedule II, note 17) but a more favourable exchange rate from that used in the August 31filing offset the increase.

In P.U. 7, at page 60, the Board stated that it is required to set rates based on forecast costs for the test period and the most prudent course of action was to set fuel prices at or near the price forecast for the test year.

No Intervenor at the hearing raised the issue of whether a price other than the forecast price for No. 6 fuel as filed by Hydro should be used in setting rates. Hydro submits that the forecast prices for 2004 for No. 6 fuel filed with the revision of October 31, 2003, that resulted in a weighted average purchase price of $28.95 (Cdn.) per barrel (which reflects an updated foreign exchange rate) be used in establishing the No. 6 fuel cost forecast for 2004 test year costs.

B. 4.3 <u>Forecast Holyrood Thermal Generation</u>

The second principal factor which influences the cost of No. 6 fuel in any year is the amount of generation from the Holyrood Thermal Plant in that year. The forecast for thermal production is determined by subtracting the forecast hydraulic generation and power purchases from the forecast load.

The methodology to be used in the determination of the hydraulic production forecast was considered by the Board in P.U. 7. At that time, the Board ordered Hydro to use the average annual hydraulic production based on the most recent 30-years of hydrological records for the test year forecast and further directed that Hydro commission an independent study into its current forecasting methodology for hydraulic production to address such issues as data reliability, long-term trends and climate change.

In submitting its 2003 Application Hydro included, as directed by the Board, the forecast hydraulic production for 2004 based on a 30-year average for the existing plants and for the new Granite Canal Project, the estimate was obtained from a power and energy analysis. As directed by the Board, Hydro retained SGE Acres to complete an independent study of Hydro's hydraulic production forecasting methodology with the terms of reference for this review being first approved by the Board. This report, "Island Hydrology Review Final Report", was attached to the evidence of J. R. Haynes as Exhibit JRH-2. Ms. S. Richter of SGE Acres testified at the hearing with respect to this report and the recommendations arising from the review.

The principal recommendations of this Report are contained on pages 9-2 and 9-3 of Exhibit JRH-2. These recommendations, which Hydro accepts and endorses, include the following:

1. The longest reliable reference inflow sequence (period of record) should be used for all Hydro's operation, planning and rate setting purposes.

2. The inflow sequence as presently used by Hydro should be corrected to ensure internal consistency.

3. The same estimate of average annual energy from hydroelectric resources should be used for operations, planning and rate setting.

4. Computer simulation of the operation of the hydroelectric system using the reference inflow sequences should be used to estimate energy production and spill from Hydro's hydraulic resources. Hydro should review its in-house models and other models available and select one for these purposes.

5. Hydro should continue to use its present inflow sequences and methodology for energy estimates until such time that the rectification of inflow sequences and selection of a computer model has occurred. The present records, even with minor inconsistencies, give better estimates of expected flows than shorter records.

In her evidence, Ms. Richter stated that SGE Acres recommended the use of the full historic record for all purposes including the estimate of hydraulic production for rate setting purposes:

> "With respect to the length of hydrological record, the longest reliable record is preferable. Hydro is fortunate to have records from 1950 onwards at each of the stations key to its purposes providing a respectable record length of 52 years increasing with time. The sources on which the stream flow sequences are based are sound, with the exception of the early part of the Cat Arm sequence. The technological improvements in data collection from 1950 to the present have not affected accuracy and should not affect the selection of the length of record in this period. SGE Acres recommends the use of the full historic record for all purposes including the estimate of hydraulic production for rate setting purposes. The only reason to curtail a record is for computer modeling purposes where a consistent length of record is necessary for all the facilities to be used in an integrated system model." (Transcript, October 28, 2003, p. 4, lines 3-24).

Ms. Richter also explained that the use of the longest available records is the most appropriate as it will provide the best estimate possible. (Transcript, October 28, 2003, p. 14, lines 14-25 and p. 15, lines 13-19).

Hydro accepts the recommendations of SGE Acres that the longest reliable records should be used to determine the estimate of hydraulic production. However, Hydro is not proposing that the longest historical record be used to set rates for 2004. As stated in the pre-filed evidence, using the longest available records would result in a decrease in the hydraulic production forecast to 4,234 GWh which would increase the cost of No. 6 fuel expense by approximately $6 million (Pre-filed evidence J. R. Haynes, p. 29, lines 27-30 and

p. 30, lines 3-5). In light of this, and in light of the need to correct certain internal inconsistencies within the Bay D'Espoir hydraulic records and the selection of an appropriate computer simulation model, Hydro proposes that the Board accept, in principle, that the full historic record should be used to determine the annual hydraulic production forecast and that it be used by Hydro in the filing of its next GRA.

During her evidence, Ms. Richter dealt with the minor inconsistencies in the data which needed to be corrected (Transcript, October 28, 2003, p. 24, lines 11-25 and pp. 25-26). Ms. Richter confirmed that a project to correct the inconsistencies was in progress at that time by SGE Acres and was expected to be completed by year-end (Transcript October 28, 2003, p. 26, lines 16-21). The issue of the selection of an appropriate computer simulation model was also addressed by Ms. Richter during cross-examination where she explained that Hydro currently has models which are capable of doing the simulation that need to be reviewed along with other models to determine the most appropriate model (Transcript, October 28, 2003, p. 32, lines 1-18). It was explained by Ms. Richter that the use of computer simulation allows less reliance on the expertise of the people who are actually doing the calculations (Transcript, October 28, 2003, p. 32, lines 23-25 and p. 33, lines 1-21).

SGE Acres also undertook a survey of other utilities and regulators to determine their practices with respect to the determination of estimated hydroelectric production. As indicated in the report (JRH-2, Section 7, pp. 7-1 to 7-6) all the responding utilities use a historic sequence that is based on the entire length of record available to determine their estimate. Ms. Richter in her testimony stated that all utilities that responded use the longest record available and one that had at one time shortened the record, had reversed its decision and now use the longest available (Transcript, October 28, p. 5, lines 9-25).

Hydro submits that the evidence is clear that the longest available hydraulic record should be used as is the practice in other jurisdictions. Records from 1950 onwards have been recommended for use by SGE Acres, (see for example Exhibit JRH-2, Section 9 and Transcript, October 21, 2003, p. 46, lines 14-25 and p. 47, lines 1-6). Hydro further submits that the Board should direct Hydro to file its next GRA utilizing the full historic record available to determine the appropriate hydrological production record. Hydro is prepared to file with the Board the results of the SGE Acres review with respect to the internal inconsistencies which was expected to be completed by year end (Transcript, October 21, 2003, pp. 43-44) and to update the Board on the final selection of the computer simulation model.

B. 4. 4 <u>Efficiency Factor – No. 6 Fuel</u>

The third principal factor which affects the forecast of thermal production to be used in the 2004 test year is the efficiency factor or the fuel conversion factor for a barrel of No. 6 fuel oil. The Board in P.U. 7 set the fuel efficiency factor to be used for 2002 test year purposes at 615 kWh/bbl. Hydro, in its Application, proposed that this be increased for the 2004 test year to 624 kWh/bbl, representing the average value for the period 1996 to 2002.

Hydro is proposing that the fuel conversion factor be set based on the average value for the period from 1996 to 2003 which reflects the efficiency improvements actually experienced since the on-line efficiency monitoring system was placed in operation at the Holyrood plant in 1995 (Pre-filed evidence, J. R. Haynes, p. 12, lines 21-24) and the efficiency the plant can achieve on average through a variety of operating conditions. The period from 1996 to 2003 used in the calculation of the fuel conversion factor proposed by Hydro does include both dry years (2001and 2002) when Holyrood production was higher than average and wet years (1999 and 2000).

The response to NP-310 NLH provided the year-to-date conversion factors for Holyrood as of November 30, 2003. Adding on this actual experience to the end of November and assuming the same conversion factor in December as in November of 636.9, then the weighted average conversion factor for the period from 1996 to the end of 2003 would be 625.6 kWh/bbl (Transcript, December 11, 2003, p. 44, lines 11-25 and p. 45, lines 1-2).

The actual conversion factor for December, 2003, was 623.6 kWh/bbl. Should the Board wish to use the actual average for 1996 to 2003 including December, 2003, the actual average for that period is 625.4 kWh/bbl. The 2003 average conversion factor was 634.9 kWh/bbl.

There are a number of conditions which can affect the achieved efficiency including the actual units in operation, the load level on the units, unit fouling, the heat content of fuel, ambient conditions and the fuel consumption measurement (Transcript, October 21, 2003, p. 35, line 25 and p. 36, lines 1-14 and p. 37, lines 1-14 and the responses to IC-317 NLH and NP-198 NLH). All of these conditions affect the actual conversion factor that can be achieved.

Hydro has made a number of efficiency improvements at the Holyrood Thermal Plant which affects the fuel conversion factor and which led Hydro to selecting 1996 as the commencement of the period for use in determining the fuel conversion factor. The improvements include the following: the implementation of the controllable losses program in 1995 referenced above; the Holyrood Unit No. 3 water lance installation completed in 2002 (IC-252 NLH); the Holyrood Unit No. 3 reheater tubing completed in 2002 (IC-252 NLH); and the continuous emission monitoring system expected to be completed late fall 2003 (IC-252 NLH).

In his evidence, Mr. Haynes also reviewed these projects and the impact they have on the efficiency factor. These new projects which have been undertaken

at Holyrood to improve efficiency were taken into account by Hydro in its proposal to increase the conversion factor (Transcript, October 21, p. 34, lines 2-8). Further, Mr. Haynes explained that the anticipated efficiency needs to be verified and any improvements will be reflected in the future with the average reflecting actual achieved efficiencies (Transcript, October 21, p. 39, lines 4-15).

The impact of a change in the fuel conversion factor was illustrated in the response to NP-269 GT which shows the impact of using a conversion factor of 636 kWh/bbl rather than the 624 kWh/bbl proposed by Hydro in its original filing. The impact of such a change in the fuel conversion factor on the 2004 forecast would be a decrease in the forecast 2004 fuel expense of approximately $1.6 million. While some of the numbers used in this RFI have changed with revisions since the response was prepared, it indicates the order of magnitude of a change in the fuel conversion factor on the Revenue Requirement.

A decrease in actual efficiency achieved compared to that used in setting rates will impact Hydro directly and have a negative impact on Hydro's net income as Hydro is affected proportionally in the other direction with respect to the information contained in NP-269 GT. Thus, if the Board sets a fuel conversion factor of 636 KWh/bbl and if only 624 kWh/bbl were achieved, then there would be a reduction in Hydro's net income of approximately $1.6 million.

It can be seen from the above that the determination of the conversion factor for No. 6 fuel used at the Holyrood Plant will have an impact on the rates charged to customers, as well as, on Hydro's net income. Hydro believes that the most appropriate way to determine the conversion factor to apply for a range of expected conditions is a conversion factor which is representative or can be expected to be achieved based on experience over a reasonable period of time. This period would include the implementation of projects which are anticipated to improve efficiency at the Plant. If improvements in the efficiency materialize, they will be reflected in the average.

It is Hydro's submission that the most appropriate fuel conversion factor to use in setting rates for 2004 is the average actually achieved at the Plant over the period from 1996 to 2003, which is 625 kWh/bbl (625.4 kWh/bbl rounded to a whole number).

B.4.5 Diesel Fuel

The second largest component of the fuel expense category shown on Schedule II is diesel fuel, which as of October 31, 2003, was forecast to be $6.8 million for 2004. As with No. 6 fuel oil, the cost of diesel fuel is determined by applying forecast fuel prices to the fuel quantity required. The forecast price for diesel fuel is also based, like No. 6 fuel prices, on a forecast provided by PIRA. The original forecast decreased with the October 31, 2003, revision from $7.3 million in the August revision to $6.8 million to reflect a more current forecast from PIRA than used in the original Application. The decrease in diesel fuel expense from the original filing is due to a projected decrease in the weighted average diesel fuel price, including sellers mark-up and delivery costs, from $0.433 to $0.403 per litre as well as a small decrease in the load forecast from the one originally filed (Schedule II, note 18).

No substantive issues were raised by any of the parties to the proceeding with respect to Hydro's 2004 forecast of diesel fuel costs.

It is Hydro's submission that the 2004 forecast for diesel fuel of $6.8 million should be approved by the Board.

B.4.6. Fuel Costs – Other Issues

In P.U. 7, the Board directed Hydro to file by December 31, 2002, a statement of policies and procedures relating to fuel purchasing, addressing such issues as the adequacy of existing storage capacity, fuel purchases and an oil-hedging program. This report was filed by Hydro as directed by the Board in December 2002, and was filed with Hydro's Application as Exhibit JRH-1. Included with this Exhibit, was a report from Risk Advisory on a No. 6 Oil Risk Management Program.

Exhibit JRH-1 explained in detail Hydro's oil inventory and purchasing practices, its existing storage capacity, the appropriateness of an oil-hedging program and the policies and procedures used by Hydro for oil purchases. The report concluded that Hydro's current practices are prudent and result in the lowest reasonable costs for fuel purchases with no changes being recommended. No issues were raised by any party to the hearing with respect to any of these issues.

Hydro submits that its current practices with respect to the purchases of fuel and its management of such fuel as set out in Exhibit JRH-1 should be accepted by the Board.

B. 5 Power Purchased

Power purchased is the third main category of expenses in the 2004 Revenue Requirement listed on Schedule II. It is forecast to be $33.6 million in 2004, an increase of $18.5 million over the costs included in the 2002 test year as approved by the Board.

Hydro's power purchase arrangements for the Island Interconnected System were described in the pre-filed evidence of J. R. Haynes on p. 27 and in Schedule X. Hydro entered into two new power purchase arrangements since its 2001 GRA with CBPP and the Exploits River Hydro Partnership. These two new sources of supply were required to meet the forecast load. The contract with the Exploits River Hydro Partnership will provide an additional capacity and average annual energy available of 32.3 MW and 137 GWh, respectively, (Pre-filed evidence J. R. Haynes, p. 34, lines 17-22). The contract with CBPP will provide additional capacity of 15 MW and annual energy of 100.2 GWh (Pre-filed evidence J. R. Haynes, p. 34, lines 25-27).

The Lieutenant Governor-in-Council gave direction to the Board under Section 5.1 of the *EPCA* that the costs of projects exempted from the *Public Utilities Act* and the *EPCA* by an Order-in-Council are to be recovered in rates. This direction was filed in I #1. Both power purchase contracts entered into by Hydro with CBPP and the Exploits River Hydro Partnership were exempt by Order-in-Council from the *Public Utilities Act* and the *EPCA* (Newfoundland and Labrador Regulation 96/00 (O.C. 2000-489; O.C. 2001 – 491) and 53/02 (O.C. 2002 – 242; 2002 – 243)).

Also included in the category of power purchased is the cost associated with the purchase of secondary energy for the L'Anse au Loup system from the Hydro-Quebec Lac Robertson Plant and the cost of purchases from CF(L)Co for sales by Hydro to customers in Labrador. As well, Hydro continues to purchase energy from two other non-utility generators, the Star Lake Hydro Partnership and

Algonquin Power, the costs of which were approved by the Board in P.U. 7., Section 17(3) (c) of the Hydro Corporation Act, R.S.N. 1990 c. H-16 provides that all amounts paid by Hydro for these two non-utility purchases are to be included within the expenses as charged by Hydro to customers.

The purchase of power and energy from other suppliers to meet Hydro's customers' requirements is prudent and the costs included by Hydro in its forecast 2004 Revenue Requirement for these power purchases are reasonable. As well, direction has been provided to the Board to include such costs in Hydro expenses.

Hydro submits that all the power purchased costs forecast for the 2004 test year should be allowed by the Board.

B. 6 Interest

The fourth major category of expense included in the 2004 Revenue Requirement as detailed in Schedule II is interest expense which is forecast to be $98.2 million in 2004. The debt guarantee fee paid to the Province of Newfoundland and Labrador is included as part of this interest expense.

The Provincial Government provides a guarantee in relation to Hydro's debt and in turn receives compensation in the form of an annual fee equivalent to 1% of the previous year's debt net of sinking funds. This fee is forecast to be approximately $14.5 million in 2004 (NP-98 NLH).

Ms. McShane, Hydro's Cost of Capital expert, testified that Hydro would not be financially viable in the absence of a guarantee and the guarantee allows Hydro to raise debt at a cost that is equivalent to that available to the Province (Pre-filed evidence K. C. McShane, p. 19, lines 6-8). Ms. McShane's evidence demonstrates that the guarantee fee of 1% is clearly reasonable. The financial expert called by the Consumer Advocate, Dr. Kalymon, also concluded that the capital structure of Hydro would not be financially viable in the absence of a provincial guarantee (Pre-filed evidence, Dr. B. Kalymon, p. 11, lines 7-8). A similar conclusion was reached by Dr. Waverman (Pre-filed evidence Dr. Waverman, p. 11, lines
22-25).

No party at the hearing raised any issue with respect to the amount of the fee paid by Hydro and included in the 2004 interest category of expense. It should also be noted that the Board allowed the recovery of the debt guarantee fee as part of the interest expense in P.U. 7.

Other issues with respect to interest were raised in the hearing by Newfoundland Power in cross-examination of Mr. John Roberts and Mr. Bill Brushett of Grant Thornton. The two issues raised by Newfoundland Power related to the

"Promissory Note" line and the "Accounts Payable and Accrued Liabilities" line of Schedule XIII to the evidence of J. C. Roberts, and the operation of Hydro's sinking fund and its impact on the calculation of interest expense.

Hydro provided answers to both issues raised by Newfoundland Power in responses to information requests and through the evidence of Mr. Roberts. The response to NP-308 NLH provided the explanation of the line, "Accounts Payable and Accrued Liabilities" as shown on Schedule VIII (2nd Revision, October 31, 2003) to the evidence of J. C. Roberts. Further Mr. Roberts explained this in his evidence of November 12, 2003:

> "The forecasted balance sheet is the accounts payable is the last balancing number of all the knowns that are known throughout the balance sheet so that's the self balancing number that you need. As you go through preparing the financial statements, your fixed assets you fairly well know what they are, your accounts receivable you know what they are, they're based on what your sales are for your last month and the same thing with your inventories, your pre-paids, your Rate Stabilization Plan, all of these are knows so as to make your balance sheet balance, the balancing number is your accounts payable and they include liabilities". (Transcript, November 12, 2003, p. 114, lines 19-25 and p. 115, lines 1-8).

Further, at page 117 of the transcript of November 12, Mr. Roberts again explained that the accounts payable number is simply a balancing number used to balance the balance sheet and it has no other significance.

The second issue raised by Newfoundland Power was with respect to the operation of the sinking fund. This was explained by Mr. Roberts in his evidence: "Well, Hydro wouldn't necessarily be buying just one bond with its annual contribution, it would be a function of what was available at the time together with the rates. And these are based on average projections in the case of 2004. In the case of 2003 when this was being updated its reflecting what actually happened up to the end of August so that if rates were different in that first opening period then that would cause why you're getting a difference in the rates." (Transcript, November 12, 2003, p. 133, line 25 and p. 134, lines 1-10)

Mr. Roberts also explained that Hydro actually does trade bonds within its sinking fund (Transcript, November 12, 2003, pp. 134-136).

This issue was also addressed by Mr. Brushett in cross-examination by Counsel for Newfoundland Power. He referred to the explanatory note to Schedule II where the decrease in interest in 2003 was stated to be due primarily to a decline in projected short-term interest rates and unanticipated capital gains in sinking funds. These gains, reflected in the 2003 forecast do not carry over to 2004 (Transcript, December 11, 2003, p. 127, lines 1-12).

It is Hydro's position that satisfactory answers have been provided in responses to requests for information and through cross-examination to both questions raised by Newfoundland Power on the calculation of interest expense as detailed in this section.

It should also be noted that Grant Thornton in its 2003 report on Hydro's GRA stated that it had reviewed Hydro's estimate of interest expense and guarantee fee (I #9, p. 3, lines 41-43) and determined that the overall methodology used by Hydro for forecasting revenue and expenses (including interest) and net income were reasonable and appropriate (I #9, p. 4, lines 14-15). No recommendations were made by Grant Thornton in its review with respect to Hydro's calculation of the forecast interest expense for 2004.

Hydro submits that its proposed 2004 forecast of interest expense as shown on Schedule II of $98.2 million should be approved by the Board and included in the 2004 test year costs.

B.7 Other Costs

The fifth category of expense in the 2004 Revenue Requirement outlined in Schedule II is “Other Costs” which is forecast to be $101.4 million before allocations. This category includes expenses that are sometimes referred to as controllable expenses (CA-40 NLH) in the sense that Hydro can influence them more than other costs such as interest or fuel. It includes such items as salaries and fringe benefits, system equipment maintenance, insurance, professional services, office supplies, transportation, etc. Approximately 80% of these costs consist of two categories: salaries, including fringe benefits; and system equipment maintenance, with the remaining 20% covering all other expenses included under this heading (Pre-filed evidence W. E. Wells, p. 7, lines 7-9).

The largest category of costs within this heading is that of salaries and fringe benefits which accounts for approximately 63% of Hydro’s Other Costs for 2004. Detailed information on the category of salary and fringe benefit costs was provided in pre-filed evidence, in responses to information requests and during cross-examination of a number of Hydro’s witnesses including W. E. Wells, J. C. Roberts, J. R. Haynes and F. H. Martin.

As outlined in the pre-filed evidence, Hydro, as a result of changes in organizational structure and business processes, technological improvements and efficiency enhancements, has reduced its workforce. Since 1992, there has been a 21% reduction in Hydro’s permanent positions with a net of 211 positions eliminated (Pre-filed evidence W. E. Wells, p. 8, lines 21-24). Focusing on the period 2000 to 2002, the reduction has been approximately 10%.

The response to NP-301NLH updated the changes in the permanent complement from December 31, 2002 to October 31, 2003 and reflected a further deletion of ten permanent positions during 2003 for a total reduction in the permanent complement since 2000 of 12%. Forty-four permanent positions were

eliminated in 2001, 46 in 2002 and a further ten in 2003 to October, for a total of 100 positions in just three years.

With respect to total staffing levels, including temporaries and permanent complement, the evidence demonstrated that overall staffing levels at year-end have also decreased from the period 1992 to 2002 by 19%. The response to NP-301 NLH demonstrates that as of the end of October 2003, there was total staffing at year-end of both permanent and temporaries of 922 positions vs. 995 at December 31, 2002.

The core wage expense, which is all salary expenses, excluding employee future benefits, for both the permanent and temporary employees is forecast to be below the rate of inflation for 2004 as illustrated in Chart 3 to the pre-filed evidence of W. E. Wells (Pre-filed evidence, p. 10).

Evidence was also given throughout the hearing with respect to Hydro's focus on the strategic issue of optimizing performance throughout all activities of the Corporation. In his pre-filed evidence, Mr. Wells explained that Hydro's focus is to optimize corporate performance through an assessment of business processes and the identification of changes necessary to improve performance which will be measured through the use of key performance indicators. Internal process improvement teams have been formed to review key business processes (Pre-filed evidence W. E. Wells, pp. 19-20). The goal of the business improvement process is to change work measurements, practices and procedures to eliminate any non-value added work and to improve efficiencies.

This was also described by Mr. Wells during his testimony where he described Hydro's goal to optimize corporate performance:

> "Within Hydro we have established a formal and systematic approach to achieving operational efficiencies by improving business processes. This approach includes a review of a business process or work method to determine opportunities to reduce cost or to add value or indeed to

> eliminate non-added value. An integral part has been the development of performance measures to ensure that improvements and deficiencies are identified and work processes are measured. And finally, once those improvements in processes are identified, the changes are implemented. I think this process of continuous improvement takes place in the context of reliability, customer service, safety and environmental responsibility. It includes the appropriate balance between customer's expectations for reliable, safe and environmentally responsible service with cost considerations. Hydro personnel are focused on improving operational and organizational efficiencies and eliminating waste and non-value added work to ensure that costs will be minimized for the benefit of electrical consumers. Using this approach Hydro has kept costs over which it has influence to a minimum. Several examples of initiatives which have been implemented and which reduce cost have been included in the pre-filed evidence." (Transcript, October 6, p. 63, lines 22-25 and p. 64, lines 1-25 and p. 65, lines 1-3)

Further detail was provided by Mr. Wells throughout his evidence (for example: Transcript, October 7, pp. 71-97).

In addition, Mr. Roberts in his evidence provided examples of initiatives that have been implemented to date in the business process improvement initiative. The implementation of process changes in accounts payable and in the areas of the corporate purchasing card, travel, consumables and inventory were outlined in the pre-filed evidence of J. C. Roberts, pp. 23-24. The combined savings arising from the changes implemented in these areas is $600,000 annually (Pre-filed evidence, p. 24, lines 5-7).

Mr. Roberts also outlined the three other processes that are under review in 2003 and 2004 being the acquisition of goods and services, work management, including work identification and execution, and budgeting and asset management (Pre-filed evidence, p. 24, lines 16-24).

In light of anticipated further gains in 2004, Hydro has provided for an additional savings of $1.5 million in this category of costs for 2004 (NP-248 NLH and Transcript, October 15, 2003, p. 55, lines 7-12). This is in addition to a vacancy credit of $1 million which Mr. Roberts has explained is getting more and more

difficult to achieve as Hydro's flexibility has decreased with its reduction in staffing levels (Transcript, November 12, 2003, p. 71, lines 22-25 and p. 72, lines 1-7).

The second largest category of expenses under this heading of Other Costs is system equipment maintenance which accounts for approximately 17% of the costs in this category. The challenges which Hydro faces in operating the electrical system are outlined in the evidence of J. R. Haynes (Pre-filed evidence, pp. 8-12 and in the Pre-filed evidence of F. H. Martin, pp. 6-8). As stated in this evidence, Hydro operates an isolated electrical system in a harsh environment with extreme weather conditions. It is responsible for providing 80% of the total power and energy needs of the Province. Hydro operates an aging complex thermal plant which provides approximately 40% of Hydro's average energy capability and 31% of its capacity and several large hydro plants on the Island with increasing challenges related to expectations for reliability and environmental practices. Most of Hydro's assets have been in service for significant periods of time. The costs for system equipment maintenance must be viewed in the context of the challenges described above.

All of the remaining categories of expenditures listed on lines 17-25 of Schedule II comprise the other categories included under the broad heading of Other Costs, including insurance, transportation, office supplies, building rentals, professional services, travel expenses, equipment rentals and miscellaneous expenses. These categories account for only 20% of the category of Other Costs.

Chart 5 in the pre-filed evidence of W. E. Wells on p. 12 illustrates that Hydro's total controllable operating costs for the period 2000 to 2004 has tracked below inflation which demonstrates that Hydro has achieved performance gains.

As well, Hydro's performance with respect to its operating efficiency can be compared to its peers in the Canadian electric utility business. Schedule I attached to the pre-filed evidence of W. E. Wells illustrates Hydro's controllable costs for the period 1992 to 2002 in comparison to similar costs for B. C. Hydro, Hydro Quebec, Nova Scotia Power, New Brunswick Power, Manitoba Hydro and Sask Power. This schedule demonstrates that for the period 1998 to 2002 all the companies included in the comparison experienced increases in their operating, maintenance and administration expenses with the percentage of increase shown for Hydro being the lowest of the group. Hydro submits that this evidence demonstrates that its performance with respect to its operating efficiencies and controllable costs has been similar to, and indeed, better than the experiences of other Canadian utilities with significant generation and transmission assets, as well as, distribution assets.

All of Hydro's expenses are subject to review each year by the Board's financial consultants, Grant Thornton. In its report on Hydro's 2003 GRA (I #9), Grant Thornton reviewed each of the categories of expenses included under Other Costs. No exception was taken by Grant Thornton to any of the costs. This was confirmed by Mr. Brushett in his evidence where he stated that during its review Grant Thornton did not find any expenditure to be unreasonable or imprudent. Grant Thornton did not recommend that any category should be reduced or any expense eliminated (Transcript, December 11, 2003, p. 6 and p. 8, lines 8-19). The only exception raised by Grant Thornton was with respect to the loss on disposals related to Davis Inlet which is dealt with later in this Argument.

Exhibit 5C to Grant Thorton's 2003 Report (I #9) also demonstrates that total Other Costs on a kWh basis sold has been declining over the period 2000 to 2004.

B. 8 Productivity Allowance

The Board in P. U. 7 imposed a productivity allowance on Hydro of $2 million. Certain comments were raised throughout the hearing with respect to the continuation of a productivity allowance. The context in which the Board imposed the productivity allowance in 2002 must, however, be reviewed first. Here it is helpful to review the statements of the Board with respect to this issue from P. U. 7:

> "The Board believes the onus is on NLH to bring forward performance measures which clearly demonstrate the efficiency of its operations. This perspective was not presented into evidence before the Board in any of the normal business performance measures, either overall corporate performance, cost efficiencies or business unit accountability. There was also no indication that NLH had any of these performance measures/targets/objectives built into the existing business systems or was contemplating their implementation in relation to the strategic or business planning exercise currently underway. Under these circumstances the Board has no level of comfort regarding individual cost savings or efficiencies and the Board is left with little choice in keeping with the least cost power policy of the Province but to impose an appropriate productivity allowance as suggested by GT and the intervenors." (p. 73)

The Board went on to direct Grant Thornton to work with Hydro to make recommendations on suitable regulatory performance standards that could be implemented (p. 74).

It is clear from the above that one of the considerations guiding the Board in imposing a productivity allowance in the 2001 GRA was the lack of performance measures. Grant Thornton subsequently produced a report (I #4) in which the action undertaken by Hydro in 2001 and 2002 with respect to the development of key performance indicators was outlined. This report recommended the adoption of 12 key performance indicators to be reported by Hydro to the Board. Hydro has agreed to report on these performance measures to the Board and provided information on these key performance indicators in U-Hydro #17. Hydro has suggested that one of the measures should be modified, that is, that operating maintenance and administration costs for generation should be on a per

megawatt basis and not a per megawatt-hour basis. Mr. Brushett confirmed in his testimony of December 11, 2003 that Grant Thornton had no major concern with the change and understood the rationale for the change suggested by Hydro (Transcript, December 11, 2003, p. 32, lines 1-24).

It is clear from the evidence that Hydro had already been working on the development of key performance indicators to measure performance in all areas including operating efficiencies, reliability and customer service prior to the issuance of P.U. 7. These measures are to be used to measure and track internal improvement against Hydro's own performance. Hydro has also agreed in Consent #1 to propose a peer group of Canadian utilities for comparison purposes. As pointed out in I #4, pp. 10-11 and by Mr. Brushett in his testimony (Transcript, December 11, 2003, pp. 36-37) comparisons to other peers can be misleading due to significant variances and operating distinctions between utilities and caution must be exercised in making inter-utility comparisons.

It is thus clear from the evidence that performance measures are available and in place for Hydro to report to the Board its performance on a number of key areas including reliability, customer satisfaction and efficiency, including the thermal conversion factor, corporate OM&A's per MWh and generation OM&A's per MW.

The evidence also demonstrates the following:

1. Hydro has taken clear action to manage the largest category of expense over which it has influence, that is salaries and fringe benefits. The permanent complement has been reduced by 20% since 1992 and over 12% since 2000. There has been a reduction since the beginning of 2000 of 100 permanent positions. Similarly, overall staffing, including temporaries, has declined by a similar percentage over the same time period.

2. Hydro's total controllable costs have been below inflation for the relevant period, demonstrating real performance gains.

3. Hydro's performance on efficiencies regarding operations and administration expenses has been similar to, and even better than, the experience of peer utilities in Canada.

4. Hydro has included in its 2004 proposed Revenue Requirement its own allowance of $2.5 million which includes a vacancy allowance of $1 million and a further provision for anticipated efficiencies arising from process review of $1.5 million.

5. Benchmarks or performance indicators are in place for the Board to track Hydro's reliability, customer satisfaction and operating efficiencies. Hydro will be providing relevant data from comparison groups to allow inter-utility comparisons where appropriate.

Hydro submits that the imposition of a productivity allowance during this GRA would be totally inappropriate in the absence of evidence that any expenditures are unreasonable, unnecessary or imprudent and in light of the action Hydro has taken which clearly demonstrates it is managing these costs. As well, Hydro has developed and implemented performance measures and targets which will be reported to the Board to allow the Board to track Hydro's performance in relevant areas. Hydro submits that it has addressed the concerns expressed by the Board in P.U. 7.

It is Hydro's position, as explained by Mr. Wells, that the imposition of an additional productivity allowance in the current context would be a penalty. Mr. Wells, in responding to a question as to whether it was appropriate to consider the imposition of a productivity allowance, responded as follows:

> ” Absolutely not. I’ve just explained, Hydro has in place a formal system to ensure that there is a continuous improvement throughout all areas of the operations. There are also means by which performance within Hydro can be measured on a corporate and divisional level. In P.U. 7 the Board stated that it believed the onus is on Hydro to bring forward measures which clearly demonstrate the efficiency of its operations. In our view, this has been done. And as directed by the Board, performance measures have been reviewed with the Board’s accounting firm, Grant Thornton, which has reported favourably with respect to the performance measures proposed by Hydro. It was, in the opinion of the Board, the absence of performance measures which lead the Board to apply a productivity allowance with respect to Hydro’s operating costs in Hydro’s previous rate application. The basis for that reasoning no longer exists. Hydro has clearly demonstrated in this Application that where it has the opportunity to influence costs and reduce its revenue requirement the actions taken have resulted in demonstrable productivity gains, efficiency improvements and cost containment. The standards are also in place to measure performance throughout the organization. These measures set out in detail in the evidence and include controllable operating maintenance and administration expenses per megawatt hour delivered and traditional measures with respect to operating performance and reliability including the system average interruption duration index, the system average interruption frequency index. Other measures include the customer satisfaction index to determine customer satisfaction with respect to Hydro’s services and reliability. Hydro has a system in place to identify and measure appropriate opportunities for efficiency enhancements. In my view, for the Board to impose a productivity allowance when this environment exists within Hydro would only operate as a disincentive and a penalty.” (Transcript, October 6, pp. 69-71).

It should also be noted that, while the Board did apply a productivity allowance to Newfoundland Power in Newfoundland Power’s 1996 GRA, it did not apply such an allowance thereafter (see Order No. P.U. 36 (1998-1999) p. 33).

B. 9 Return on Equity

The last remaining category in expenses on Schedule II to be included in the Revenue Requirement is Hydro's return on equity. The return forecast for 2004 based on a return on common equity of 9.75% is $18.7 million. Hydro's submissions with respect to the appropriateness of the return on equity to be included in Hydro's 2004 Revenue Requirement are included in the section in this argument under Financial Issues.

B. 10 Miscellaneous Issues

A number of miscellaneous issues were raised during the course of the hearing with respect to Hydro's proposed 2004 Revenue Requirement, including the amount of capitalized expense, the application of an adjustment to reflect underspending of the capital budget, the amount included for retirements and the inclusion of the relocation costs associated with the abandonment of the Davis Inlet Diesel Plant. Each of these issues will be addressed in this section of the Argument.

B.10.1 Capitalized Expense

Expenses associated with capital projects, such as the salary of Hydro employees who are working on capital projects, are capitalized and the amount then is a credit to the proposed Revenue Requirement. For 2004, Hydro is forecasting that the capitalized expense credit will be $5.2 million (Schedule II).

The methodology used by Hydro to allocate expenditures to capitalized expense was explained in the Grant Thornton Report on Hydro's 2003 GRA (I #9 at p. 49, lines 15-41). Similarly, Mr. Roberts explained the methodology in cross-examination (Transcript, October 14, 2003, pp. 146-150). Mr. Roberts explained that the estimate will vary in any year depending on the particular capital program forecast for that year and whether or not it entails the utilization of Hydro's internal resources. If there is a capital program with a significant number of capital expenditures and little involvement of Hydro personnel, then the capitalized expense will be lower than in a year when there is a capital program which involves the use of a significant amount of internal Hydro resources (Transcript, October 14, 2003, p. 150, lines 6-25 and p. 151, lines 1-5).

Hydro's forecast for the 2004 test year for capitalized expense is based on its knowledge of the capital budget approved by the Board (the October 31st revision to the Revenue Requirement reflected the decision of the Board on the 2004

capital budget) and its projection of the involvement of Hydro internal resources in the approved capital program, as well as the resources of third party contractors.

Mr. Roberts also explained that, if one viewed the forecast for 2004 in relation to the total capital program, it is in line with Hydro's previous historic experience (Transcript, October 14, 2003, p. 146, lines 5-10 and p. 148, lines 11-19). This is also illustrated in the response to Information Request NP-19 NLH where Hydro's capitalized expense as a percentage of capital expenditures from 1998 to forecast 2004 is provided. This was also confirmed by Grant Thornton in its report on Hydro's 2003 GRA (I #9), where at page 50, it found that the forecast of capitalized expenses for 2003 and 2004 appeared to be reasonable when compared to prior years. In cross-examination on December 11, 2003, the percentage of the capitalized expense in relation to the capital budget based on Hydro's revision to the Revenue Requirement for October 31st was updated to reflect that capitalized expense is approximately 19% of Hydro's approved 2004 capital program, still well within the range based on past historical experience.

While there may be evidence that the actual capitalized expense has exceeded the budget in previous years, Mr. Roberts explained that the 2004 forecast used in the October 31st revision is Hydro's best estimate based on its knowledge of the approved capital budget and its knowledge of the resources to be used in the completion of that budget.

Hydro submits that the forecast included in the Revenue Requirement for 2004 for capitalized expense is the most reasonable estimate to use as it was made with the knowledge of the approved capital program and the knowledge of the involvement of internal resources in the completion of the program. Hydro submits it would not be appropriate to make an arbitrary adjustment to the capitalized expenses forecast for 2004 as may be suggested by others.

B. 10.2 Capital Budget Adjustment

In P.U. 7 the Board ordered, for the purpose of establishing Hydro's 2002 Revenue Requirement, a reduction in the approved capital budget of 7.5% which reduced depreciation and interest expenses, as well as, the forecast rate base in the test year. This was imposed by the Board in light of the historical underspending of the capital budget set out in the Grant Thornton 2001 General Rate Hearing Report. That report indicated that from the period 1996 to 2000, inclusive, the total capital expenditures were lower than budget by an average of 15% after taking into account exceptional events.

In its report on Hydro's 2003 GRA, Grant Thornton again raised this issue (I #9). On page 17 of this report, Hydro's experience from 1998 to 2002 is provided which shows an average underspending of 14.4%. However, the table on page 17 also illustrates that Hydro's performance since 2000 has been improving in this regard, with the average underspending for the period from 2000 being 11.6%. The evidence during Hydro's 2001 GRA, confirmed in this hearing, is that Hydro has focused not only on the total capital cost of a project but cash flow requirements within each year of a multi-year project. The fact is that, as illustrated in I #9, p. 17, there has been improvement since 2000 in the level of underspending of the capital budget.

As Mr. Brushett pointed out in his cross-examination, the issue is not the management of the capital program but whether there should be an adjustment in the Revenue Requirement and the rate base to reflect an allowance for historical underspending of the capital budget.

The variance applied by the Board to Newfoundland Power with respect to this issue of underspending the capital budget is 4%. At the time, the Board imposed the 4% in 1996 the underspending for the previous five-year period was 11.64% (Order No. P.U. 7 (1996-1997). Similarly, in 1998 the underspending at that time was approximately 10% and, the Board ordered a 4% reduction again for

Newfoundland Power (Order No. P.U. 36 (1998-1999). A 4% reduction continues to apply for Newfoundland Power.

It is Hydro's submission that the evidence discloses that Hydro has improved the variance with respect to the underspending of its capital budget. The variance for the period since 2000 has been approximately 11.6%. Hydro acknowledges that an adjustment for capital budget underspending is appropriate. However, in light of its experience and in light of the allowance ordered by the Board with respect to Newfoundland Power, where there was evidence of similar variances with respect to underspending (11.6% and 10%), Hydro submits that the adjustment should be no more than 4% for the 2004 test year.

B.10.3 Capital Retirements

In its report on Hydro's 2003 GRA, Grant Thornton raised the issue of Hydro's forecast retirements for 2004 (I #9, p.18 and 19). Information was provided to show that capital retirements as a percentage of total assets have been higher historically than used in the 2004 forecast Revenue Requirement. Mr. Roberts addressed this issue in his evidence where he testified that Hydro forecasts its known retirements that are associated with budgeted capital projects and that it is difficult to anticipate in any given year the magnitude of other assets that could be taken out of service prior to the end of their expected service life. He further pointed out that the losses on disposal of the retired assets would also have to be included in the Revenue Requirement and would exceed any reduction in depreciation expense and return on rate base that would arise should the amount of retirements be increased. Thus, Hydro's approach to forecasting retirements tends to favour the ratepayer. He stated that Hydro did not intend to increase its forecast retirements nor its losses on disposals for the 2004 test year (Transcript, October 14, 2003, p. 12, lines 21-25 and p. 13, lines 2-10). A similar response was provided in NP-306 NLH.

It is Hydro's submission that it is not necessary to adjust the forecast capital retirements used in the determination of the 2004 test year for the reasons set out in this section.

B.10.4 Deferral of Davis Inlet Costs

In its supplementary evidence dated December 5, 2003, Grant Thornton raised the issue of whether it would be appropriate to amortize the costs associated with the abandonment of the Davis Inlet Diesel Plant over a number of years. This position was taken on the basis that the loss was unusual (Evidence December 5, 2003, p. 7, lines 1-9 and Transcript, December 11, 2003, p. 22, lines 10-25 and p. 23, lines 1-6). However, the evidence clearly demonstrates that the loss associated with the closure of the Davis Inlet Plant is not unusual.

Schedule 2C to the 2002 Grant Thornton Report (I #3) illustrates Hydro's loss on disposals from 1998 to 2002 as $1.1 million, $0.9 million, $2.2 million, $1.8 million and $2.8 million, respectively, with the average for this period being $1.8 million. The forecast loss on disposals for 2004, including the Davis Inlet decommissioning is $1.3 million (Schedule II). Thus, the forecast loss for 2004 included in the 2004 test year is below the average loss on disposals for Hydro since 1998.

Mr. Brushett in cross-examination also acknowledged that Hydro has decommissioned a number of facilities over the years including diesel plants in Harbour Deep in 2002, Petites in 2003, Petite Forte in 1993, Roddickton in 1996, Westport in 1996, Southeast Bight in 1998, Mud Lake in 1998, and La Poile in 1999 (Transcript, December 11, 2003, p. 23-24).

Given that there have been significant disposals of diesel plants by Hydro and the fact that the average loss on disposals for the past five years is higher than the 2004 forecast loss (including the loss on the disposal of the Davis Inlet Plant),

it is difficult to see how one can conclude that the costs associated with the abandonment of Davis Inlet are unusual.

Hydro submits that the full costs of decommissioning the Davis Inlet Plant should be included in the 2004 test year.

B.10. 5 Deferral of Hearing Costs

Hydro in its Application has proposed that the external regulatory costs related to the Board and the Consumer Advocate associated with the 2003 GRA of $1.2 million be amortized over a three-year period beginning in 2004. This treatment is consistent with the treatment of regulatory costs in the 2001 GRA. It should be noted that Grant Thornton in its report on Hydro's 2003 GRA (I #9, p. 45, lines 27-28) concluded that this proposal was reasonable.

Hydro submits that, prior to the finalization of the final cost of service used to determine actual rates which will be filed on receipt of the Board's Order, it would be appropriate to receive from the Board an update of the Board's and the Consumer Advocate's costs associated with this hearing, as well as the costs of any other Intervenor that may be allowed by the Board. If this amount exceeds $1.2 million used by Hydro in determining the amount included in the 2004 test year Revenue Requirement, Hydro submits that it should be allowed, in the final cost of service, to increase the amount of its regulatory costs and adjust the allowance in 2004 accordingly.

C. FINANCIAL ISSUES

C.1 General

Section 3 (a) of the *EPCA* states that it is the policy of the Province that the rates to be charged for the supply of power within the Province "should provide sufficient revenue to the producer or retailer of the power to enable it to earn a just and reasonable return as construed under the *Public Utilities Act* so that it is able to achieve and maintain a sound credit rating in the financial markets of the world." Section 80 of the *Public Utilities Act* states that a public utility is entitled to earn a "just and reasonable return" on its rate base.

The analysis of a "just and reasonable" return for Hydro needs to be addressed in the context of these legislative provisions and Hydro's circumstances.

C.2 Capital Structure

The Provincial Government provides a guarantee in relation to Hydro's debt and in return receives a guarantee fee equivalent to 1% of the previous year's debt net of sinking funds. It is clear from the evidence that Hydro's ability to maintain a sound credit rating is currently dependent on the Government's guarantee which allows Hydro to operate with a higher debt ratio than a stand-alone utility (Pre-filed evidence, K. C. McShane, p. 14, lines 7-9). Further at p. 19 of her pre-filed evidence, Ms. McShane stated that Hydro would not be financially viable at either its forecast capital structure or its target capital structure in the absence of the guarantee which allows Hydro to raise debt at yields equivalent to those available to the Province (Pre-filed evidence, K. C. McShane, p. 19, lines 6-8).

This is similar to the position of Dr. Kalymon, the financial expert for the Consumer Advocate, who stated that Hydro's current financial structure would not be financially viable in the absence of the provincial guarantee (Pre-filed evidence p. 11, lines 7-8 and Transcript, December 4, 2003, p. 13, lines 17-25 and p. 14, lines 1-11).

Hydro's 2003 forecast ratio of debt to capital is 86/14 (Pre-filed evidence J. C. Roberts, p. 7) which is a deterioration from 2001 when it was 82/18. A similar debt to capital structure is forecast for 2004 (Pre-filed evidence, J. C. Roberts, p. 10, lines 12-14). The deterioration in the capital structure since 2001 is due to the payment of dividends in 2002, as noted during the 2001 GRA, and increased financing costs associated with Granite Canal and the Rate Stabilization Plan ("RSP").

Hydro experienced a loss on its regulated activities in 2003 and no dividends were paid to the Government related to Hydro's net income from these activities.

The Board in P.U. 7 recommended consultation between Hydro and the Government on Hydro's dividend policy (P.U. 7, pp. 38 and 39). The evidence demonstrated that this has occurred with meetings and discussions being held. The report to Government on dividends provided with the Application sets out the implications for Hydro's capital structure of various dividend payouts (Pre-filed evidence, W. E. Wells, Schedule II).

Ms. McShane, in her evidence recommended an 80% debt to capital target for Hydro and stated that this is the upper end of a reasonable range associated with being self-supporting, even with the debt guarantee (Pre-filed evidence K. C. McShane, p. 17, lines 4-5). Ms. McShane also compared Hydro's target capital structure of 80/20 to the targets of other crown-owned utilities and concluded that an 80% debt ratio is at the upper end of the range of target debt ratios adopted by other crown corporations (Pre-filed evidence, K. C. McShane, pp. 16-18 and p. 17, lines 1-2).

The Board, in P.U. 7, accepted a short term debt/equity ratio of 80/20 for Hydro and noted it had also recommended this target in its 1992 Report (P.U. 7, p. 43 and paragraph 1, p. 176).

In his evidence, Mr. Roberts stated that Hydro's goal is to move towards the target capital structure of 80/20 over the next five years and that to do this would require a modification of the current dividend policy which provides for a dividend payment of up to 75% of net income, following consideration of its impact on the capital structure (Pre-filed evidence J. C. Roberts, p. 10, lines 12-22). Hydro has recommended to its shareholder, the Government, a modification of the dividend policy to reduce the amount of dividend payouts to assist in the movement towards the target capital structure of 80% (Pre-filed evidence, J. C. Roberts, p. 11, lines 1-3, Pre-filed evidence, W. E. Wells, p. 23, lines 15-22). To date, no reply has been received from Government (Transcript, October 15, 2003, p. 104, lines 22-24).

It is Hydro's submission that it is clear from the evidence that the forecast capital structure for 2004 of 86/14 does not adversely affect Hydro's financial viability because of the provincial guarantee. Hydro submits that it is appropriate, however, for the Board to endorse the target capital structure of 80/20 recommended by Hydro's financial consultant as a reasonable objective so as to ensure that Hydro is able to maintain its self-supporting status. This target was approved by the Board in P.U. 7.

C. 3 Return on Common Equity

Both Ms. McShane and Dr. Kalymon evaluated the business and financial risks Hydro faces in order to provide an assessment of both the capital structure and the appropriate return on equity for Hydro. Ms. McShane concluded, following a review of the relevant risks, that Hydro faced no less business risk than the typical investor-owned electric utility in Canada, including Newfoundland Power (Pre-filed evidence, K. C. McShane, p. 13, lines 9 –11 and Transcript, December 3, 2003, p. 123, lines 13-25 and p. 124, lines 1-5). Dr. Kalymon reached a similar conclusion (Pre-filed evidence, p. 10, lines 21-24 and Transcript, December 4, 2003, p. 11, lines 1-16).

To determine the appropriate return on shareholder's equity for Hydro in the context of a debt guarantee (with a 1% debt guarantee fee) and with the risks faced by Hydro, Ms. McShane's position is that the total compensation to the debt guarantor and the shareholder should not be any greater than if Hydro were financed on a stand-lone basis (Pre-filed evidence, p. 21, lines 4-7). On p. 23 of her pre-filed evidence, Ms. McShane stated that in light of the sensitivity of the return on equity to the capital structure, the debt cost and the guarantee fee, the equity return for Hydro should be set at a level no less than that applicable to an average risk Canadian utility (Pre-filed evidence, p. 23, lines 12-15).

Ms. McShane applied three tests typically used in the regulatory arena to determine a just and reasonable return. Based on her analysis, (including updates) her recommendation for a return on equity for Hydro is 11% – 11.25% (Transcript, December 3, 2003, p. 45, lines 1-2).

Dr. Kalymon, the cost of capital expert for the Consumer Advocate, recommended a return on equity in the range of 8.5% – 9% in his pre-filed evidence (p. 39, lines 6-8), which was not changed in his testimony.

Hydro, in its Application, has requested a return on common equity of 9.75%, the same return as allowed by the Board with respect to Newfoundland Power in its decision on Newfoundland Power's 2003 GRA (Order No. P.U. 19 (2003)). This was explained by Mr. Wells and Mr. Roberts as a way of resolving the issue, given that the experts have said that the risks faced by Hydro are no less than the risks faced by Newfoundland Power (for example: Pre-filed evidence of W. E. Wells, p. 22, lines 16-22 and of J. C. Roberts, p. 11, lines 23-29).

During its 2001 GRA, Hydro, in order to mitigate the impact of the rate increases on ratepayers, asked for a return on equity of only 3%. At that time, this was acknowledged by the Board as being "well below market" (P.U. 7, p. 44). In this GRA no financial expert suggested a return for Hydro in the range of 3%, which is still obviously below current market conditions. As explained by Mr. Wells, Hydro's request for a 3% return on equity in its 2001 GRA was intended to apply for a limited time only to what was thought to be a temporary issue of adjusting base rates to reflect higher fuel costs. As stated by Mr. Wells, Hydro cannot compromise its financial integrity by continuing at a rate of return that was recognized by all to be well below market and well below what Hydro is entitled to earn under the current legislative provisions (Pre-filed evidence W. E. Wells, p. 22, lines 24-31).

While Ms. McShane and Dr. Kalymon addressed the issue of the appropriate return on equity for Hydro using traditional concepts, the financial consultant called by Board Hearing Counsel, Dr. L. Waverman, outlined a novel approach to the issue of the appropriate return for Hydro. Dr. Waverman's theory is that the fair return to Hydro should include the embedded costs of outstanding debt, including the guarantee fee and the opportunity costs for the Province for the portion of Hydro's capital structure represented by shareholders' equity. The opportunity cost was defined by Dr. Waverman as the cost of newly issued provincially guaranteed debt (Pre-filed evidence p. 3, lines 7-15).

Dr. Waverman candidly acknowledged during cross-examination that this theory has never been accepted or even considered by any other regulatory authority. In fact, he could not provide support for this theory in academic articles or texts or indeed in any other form (Transcript, December 4, 2003, pp. 55- 57).

Dr. Waverman stated that his theory should apply to other provincial crown corporations in Canada which have no publicly traded common stock (Transcript, December 4, 2003, p. 53). However, Dr. Waverman advised that he had not reviewed the returns for crown corporations in Canada prior to his testimony to determine whether the allowed returns or the actual returns of these entities reflected his theory. Dr. Waverman acknowledged, during cross-examination, that the allowed returns for crown corporations in Canada were certainly above the cost of their debt at the margin (Transcript, December 4, 2003, p. 54, lines 10-18 and p. 55, lines 7-14 and p. 57, lines 7-16). Indeed, in response to PUB-46 NLH, Ms. McShane demonstrated that the allowed return for the rate base-regulated crown corporations were similar to those allowed for investor-owned utilities.

Hydro submits that the theory advanced by Dr. Waverman has not been accepted by any other regulatory board nor supported by academic writing. Moreover, the allowed returns for the other crown corporations in Canada are clearly above the return that would flow from the acceptance of Dr. Waverman's theory.

Hydro's submits that it is entitled to the opportunity to earn a just and reasonable return which reflects the level of business and financial risks it faces, which have been acknowledged to be no less than that of the other utility in this Province, Newfoundland Power. Hydro submits that the evidence supports its position that the Board should allow a return on equity of 9.75%, the same as allowed recently for Newfoundland Power.

C. 4 Return on Rate Base

Hydro's rate base is comprised of capital assets in service, fuel inventory, supplies inventory, deferred foreign exchange losses and rate hearing costs, as well as, an allowance for cash working capital. Schedule III to the evidence of J. C. Roberts (2nd Revision, October 31, 2003) provides the forecast of Hydro's 2004 rate base with the average rate base being forecast at $1,483,381,000. This rate base was calculated in accordance with the approach and methodology approved by the Board in P.U. 7.

The Board in P.U. 7 directed Hydro to file, prior to its next GRA, an analysis of the cash working capital allowance calculation, specifically with respect to whether an adjustment should be made to reflect the timing difference between the payment of semi-annual long-term bond interest and the receipt of funds for their payment (P.U. 7, p. 100 and p. 179, paragraph 19). Hydro filed this report with its Application as Exhibit JCR-1.

This report concludes that Hydro's current method of forecasting interest expense and the cost of debt already reflects the timing of semi-annual interest payments and recommended continuation of the current methodology for the determination of Hydro's cash working capital allowance (Exhibit JCR-1, p. 9). Ms. McShane supported this recommendation (Pre-filed evidence, K. C. McShane, pp. 3-4).

No issues were raised by parties at the hearing with respect to the calculation of rate base, including the issue of the determination of Hydro's cash working capital allowance. The only issue on rate base raised is whether there should be an allowance with respect to the capital budget to reflect underspending, dealt with previously. As well, the forecast 2004 rate base would need to be adjusted following the Board's Order on Hydro's November 21, 2003 Application for approval of additional 2004 capital projects.

Hydro's return on rate base is calculated by applying its weighted average cost of debt to rural assets and its weighted average cost of capital to the remainder of its rate base. The requested return on rate base for 2004 is $116.8 million or 7.88% (Schedule IV – 2nd Revision, October 31, 2003, to evidence of J. C. Roberts).

Hydro submits that the rate base and the return on rate base as submitted by Hydro should be approved by the Board, with any adjustments directed by the Board relating to the adjustment for capital budget underspending and required as a result of the Board's Order on Hydro's November 21, 2003 Application.

C. 5 Range of Return on Rate Base

Grant Thornton, in its report on Hydro's 2003 GRA (I #9), raised the issue of whether there should be a range of return on rate base. This issue was raised again in its Supplementary Evidence of December 5, 2003. Grant Thornton did not make any recommendation with respect to a specific range for the rate of return but stated that the Board would "need to assess the range in the context of its findings on other related financial matters" (Supplementary Evidence, December 5, 2003, p. 5, lines 26-28). In cross-examination Mr. Brushett also recognized that the establishment of a range must be done in the overall context of the Board's findings on all financial issues (Transcript, December 11, 2003, p. 88, lines 24-25 and p. 89, lines 1-9).

It should be noted that there was no evidence by any of the financial experts with respect to an appropriate range for the return on rate base for Hydro. Hydro did express its position on this in the responses to NP-105 NLH and NP-234 NLH. As pointed out in the responses to these information requests, there are issues related to the level of rates relative to costs paid by various customer classes which would need to be resolved so that the distribution of any excess revenues over customer classes could be accomplished in a fair and relatively simple way.

Further, until such time as the Board has indicated its findings with respect to a fair and reasonable return for Hydro, it is not practicable to estimate a reasonable range of return on rate base.

It is Hydro's submission that Hydro should be asked to provide its opinion, along with relevant evidence, with respect to the appropriate range for its return on rate base once the Board has made its decision on the fair and reasonable return for Hydro.

C. 6 Excess Earnings Account

Grant Thornton also suggested that Hydro establish an excess earnings account to deal with earnings generated in excess of the upper limit of the range of return on rate base (Supplementary Evidence, December 5, 2003, p. 5, lines 22-24). For the reasons set out above, Hydro believes that this issue should be deferred until the Board has made its decision with respect to the appropriate rate of return on equity for Hydro.

C. 7 Automatic Adjustment Formula

Grant Thornton suggested that if the Board were to decide that implementation of an automatic adjustment formula were appropriate, Hydro should be requested to file a proposal detailing how implementation could be achieved for 2005 (Supplementary Evidence, December 5, 2003, Grant Thornton, p. 6, lines 12-14).

No financial expert provided evidence with respect to the application of an automatic adjustment formula for Hydro. Some of the issues that would arise in the development and application of such a formula for Hydro were set out by Hydro in the responses to CA-169 NLH and NP-105 NLH.

Hydro submits that, following the determination of an appropriate rate of return on common equity for Hydro, it would be appropriate for Hydro to make a proposal with respect to the application of an automatic adjustment formula for adjusting the allowed rate of return on rate base on an annual basis. Hydro further proposes that the issues of a range for the return on rate base and the appropriateness of an excess earnings account be dealt with at that time as well

D. COST OF SERVICE

D.1 General

Once the revenue requirement of a utility has been determined, it is then necessary to determine how that revenue requirement is to be recovered from customers. Generally, a cost of service study is completed to determine the appropriate manner in which this is to be done. The appropriate methodology to be used by Hydro for its cost of service study was reviewed by the Board in a special generic hearing in 1992, with the Board issuing a report in 1993 containing a number of recommendations on the cost of service methodology ("1993 Report"). One of the recommendations in that report was that Hydro use this methodology at its next rate referral. Hydro first implemented the recommendations contained in the 1993 Report in its submission in its 2001 GRA.

Certain specific issues were raised on the cost of service methodology in Hydro's 2001 GRA which were dealt with by the Board in P.U. 7. The Board directed that Hydro was to use the cost of service methodology proposed by Hydro with one change, which was that the allocation of generation demand costs for both the Island and Labrador Interconnected Systems was to be based upon a 1 CP allocator (P.U. 7, Paragraph 20, p. 179). The Board further ordered that, for the 2002 cost of service study, the Great Northern Peninsula ("GNP") assets be assigned to Rural and that the Doyles-Port aux Basques assets be specifically assigned to Newfoundland Power. The Board also directed that Hydro file a detailed study as to the proper cost of service assignment of the GNP assets, the Doyles-Port aux Basques assets and the Burin Peninsula assets at the next General Rate Application (P.U. 7, p. 179, paragraph 21).

In the submission of its 2003 Application, Hydro filed a cost of service study in compliance with P.U. 7, with three minor proposed changes. The cost of service study, including the proposed changes, was one of the issues on which

agreement was reached during the mediation process. The parties agreed, as set out in Consent #1:

(a) Hydro's Cost of Service ("COS") filed in this proceeding is in general compliance with Board Orders, specifically P.U. 7, regarding the use of embedded cost of service studies as a guide in determining the revenue requirement increases or decreases to be applied to each class.

(b) Hydro Place costs should be assigned to all systems as proposed by Hydro. This was one of the minor changes proposed by Hydro in its Application.

(c) General plant assets should be functionalized on the basis of direct generation, transmission, distribution and customer expenses rather than plant ratios. This was one of the minor changes proposed by Hydro in its Application.

(d) Hydro's municipal taxes and Board assessments should be allocated based on revenues. This was one of the minor changes proposed by Hydro in its Application.

The Board also issued an order on October 2, 2003, following an Application by the Industrial Customers with respect to issues to be raised relating to Hydro's cost of service study in the 2003 GRA. In the transcript of October 2, 2003, commencing on page 67, the Board decided that the following issues with respect to the cost of service study would not be revisited as they had been dealt with by the Board in P.U. 7: the zero intercept method for classification of distribution system costs; the use of a one CP allocator for distribution demand costs; and the classification of generation plant based on the load factor method.

The Board also found that the issue of the proper assignment of the GNP assets would be reviewed in the 2003 GRA (Transcript, October 2, 2003, pp. 67-68). On October 7, 2003, the Board decided that the treatment of the generation credit provided in the cost of service study to Newfoundland Power would be reviewed during the 2003 GRA (Transcript, October 7, 2003, pp. 1-2).

The only issues, therefore, that arise on Hydro's cost of service methodology that need to be addressed in Argument are the assignment of certain assets, namely, the GNP, Burin and Doyles/Port aux Basques assets and the treatment of the generation credit given to Newfoundland Power in the cost of service study.

D. 2 Generation – GNP, Doyles-Port aux Basques and Burin Assets

As noted above, the Board in P.U. 7 directed Hydro to file a report on the appropriate assignment of the GNP assets, the Doyles/Port aux Basques assets and the Burin Peninsula assets. Hydro completed this report as directed and it was filed with Hydro's Application as Exhibit JRH-3. The analysis contained in this report demonstrates that the generation assets on each of the three systems provide benefits to all customers on the Island Interconnected System.

Hydro proposes that the generation allocation guidelines be that all of Hydro's production facilities (hydraulic, thermal, gas turbine and diesel) be assigned as common plant which is a continuation of the guideline for the assignment of generation assets as recommended by Hydro in all previous referrals (Exhibit JRH-3, p. 16). Also, Newfoundland Power should continue to receive a capacity credit for its generation facilities on the Doyles-Port aux Basques and Burin Peninsula radial systems. This would be a continuation of the past treatment for these generation assets in all previous referrals.

With respect to the GNP generation assets, Hydro recommends that these GNP assets be assigned as common. This would be a change from the assignment in P.U. 7 that these assets be assigned to Rural (Exhibit JRH-3, p. 16 and pre-filed evidence J. R. Haynes, p. 40, lines 28-31 and p. 41, lines 1-4). The proposed change in assignment of the GNP generation assets from Rural as ordered by the Board in P.U. 7 to common, as recommended by Hydro in this Application, affects the amount paid by customers. The response to IC-233 NLH indicated that, based on Hydro's May filing, the assignment of GNP generation assets to common results in an increase to Newfoundland Power of $11,830 and to the Industrial Customers of $191,136, after rural deficit and revenue credit allocation.

The evidence demonstrated that the generation on the GNP has been used to benefit customers on the Island Interconnected system when the generation was

operating on January 31, 2002 and January 30, 2003 (Exhibit JRH-3, pp. 15-16). In addition, Mr. Haynes in his evidence testified that in September, 2003, GNP generation was again run to provide benefit to the customers on the Island Interconnected system (Transcript, October 20, 2003, p. 191). Hydro provided a response to an undertaking (U Hydro #18) with respect to the incident on September 18, 2003 which indicates the times and duration in which the GNP generation assets were called in service during the incident of September 18 and 19, 2003.

It should also be noted that if the GNP generation were not available to the Island Interconnected system, then the need for new capacity would be advanced from 2011 to 2009 (Table 3-3, Exhibit JRH-3, p.12).

R. D. Greneman, the cost of service expert called by Hydro, stated in his pre-filed evidence that he had reviewed Exhibit JRH-3 and found that “the principles relied on are consistent with those commonly used in the industry to evaluate whether an asset should be treated as commonly or directly assigned” (Pre-filed evidence, p. 10, lines 18-21). As well, the cost of service expert called by the Board Hearing Counsel, EES Consulting, said that all customers on the Island Interconnected system benefit from the generation assets and supported Hydro’s recommendation that the generation assets be assigned as common (Pre-filed evidence, EES Consulting, p.19, lines 21-25 and Transcript, November 19, 2003, p.18, lines 4-6).

It is clear from the evidence submitted that the customers on the Island Interconnected system benefit from the GNP generation assets. Hydro submits that the Board should approve its recommendation that these assets be assigned as common. If the Board determines that these assets should be assigned as Rural, then consideration should be given to providing a generation credit to Hydro Rural Customers, as is the case with Newfoundland Power.

D. 3 GNP Transmission Assets

During the 2001 GRA, Hydro proposed that the GNP transmission assets also be assigned as common. However, as noted above, the Board in P.U. 7 did not accept this designation and ordered further study. Exhibit JRH-3 also deals with the issue of the assignment of the GNP transmission assets. The study concluded that while the generation assets on the GNP were originally constructed to serve the isolated systems, as a result of the interconnection of the GNP in 1996, they now are a benefit to all customers. However, the report concluded that while the generation assets are of benefit to all customers, they were not of significant magnitude, in Hydro's opinion, to justify the assignment of the GNP transmission assets to common, given the dominant use of the transmission system to serve Hydro's Rural Customers on the GNP (Exhibit JRH-3, p. 21). Hydro, therefore, recommended that the GNP transmission assets be assigned to Hydro Rural.

EES Consulting in its pre-filed report stated at p. 19 that generation facilities and associated transmission facilities should be assigned in a similar manner. They further stated that the benefits of the generation cannot be delivered without the associated transmission facilities and that in general, transmission facilities which are part of an integrated system are assigned common (Pre-filed evidence, p. 19, lines 1-8). They concluded that, as the customers on the Island Interconnected system benefit from generation facilities on the GNP and they would not receive this benefit without the transmission facilities, the transmission facilities should be assigned as common, as well as the generation assets. This recommendation of EES is the same as proposed by Hydro in its 2001 GRA. However, as pointed out in Exhibit JRH-3, pp. 19-20, remote generation and the associated transmission and terminal station assets can, in Hydro's opinion, be logically assigned differently in the cost of service study.

As Hydro has said in the past, the issue of the assignment of plant is often a matter of judgement with no one absolutely correct answer. It is Hydro's submission that, based on the consideration of all relevant issues, the GNP transmission assets should continue to be specifically assigned to Hydro Rural as ordered by the Board in P.U. 7 (Pre-filed evidence J. R. Haynes, p. 41, lines 15-25).

A change in the assignment of the GNP transmission assets from Rural, as included in the cost of service study filed with Hydro's Application, to common as proposed by EES Consulting would significantly affect the amounts paid by Island Industrial Customers. U Hydro #14 indicates that the increase in costs to Island Industrial Customers as a result of the change in the assignment of the GNP transmission to common would result in an increase in the costs paid by Island Industrial Customers of approximately $1.1 million. Newfoundland Power's costs would increase by approximately $500,000.

Hydro submits that its proposal to assign GNP generation assets as common and GNP transmission assets as Rural is an appropriate and fair way to balance the various interests involved.

D. 4 Doyles-Port aux Basques Transmission Assets

Exhibit JRH-3 at page 21 describes the purpose of the Doyles-Port aux Basques transmission assets as connecting a single customer, Newfoundland Power, and remote generation or voltage support equipment to the Island grid, with the primary purpose of the transmission assets being to provide service to Newfoundland Power's customers on that radial system. Like the GNP, Hydro believes that the generation assets in the Doyles-Port aux Basques area, while of benefit to all customers, are not of significant magnitude, in Hydro's opinion, to justify assignment of the transmission assets to common given the dominant use of the transmission system in serving Newfoundland Power's customers. Hydro, therefore, recommended in its Application that the Doyles-Port aux Basques transmission assets continue to be specifically assigned to Newfoundland Power, as has been the case in all previous rate referrals (Pre-filed evidence J. R. Haynes, p. 41, lines 27-31 and p. 42, lines 1-4).

EES Consulting Services agreed that these assets should be specifically assigned to Newfoundland Power as long as Newfoundland Power receives a credit for their generation facilities in the area (Transcript, November 19, 2003, p. 18, lines 6-22).

Hydro submits that its proposed assignment for the Doyles-Port aux Basques transmission line is consistent with its proposed treatment of the GNP transmission line and that it represents a fair treatment for the assignment of these assets for all customers.

D. 5 Burin Peninsula Transmission Assets

Exhibit JRH-3, page 21 describes the purpose of the Burin Peninsula transmission assets as serving both Newfoundland Power and Hydro Rural Customers and connecting generation assets of Newfoundland Power and of Hydro to the Island Interconnected grid. Hydro recommends that the Burin Peninsula transmission system, as it connects significant generation to the grid and as it serves two customers groups, should remain assigned to common plant which is consistent with the assignment in all previous referrals by Hydro to the Board, including P.U. 7. EES Consulting has also recommended that the Burin Peninsula transmission lines be assigned as common (Pre-filed evidence, pp.18-19 and Transcript, November 19, 2003, p. 18, lines 6-7 and p. 19, lines 1-23).

The Industrial Customers suggested that only one of the lines should be assigned as common, that is the older line, TL212. As Mr. Haynes pointed out in his evidence, both transmission lines provide service to the customers on the Burin Peninsula (Transcript, October 23, 2003, p. 132, lines 5-11). As explained in Hydro's evidence, it is Hydro's view that the Burin transmission lines meet two guidelines in that they connect significant generation owned by both Newfoundland Power and Hydro to the Island Interconnected grid and they serve two customer groups. Either is sufficient, in Hydro's opinion, to justify assignment to common.

The response to IC-228 NLH provides the cost implications if TL219 were to be specifically assigned to Newfoundland Power. The cost to Newfoundland Power would increase by approximately $263,244, while the cost to the Island Industrials would decrease by approximately $231,709 and the costs to Rural Labrador Interconnected customers would decrease by $31,535.

In light of the assessment of the transmission and generation assets as provided in Exhibit JRH-3 and in evidence by Mr. J. R. Haynes, Hydro submits that the guidelines for the assignment of plant as set out in the pre-filed evidence of J. R. Haynes, p. 42, lines 20-30, p. 43 and p. 44, lines 1-4, be approved by the Board and that Hydro's specific recommendations with respect to the assignment of generation and transmission assets on the GNP and transmission assets on the Burin Peninsula and the Doyles/Port aux Basques area be approved by the Board.

D. 6 Newfoundland Power's Generation Credit

Currently Hydro provides a credit in the cost of service study to Newfoundland Power for its hydraulic and thermal generation capacity. This was approved by the Board in the 1993 Report, as well as in P.U. 7.

Hydro proposes that this credit to Newfoundland Power continue (Pre-filed evidence, R. D. Greneman, p. 17, lines 12-19). The basis for the credit is that Newfoundland Power operates its generation facilities when requested to do so by Hydro, for example at times of system peak. The purpose of the generation credit, explained in response to NP-215 NLH, is to provide Newfoundland Power a credit that represents the capacity value that its generation brings to the Island Interconnected system with respect to system planning and operation from which all customers benefit. This credit, in various forms, has been consistently accepted by the Board since 1977. As well, Mr. Haynes in his evidence explained how the generation credit works (Transcript, October 21, 2003, pp. 7 -18).

Mr. L. Brockman, Newfoundland Power's cost of service expert, supported the use of the full credit as currently given through the cost of service study (Transcript, November 18, 2003, p. 15 through to p. 17, lines 2-10).

EES Consulting made a number of recommendations with respect to Newfoundland Power's generation credit not supported by the other experts. It is Hydro's submission that the recommendation of EES Consulting with respect to the development of a generation tariff option or in the alternative, that generation costs be allocated using load data net of the generation credit, is unnecessarily complicated and not required to address the issues before the Board.

Messrs. Osler and Bowman, the Industrial Customers' cost of service experts, recommended that no generation credit be provided to Newfoundland Power for

their thermal generation, but that it remains appropriate to provide a credit for hydraulic generation, albeit at a lower number than currently given.

Hydro's position with respect to the generation credit has not changed throughout the course of the hearing. It is Hydro's submission, that it is appropriate to provide a full credit, less appropriate reserve, through the cost of service study to Newfoundland Power for its hydraulic and its thermal generation. These resources are utilized by Newfoundland Power and available at Hydro's request to the system to provide real benefit to all customers.

Hydro submits that the Board should approve the continuation of a full credit, less appropriate reserve, to Newfoundland Power for both its available hydraulic and thermal generation.

E. RATES ISSUES

E. 1 General

The issues to be dealt with under this heading include the rural rates proposed by Hydro, including rates for customers served on the Labrador Interconnected system, the implementation of a demand/energy rate for Newfoundland Power, the appropriateness of a marginal cost study, and the creation of an interruptible rate option as suggested by the Industrial Customers, similar to the interruptible contract that has terminated between Hydro and Abitibi Consolidated Company of Canada, Stephenville.

Issues relating to the RSP have now been addressed by the parties and approved by the Board in Order No. P.U. 40 (2003). Thus, there are no issues arising from the RSP that need to be addressed in Final Argument, other than the recommendations of Grant Thornton on the RSP set out in its Supplementary Evidence of December 5, 2003 at pp. 4-5.

Grant Thornton recommended that the Board direct Hydro to provide all monthly activity or summarized quarterly activity to the Board in Hydro's regular quarterly reports. Currently, Hydro provides the RSP monthly report for the last month in the quarter with that quarter's report to the Board. Hydro agrees that, should the Board deem it appropriate, it will provide either all monthly RSP reports or a summary of the quarter's activity in the RSP in its quarterly reports.

Grant Thornton's second recommendation was that Hydro be directed to undertake a review of the RSP after a 24-month period. Hydro agrees it would be appropriate to review the operation of the RSP, with the changes agreed to by the parties at this hearing, to assess the effectiveness of the Plan and the impact on customers. Hydro proposes that such review be undertaken as part of its next GRA.

E. 2 Rural Rates - General

In P.U. 7, the Board gave direction to Hydro on a number of matters affecting the rates charged Hydro's Rural Customers including the preferential rates that are charged these customers. The Lieutenant Governor-in-Council gave direction under Section 5.1 of the *EPCA*, in July, 2003, to the Board that the current preferential rates charged Rural Customers were to continue to be set, essentially, on the same basis as the current policies (I #1). Subsequent to the receipt of this direction, Hydro filed an Amended Application on August 12, 2003, to reflect the direction received from Government with respect to rural rates. The specific rates proposed for each class of Rural customer were filed with the October 31, 2003 Revision in the Amended Rates Schedules to the Application and Hydro submits that these rates should be approved by the Board.

The rates proposed by Hydro for Rural Customers are reviewed in the pre-filed evidence of S. D. Banfield (2nd Revision, October 31, 2003, pp. 6-13 inclusive) and a brief summary only is provided here.

E.2.1 Rates – Island Interconnected System Rural Customers

Rural Customers on the Island Interconnected system (with the exception of the Burgeo School and Library) and on the L'Anse au Loup system are currently charged the same rates as Newfoundland Power's customers. This was accepted by the Board in P.U. 7. Hydro is proposing that the existing policy be continued of allowing Hydro, as Newfoundland Power changes its rates, to automatically adjust the rates it charges these customers.

Based on Hydro's October 31, 2003 Revision, Hydro estimates that the rates for Newfoundland Power's customers will increase by approximately 6.5% and thus, the rates for Hydro's Rural Customers on the Island Interconnected system and on the L'Anse au Loup system will increase on average by 6.5%, should the Board accept Hydro's proposals.

E.2.2 Rates – Isolated Rural – Domestic Customers

For Isolated Rural Domestic customers the current policy approved by the Board in P.U. 7 is that these customers, other than Government departments and agencies in this class, pay the same rate as Newfoundland Power's customers for the first 700 kWh per month of consumption, with this block commonly referred to as the lifeline block. In the direction provided to the Board, the Lieutenant Governor-in-Council confirmed that this policy is to continue. The direction further stated:

> "The monthly lifeline block should be satisfactory to provide for the necessary monthly household requirement, excluding space heating. Subsequent monthly energy blocks for these customers to be charged incrementally higher rates as historically structured and determined. Such rates would increase as per any percentage increase to Island interconnected rates for Newfoundland Power customers." (I #1, paragraph iii)

During the mediation process agreement was reached to increase the lifeline block. Paragraph y of Consent #1 stated that Hydro's current three block domestic diesel rate structure was to be replaced with a two block structure with the first block equal to the Alternative Lifeline and the second block set as to maintain revenue neutrality. It was further agreed by the parties that, before formal acceptance of the proposal, the Board should seek input from affected customers during the public participation days in the proceeding.

The Board in P.U. 7 directed Hydro to file a report on the adequacy of the current lifeline block (P.U. 7, p. 180, para. 26 (i)). This report was filed in December 2002 and was filed in the hearing with the response to CA-13 NLH. The report, on page 9, concluded that there was merit in considering a change in the lifeline block to reflect seasonal usage by customers. Based on this report, and following discussions in the mediation process with the Consumer Advocate and his cost of service expert, Mr. D. Bowman, Hydro developed the proposal, as agreed to in mediation, to increase the lifeline block to reflect seasonal usage, without any impact on the rural deficit. The proposed alternative rate structure

for Isolated Rural Customers to reflect this is described in I #21 which was sent to participants prior to the public hearing day in Happy Valley/Goose Bay on November 27, 2003 and it was available to all those attending the hearing on that day. Subsequently, the Board directed Hydro to provide additional information to the people who made presentations in Happy Valley/Goose Bay, as well as, to the mayors of all affected communities. This additional information was sent by Hydro on December 19, 2003 and circulated to all parties at that time.

The current proposal is that the lifeline block would remain at 700 kWh per month for the months of May, June, July, August and September and be increased to 900 kWh per month for March, April, October and November and increased to 1000 kWh per month in January, February and December. The rate for consumption above the lifeline block in each month is proposed to be calculated to maintain revenue neutrality. Hydro proposes that the current policy would continue to apply, that is, that rates for the consumption above the lifeline block would be automatically adjusted by the average rate of change granted Newfoundland Power in any future rate applications.

Concern was expressed by parties during the mediation process that any changes to the lifeline block should not increase the amount of the rural deficit paid by Newfoundland Power's customers and Rural Labrador Interconnected customers. The report contained in the response to CA-13 NLH points out that, should the seasonal block rates proposed in that report be inplemented, without adjusting the energy rate charged for consumption above the lifeline block, the rural deficit would increase by approximately $66,000 based on the assumptions outlined in that report.

Hydro believes that its proposal as outlined above to increase the lifeline block to reflect seasonal usage, without increasing the rural deficit, is a reasonable compromise and meets some of the concerns of the customers with respect to increased consumption in the colder months. Hydro leaves to the judgement of

the Board the issue as to whether the lifeline block for isolated diesel domestic customers should remain at the current 700 kWh per month or whether it should be increased as proposed by Hydro.

E.2.3 Rates - Isolated Rural – General Service Customers

The Board in P.U. 7 directed Hydro to file, at its next rate application, rates which would include the elimination of the lifeline block for general service customers on isolated systems. In July 2003, the Lieutenant Governor-in-Council did give direction with respect to the rates charged these customers. As set out in paragraph (iv) of I #1, the Government directed that the implementation of a demand/energy rate structure for General Service customers as proposed by the Board in P.U. 7 should continue, that the lifeline block should be eliminated for these General Service customers, but that the new rate should target the current cost recovery levels.

The rates proposed for the Isolated Rural General Service customers in compliance with the directions contained in both Order No. 7, as well as, in the Government directions in I #1 are set out in the Amended Rate Schedules to the Application and are reviewed in detail in Section 4.3.4 of the pre-filed evidence of S. D. Banfield commencing on p. 9 and in the Schedules attached to Mr. Banfield's evidence.

Hydro is proposing 2004 rates which are based on the criteria as outlined and is further proposing a phase-in of the targeted rate components (that is, the demand and energy rate, over three years). Hydro is requesting that the Board approve rate changes for these customers which will automatically come into effect each year for the next three years with the provision that rates would also continue to be automatically adjusted by the average rate of change granted to Newfoundland Power in any future rate application.

The specific rates proposed for these customer classes for January 1, 2004, 2005 and 2006 are set out in the Amended Rate Schedules attached to the Application and Hydro submits that these rates should be approved.

E.2.4 Rates – Isolated Rural– Government Departments

As approved by the Board in P.U. 7, Government departments within the rate class of Isolated Rural Domestic Customers are charged rates based on full cost recovery. Hydro is proposing to combine both Government and non-government domestic customers into the same rate class for costing purposes, with the Government customers paying their full cost of service.

Similarly, Government departments that are within the Isolated Rural General Service customer class are also charged rates based on full cost recovery.

The specific rates proposed by Hydro for Government departments are set out in the Amended Rate Schedules dated October 31, 2003, filed with the October 31, 2003 Revision. Hydro submits that these rates should be approved by the Board.

E.2.5 Rates – Isolated Rural – Street and Area Lighting

With respect to Isolated Rural street and area lighting, Hydro proposes to continue with the current policy, that the rates be the same as for Newfoundland Power's customers. Government departments, however, that have street and area lighting will pay full cost recovery for that service.

The specific rates proposed by Hydro are set out in the Amended Rate Schedules dated October 31, 2003, filed with the October 31, 2003 Revision. Hydro submits that these rates should be approved by the Board.

E.2.6 Rural Deficit

In P.U. 7, the Board identified a number of concerns involving the rural deficit and directed Hydro to develop an evidentiary record which would involve consultation with Government and address the magnitude of the subsidy, comparative practices elsewhere and future funding options for the rural deficit (P.U. 7, p. 127 and para. 26 (v), p. 180). This was completed as directed and a copy of the report presented to Government was filed as an attachment to the pre-filed evidence of W. E. Wells. This report clearly outlined all of the issues of concern that had been identified by the Board.

Subsequently, the Government did give direction in I #1 with respect to rural rates and with respect to the funding of the rural deficit by customers of Newfoundland Power and Labrador Interconnected Rural Customers. Thus, the Board has received clear direction from the Government that the rural deficit should continue, that preferential rural rates should continue and that any deficit arising with respect to serving Rural Customers should continue to be funded by the customers of Newfoundland Power and Rural Labrador Interconnected customers.

As Hydro has explained in its evidence, the rural deficit is calculated as an integral part of the cost of service study and is calculated as revenue less allocated costs for Rural Customers. The costs allocated to Rural Customers can only be determined from a cost of service study. The direct costs over which Hydro has control was addressed in detail in the evidence of Mr. F. H. Martin. The question of allocated costs arises from Board decisions and can be directly influenced by Board decisions. For example, the assignment of the Great Northern Peninsula generation and transmission assets to Hydro Rural, increased the rural deficit by approximately $9 million (Supplementary evidence S. D. Banfield, November 21, 2003, p. 9, lines 3-5). Costs are also allocated through the cost of service study for various corporate support areas. Thus,

increases or decreases in the rural deficit can only be explained through the use of a completed cost of service study and analysis of Hydro's overall costs.

The rural deficit can be impacted either by the revenues being received and/or the costs, including direct and allocated costs. The revenue is determined by the rates charged customers and direction has been received from Government with respect to the policies for rural rates. Thus, there is limited opportunity left, given this direction, to increase the revenue from Rural Customers to reduce the rural deficit. As pointed out by Hydro, while the rural deficit can be controlled to a certain degree, it is unlikely that, in the absence of increased revenues, there will be a significant reduction in the deficit. General inflationary pressures on costs will exceed any increases in revenues, resulting in a deficit, which, with all else being equal, will trend upward.

It is in the area of the direct operating costs that Hydro has limited opportunity to control costs, while maintaining reliable service. The evidence is clear that Hydro has undertaken a number of initiatives in providing service to Rural Customers that have effectively managed costs. This includes the introduction of diesel system representatives to provide multi-skilled personnel at each isolated diesel location; interconnection of isolated systems to the main grid where cost effective; the introduction of reliability centered maintenance practices to reduce maintenance costs, capital projects designed to improve reliability in the diesel areas and the targeting of small high cost diesel systems for electricity conservation initiatives (Pre-filed evidence W. E. Wells, pp. 25-27 and pre-filed evidence F. H. Martin, pp. 8, 9 and 10).

Suggestions were made during the hearing that there be an annual report filed by Hydro on the rural deficit and changes in the rural deficit from previous years. As explained by Mr. Banfield, this report can be provided by Hydro, if it is deemed to be of assistance to the Board, each year following the completion of a cost of service study to determine the actual costs, both direct and allocated.

It was also suggested by Mr. D. Bowman, the Consumer Advocate's cost of service expert, that it might be appropriate to have a study undertaken of the structure for only the isolated rural systems portion of Hydro's operations involved in serving Rural Customers. It should be noted that this involves 24 isolated diesel plants serving approximately 4,400 customers. At one time, Hydro did have a separate department for its rural operations. Hydro's experience, as stated in the response to CA-198 NLH, is that the current organizational structure is more efficient than a separate department as suggested. Hydro does not believe that there is merit in pursuing this suggestion further.

It should be noted that Grant Thornton, the Board's financial consultant, also did not see merit in this proposal. Mr. Brushett stated on December 11, 2003, that he saw no problems with Hydro's organizational structure and the way it manages various business activities to suggest that Hydro would need to separate out the isolated rural parts for a separate department with a separate manager (Transcript, December 11, 2003, p. 140, lines 2-17). It is Hydro's position that the current organizational structure is the most effective for managing rural operations and that there is no need to pursue a separate study at an additional cost.

It was also suggested during the hearing that Hydro should be required to provide an analysis of the impact on the deficit of each capital project that might affect the rural deficit at the time it requested approval of the capital project. The difficulties associated with implementation of this proposal were explained by Mr. Banfield, including that only a "rough" estimate could be provided in any event in the absence of a completed actual cost of service study, that it would be administratively difficult given the large number of projects, including those on the Island Interconnected system that impact the deficit, and that the usefulness of the information appeared questionable, given Hydro's obligations to provide

reliable service to its Rural Customers (Transcript, December 3, 2003, p. 5, lines 14-25 and p. 6, lines 1-21).

Hydro submits that this proposal does not add sufficient value to the considerations of the Board to impose the additional administrative burden and associated cost on Hydro that would result by acceptance of the suggestion.

E.2.7 Labrador Interconnected System

The Board in P.U. 7 stated that it had already ruled in the 1993 Report that there should be a single cost of service study for the Labrador Interconnected system and directed Hydro to file a five-year plan outlining further alterations in rates on the Labrador Interconnected system as identified in the 2001 GRA, including a phase-in of the impact of applying the credit for secondary energy sales to CFB Goose Bay to the rural deficit.

Hydro did file with its 2003 Application, as directed by the Board, a five-year plan to implement uniform rates for the Labrador Interconnected customers which included a phase-in of the application of the revenue credit from secondary energy sales to CFB Goose Bay to the rural deficit. The specific rates proposed are contained in the Amended Rate Schedules filed on October 31, 2003. Hydro is requesting approval of automatic annual adjustments to the rates for the next five years to complete the phase-in. The proposed phase-in limits the average rate increases to a maximum of 20% as directed in P.U. 7 in the years 2005-2008, however this was not possible in 2004.

It was agreed during the mediation process that the revenue credit available from the secondary energy sales to CFB Goose Bay to be applied to the rural deficit, as directed by the Board in P.U. 7, will be added to the Rural Rate alteration component of the RSP (Consent #1, Section I, paragraph dd).

The Lieutenant Governor-in-Council gave direction to the Board in July, as set out in I #1, p. 2, to hold a hearing into the appropriate rate calculation methodology for the Labrador Interconnected System, upon receipt of a complaint of discriminatory rates. This complaint was subsequently filed by the Towns of Labrador City and Wabush.

Separate evidence relating only to the Labrador Interconnected system was filed by Hydro on October 31, 2003. This evidence outlined the impact of the proposed five-year phase-in of the rates for each customer class. As well, evidence from Hydro's cost of service expert, R. D. Greneman, was filed on October 31, 2003, supporting the development of rates for the Happy Valley/Goose Bay area and the Labrador West area based on one Labrador Interconnected system. This was also supported by the recommendations of EES Consulting in its pre-filed report at pages 16-17 and was explained during their testimony at the hearing.

The Towns of Labrador City and Wabush have suggested that there be two distinct cost of service studies done, one for Labrador East and one for Labrador West. Hydro submits it is appropriate to treat both areas as one Labrador Interconnected system. While there may be differences in certain of the elements of costs (e.g. transmission and distribution) between the two areas, this situation is not unlike the isolated diesel areas where all of the diesel systems are included within one cost of service study and treated as one for the purposes of designing rates. This is also not unlike what occurs between different communities served on the Island Interconnected system as well. Cost differences alone are not sufficient to justify the separation of systems for rate setting purposes (Evidence of G.Tabone, Transcript, November 19, 2003, p. 177, lines 1-20, p. 209, lines 20-25 and p. 210, lines 1-7 and pp. 215-216 and Evidence of R. D. Greneman, November 20, 2003, p. 6, lines 12-25 and p. 7, lines 1-13).

Hydro submits that there is sufficient evidence before the Board to support the conclusion that the Labrador Interconnected system should be treated as one system for the purpose of setting rates for these customers and requests approval of the rates as proposed for the phase-in of uniform Labrador Interconnected rates. Hydro would point out that this is consistent with all previous deliberations of the Board when it considered this issue, including the Board's 1979 report on the rates charged by the Power Distribution District of Newfoundland and Labrador (pp. 144-147), the 1993 Report on the Generic Cost of Service Methodology (pp. 9-11), the 1996 Report on Rural Rates (p. 35) and P.U 7.

Hydro requests that the Board approve the specific rates for the Labrador Interconnected customers for the period 2004 to 2008 as set out in the Amended Rate Schedules, dated October 31, 2003, filed with the Application, which includes automatic annual adjustments over the five-year period to complete the phase-in of uniform rates.

E. 3 Interruptible B

Hydro had a contract with Abitibi Consolidated Company of Canada, Stephenville, from 1993 to March, 2003, which allowed Hydro to interrupt capacity at the Stephenville Mill on certain limited terms and conditions. Hydro has not renewed this contract. Hydro's position with respect to this was explained on a number of occasions. It is essentially that as Hydro has sufficient capacity within its system at present, and hence, there is no requirement for the interruptible arrangement, with the cost being passed on to customers (for example: Transcript, October 9, 2003, p. 32, lines 7-25 and p. 33, lines 1-3 and Transcript, October 21, 2003, p. 51, lines 13-25 and p. 52, lines 1-6).

Hydro submits the evidence is clear that Hydro's customers have no requirements for the foreseeable future for an arrangement such as had existed

with Abitibi Consolidated Company of Canada, Stephenville under the Interruptible B contract. Hydro does not believe it appropriate that such an arrangement be entered into for the current period with Abitibi or other Industrial Customers as this is not of value to Hydro's customers for the foreseeable future.

E. 4 Marginal Cost Study

Some of the parties to the hearing have raised the issue of the completion of a marginal cost study.

The Board in P.U. 7 determined at that time that it would not be an appropriate time to commence any study of marginal cost considerations but it would continue to monitor the situation. Hydro, in its response to IC-186 NLH, stated that it was prepared to assess the need for further study of time of use rates and, thus an updated marginal cost study, after the issues arising from the 2003 GRA are addressed.

Hydro does state that, if the Board sees merit in completing a marginal cost study, it is prepared to undertake the study, following the completion of the 2003 GRA, to address long-term generation and transmission expansion and outline recommendations on resulting industrial and wholesale rate options. A second part of the study would need to be completed by Newfoundland Power which would incorporate the results of Hydro's analysis and include analysis of distribution costs which would then provide recommendations and result in retail rate options for Newfoundland Power's customers.

Hydro's approach was supported by Mr. Greneman (Transcript, November 14, p. 8, lines 10-25 and p. 9, lines 1-25 and p. 10, lines 1-5) and by Mr. Chymko (Transcript, November 19, 2003, p. 47, lines 12-25 and p. 48, lines 1-25 and p. 49, lines 1-16).

Hydro is of the opinion that it is not necessary to complete a marginal cost study prior to the implementation of a demand/energy rate for Newfoundland Power as discussed in the section of this Argument on this rate structure.

E. 5 Demand/Energy Rate for Newfoundland Power

The Board in P.U. 7 stated, at page 150, that it was not in a position at that time to make a final determination on the issue of whether an energy only rate is appropriate for the purchase of power by Newfoundland Power from Hydro. The Board went on to say that it would address the issue at Hydro's next General Rate Application, if it was not addressed by then in the Energy Policy Review, and that it expected Hydro to file supporting evidence with its next application to address the demand/energy pricing issues raised in the 2001 GRA.

In its October 31, 2003 Revision, Hydro did propose an energy only rate of 53.62 mills per kWh for Newfoundland Power effective January 1, 2004. However, as directed in P.U. 7, Hydro filed further evidence regarding a demand/energy rate structure for Newfoundland Power. A report prepared by Hydro's rate consultant, Stone & Webster Management Consultants Inc., entitled "Review of Rate Design for Newfoundland Power" was filed with the Application as Exhibit RDG-2. Page 17 of this report sets out the principal recommendations as follows:

1. An energy-only rate to a wholesale customer the size of Newfoundland Power is an anomaly in terms of current industry practice;

2. The ability to send a proper price signal by Hydro to Newfoundland Power is a key element in controlling the Island interconnected peak and conserving capital costs;

3. In order to send a price signal, Hydro must accept a degree of risk;

4. A demand/energy rate can be designed that does not permit a windfall to either Hydro or Newfoundland Power due to weather variations;

5. A demand/energy rate can be designed that will allow both Hydro and Newfoundland Power to achieve virtually the same operational efficiencies as under the current energy-only rate structure.

This issue has been reviewed by the Board on a number of occasions in the past. Exhibit RDG-2 reviewed the issues which had been raised in the past with respect to the implementation of a demand/energy rate, including the issue of revenue stability for both Hydro and Newfoundland Power, the implications of the volatility caused by weather, rate stability and the appropriate treatment for Newfoundland Power's generation in the event that a demand/energy rate structure is developed.

The report outlined three options to deal with the treatment for Newfoundland Power's generation assuming a demand/energy rate is implemented (pp. 7-8). The report concluded by recommending Option A as the preferred option under which Newfoundland Power will receive the credit for both its hydraulic and thermal generation, as is the case currently with the energy-only rate, with the generation credit being applied to the native load to determine billing demand.

In Hydro's pre-filed evidence, it was pointed out that a number of issues needed to be resolved prior to the implementation of the demand/energy rate structure for Newfoundland Power, including the degree of risk to be assumed by Hydro; an appropriate weather normalization methodology; the treatment of Newfoundland Power's generation and appropriate costing and billing determinants. Subject to the resolution of these issues by the Board, Hydro agreed that a demand/energy rate should be implemented (Pre-filed evidence S. D. Banfield, 2nd Revision, October 31, 2003, p. 3, lines 19-28).

All of the consultants called by the other parties, with the exception of Mr. L. Brockman, the consultant called by Newfoundland Power, agreed with Hydro's recommendation that a demand/energy rate should be implemented for Newfoundland Power and that the issues raised by Newfoundland Power previously and in their evidence at this hearing could be addressed with a demand/energy rate being implemented by the Board in its order on this hearing.

The Consumer Advocate's consultant, Mr. D. Bowman in his pre-filed evidence, (p. 4, lines 1-12 and p. 12, lines 16-17) stated that the rate design proposed by Stone & Webster is a "significant improvement" over the energy-only rate. Also, Mr. Bowman in his evidence stated:

> "Now in that regard, Hydro has proposed a demand energy rate. All the expert witnesses have reviewed it, I think all of the witnesses are more or less in favour with it, in favour of the rate proposed with some minor modifications with the exception –that is with the exception of Newfoundland Power. Newfoundland Power has primarily the same objective it had during the last hearing that related to the revenue stability issue, but I believe there's strong—it meets the primary criterion and that is that it recovers the revenue requirement. It is fair in the sense that it reflects both the services provided by Hydro to Newfoundland Power, that is capacity and energy. And it sends an efficient price signal in the sense that an attempt has been made to reflect the fact that demands are higher in winter and that it's priced close to marginal energy cost on the energy charge. And the overriding reason is that certainly Newfoundland appears to be the outlier and not having a demand energy rate for a customer of this size, so there's strong regulatory precedence to have such a rate. So in that regard, I recommend that the—it would appear that these issues that Newfoundland Power—sorry, that Newfoundland Hydro identified have not been resolved. I would urge the two parties to get together and resolve those issues, but in the event they are unable to resolve those issues, I would recommend that the Board direct implementation of that rate, similar to the same rate proposed by the Stone & Webster Report. (Transcript, November 17, 2003, p. 46, lines 8-25 and p. 47, lines 1-17).

The consultants for the Industrial Customers, Intergroup Consultants Limited, stated that the rate schedule proposed in Exhibit RDG-2, pp. 15-16 appeared to be sufficient to address the concerns, however they did raise the issue of the appropriate generation credit to be provided to Newfoundland Power (Pre-filed evidence, p. 48, lines 16-25 and p. 49, lines 1-2).

Mr. Osler stated in evidence that the energy-only rate for Newfoundland Power clearly doesn't purport to track the difference that may occur if Newfoundland Power's actual capacity load differs from the forecast. He went on to say that:

> "The longer term perspective should be to give people incentive in Newfoundland and in this system, there's a lot of electric heating in the Newfoundland Power system, to think about capacity effects and to give pricing must be down the road so that the system evolves in an efficient way". (Transcript November 13, 2003, p. 54, lines 13-25 and p. 55, lines 1-7).

Mr. Osler also said that the interest of the Industrial Customers is one of a long-term evolution of the system (Transcript, November 13, 2003, p. 56, lines 9-17) and he confirmed their position, that a demand/energy rate for Newfoundland Power would have benefits associated with it (Transcript, November 13, 2003, p. 125, lines 16-20) and that a demand energy rate is a logical structure to move to in Newfoundland (Transcript, November 13, 2003, p. 141, lines 6-13).

EES Consulting, the consultant called by Board Hearing Counsel recommended that the Newfoundland Power wholesale rate should include a demand charge (Pre-filed evidence, p. 4, lines 31-32). They recommended that the Board consider approving Hydro's rate proposal with two recommendations related to (i) a demand ratchet formula instead of a weather normalization approach as was recommended by Hydro and (ii) a different treatment for the Newfoundland Power generation credit than proposed by Hydro (Pre-filed evidence, p. 35). They confirmed their view in evidence that a demand component should be included in the wholesale rate to Newfoundland Power (Transcript, November 19, 2003, pp. 55-57).

Newfoundland Power's consultant, Mr. L. Brockman, is the only cost of service expert who questioned the implementation of a demand/energy rate structure at the current hearing. Mr. Brockman, however, had proposed a demand/energy rate structure in Hydro's 1990 hearing. Newfoundland Power raised several reasons why a demand component should not be introduced: the revenue

instability for Newfoundland Power: rate instability for customers; the incentive it might provide to Newfoundland Power to modify seasonal storage patterns to minimize power purchased expense; and whether it will send an effective price signal (Pre-filed evidence Perry and Henderson, p. 11 and pre-filed evidence L. Brockman, pp. 1-2).

Hydro acknowledged in its evidence that there were issues that needed to be addressed including those raised by Newfoundland Power. However, both Mr. Greneman and Mr. Banfield have testified that, in their view, these issues are capable of resolution in such a way to allow the introduction of a demand/energy rate with the implementation of new rates following this hearing. Mr. Greneman pointed out that there are two basic things that need to be done which would take approximately one month before a demand rate could be implemented. The first related to ensuring adequate metering was in place and the second was for the parties to agree on the use of a weather normalization mechanism (Transcript, November 17, 2003, p. 37, lines 12-25). With respect to the issue of revenue volatility Mr. Greneman went on to point out that it was not necessary to resolve this prior to the implementation of the demand/energy rate structure (Transcript, November 17, 2003, p. 38).

Mr. Banfield in his evidence also addressed issues that needed to be resolved. With respect to the degree of risk, Mr. Banfield stated:

> "And of those, depending on the Board's Order, the degree of risk, we believe we put forward a reasonable approach to that with the -our 98% and the -- as a bottom line for ourselves. The appropriate weather normalization methodology has to be decided with Newfoundland Power and obviously agreed to by the Board. The treatment of Newfoundland Power's generation, we believe, has been, well, resolved from our perspective in that we put forward Option A within RDG-2 which was attached to Mr. Greneman's evidence on the appropriate costing of billing determinants. And we believe the only issue that needs to be clarified there and I say clarified as opposed to resolved is on the metering aspects And I believe we have had some preliminary discussions with Newfoundland Power on that and they were very early in the game and I don't believe that that's problematic at all. So in concert with

> Mr. Greneman's estimation of a month I believe we can agree to finalizing in those couple of items which are outstanding in order to put a demand energy rate into place." (Transcript, December 3, 2003, p. 25, lines 22-25 and p. 26, lines 1-21)

Newfoundland Power's witnesses also acknowledged that the issues could be resolved. On revenue volatility Mr. Perry acknowledged that Newfoundland Power would come forward with a proposal should the Board order the implementation of a demand component (Transcript, December 9, 2003, p. 155, lines 18-23) which might include a reserve mechanism (Transcript, December 9, 2003, p. 154, lines 13-25 and p. 155, lines 1-2). Hydro cautions, however, that the use of a reserve mechanism should not simply be a means whereby costs are passed directly to customers with no signal (either positive or negative) to shareholders for demand containment. Mr. Henderson acknowledged that the issues around weather normalization and transitional issues are also capable of resolution (Transcript, December 9, 2003, p. 159, lines 1-16 and p. 158, lines 3-19 and p. 166, lines 4-12).

It should also be noted that there appears to be almost unanimous consent that a marginal cost study does not need to be done before a demand/energy rate structure can be implemented:

1. R. D. Greneman - Transcript, November 14, 2003, p. 10, lines 11-25, p. 11, lines 1-25 and p. 12, lines 1-21. Mr. Greneman said that such a study could "tweak" the rate.

2. P. Bowman, Industrial Customers' Expert - Transcript, November 13, 2003, p. 145, lines 19-25 and p. 146, lines 1-12.

3. D. Bowman, Consumer Advocate's Expert – Transcript, November 17, 2003, p. 51, lines 10-25 and p. 52, lines 1-8.

4. EES Consulting, Board Hearing Counsel's Consultant, – Transcript, November 19, 2003, p. 23, lines 13-25 and p. 24, lines 1-9.

5. L. Henderson, Newfoundland Power - Transcript, December 9, 2003, p. 159, lines 24-25 and p. 160, lines 1-9.

In light of the positions taken by the various cost of service experts, with the exception of Mr. L. Brockman, it is difficult to see how Mr. Perry could say that the imposition of a demand rate "willy nilly" by the Board would be "foolhardy" (Transcript, December 9, 2003, p. 86, lines 12-17 and p. 87, lines 9-20).

In summary on this issue, Hydro submits that there is sufficient information before the Board that an appropriate demand/energy rate as proposed by Hydro could be implemented should the Board desire a demand component as part of the rate structure for Newfoundland Power. The demand/energy rate structure proposed by Hydro adequately addresses the issues so as to allow implementation of a demand/energy rate with the order arising from this hearing.

F. OTHER ISSUES

F. 1 Rules and Regulations for Service

In its Application, Hydro proposed three changes to the Rules and Regulations for Rural Customers. These three proposed changes were agreed to by the parties during mediation as reflected in Consent #1. Hydro therefore requests that the Board approve the following changes:

1. An amendment to Regulation 9 (o) to reduce the fee for charging a customer requiring a name change from $14.00 to $8.00;

2. The elimination of the statement preparation fee which requires the removal of Regulation 9(n); and

3. To change Regulation 9 (f) and to add a Clause 12 (g) to permit charging a reconnection fee to new customers where reconnection of service is required subsequent to a request by a landlord to disconnect an apartment.

The specific changes proposed are set out in pre-filed evidence of S. D. Banfield, pp. 17-18 and were agreed to by the parties (Consent #1 in paragraphs d, e, and f of Section I).

Hydro submits that the changes proposed to the Rules and Regulations should be approved by the Board.

F. 2 Conservation

The Board in P.U. 7 directed Hydro to file a multi-year plan with respect to conservation activities, (P.U. 7, para. 38 (iv), p.182) and as well, directed Hydro in applications for capital expenditures, to provide a cost/benefit analysis of alternatives that might result in reduced load or a deferral of capital expansions (P.U. 7, p.161 and para. 17 (iii), p.179).

With respect to the first direction of the Board, Hydro filed its report on conservation activities in December 2002 and in this hearing filed a copy of the report entitled “Community Based Conservation Initiatives” in response to RFI CA-20 NLH. The focus of Hydro’s conservation activities as outlined in this report is a multi-year energy conservation initiative called Hydrowise, the primary purpose of which is to identify opportunities for customers to manage their electricity bills by helping them understand electricity usage in their homes or businesses. It is primarily an educational tool designed to provide information to customers to make their own wise choices about energy usage and consumption. Activities within Hydrowise include the development of brochures and posters, the development of partnerships with key stakeholders and the implementation of a school education program.

It is Hydro’s submission that specific targets with regard to demand reduction are not appropriate with respect to the Hydrowise program. As already indicated, Hydrowise is primarily an education program so that people will understand their electricity consumption patterns, the prices paid and actions they can take to reduce their consumption. As Hydro moves forward with this program, a type of measure might become desirable, but it is not appropriate at this time to introduce such targets (Transcript, December 2, 2003, p. 35, lines 23-25 and p. 36, lines 1-23).

It should also be noted that Hydro will be retaining statistics with respect to participation in Hydrowise and materials distributed which will allow an assessment of the program. As well, Hydro's customer survey will include a section with respect to this, which will allow Hydro to monitor customers' reactions (CA-20 NLH, p. 6).

In addition to Hydrowise, Hydro assesses diesel systems on a regular basis and targets conservation initiatives in isolated rural systems where it is considered to make economic sense if the short-term marginal cost is greater than marginal revenue and the difference between the two is sufficient to fund a demand side management initiative. Hydro has undertaken a number of initiatives where it has provided compact fluorescent lighting and electrical hot water pipe insulation to customers (CA-23 NLH).

With respect to the second direction contained in P.U. 7, where there are new capacity additions proposed, Hydro has regularly filed in its capital budget applications a cost/benefit analysis, to determine whether any DSM initiatives could defer the capital addition (Transcript, October 20, 2003, p. 38, lines 2-11).

Hydro submits that its activities in the conservation area are appropriate and no further action is required at this time.

F. 3 Effective Date and Method of Rate Changes

As stated in the *EPCA*, Hydro is required to set rates based on forecast costs. Hydro has proposed that the test year for setting its new rates be 2004. However, due to the length of the hearing, it is no longer possible to implement rates on January 1, 2004, as proposed by Hydro in its Application. Hydro, however, is requesting the same rates that would have been effective on January 1, 2004, based on the Board's final ruling, with the order to become effective at the earliest possible implementation date.

Hydro is specifically requesting that the rates be effective for consumption on and after the implementation date as ordered by the Board and be the same rates as would have been effective on January 1, 2004, other than for Labrador Interconnected firm customers and Isolated Rural Customers. Hydro is proposing that the rates for Labrador Interconnected firm customers and Isolated Rural Customers be effective for bills issued on and after the implementation date as ordered by the Board and be the same rates as would have been effective on January 1, 2004.

F. 4 Final Cost of Service

In order to determine the final base rates to be charged to customers, it will be necessary for Hydro to complete a final cost of service study for 2004, once specific direction is received from the Board. Hydro proposes that the final cost of service be as filed in its revision dated October 31, 2003, adjusted to reflect only any 2004 capital budget additions that might be approved by the Board further to Hydro's Application of November 21, 2003, any increases in regulatory costs as discussed in Section B.10.5 hereof, the adjustment for capital budget underspending discussed in Section B.10.2 and any adjustment required should the Board approve Hydro's proposal to assign the GNP generation assets as common as outlined in Section D. 2. Otherwise, Hydro proposes that nothing be changed from the October 31, 2003, cost of service as filed with the Board

unless there is clear and specific direction received from the Board in its final order to make a change.

F. 5 Costs

Section 90 (1) of the *Public Utilities Act* states that the costs of and incidental to a proceeding before the Board are in the discretion of the Board. Clearly, the Board has authority to award costs in appropriate circumstances and it has done so in the past.

Section 117 of the Public Utilities Act states that the costs of the Consumer Advocate are to be borne by the Board, which in turn passes these costs on to Hydro as it does its own costs. Hydro is proposing to amortize the costs of the Board and the Consumer Advocate over a three-year period commencing in 2004, with an estimate included in the 2004 Revenue Requirement for this purpose filed on October 31, 2003.

With respect to the costs of Industrial Customers, the Board had not awarded costs to Intervenors such as the Industrial Customers during any previous hearings until the 2001 GRA. At that time, the Board fixed an amount for the costs of Industrial Customers to be paid by Hydro and stated that its decision with respect to awarding costs to Industrial Customers was “solely to recognize the circumstances surrounding this Application” and was not intended to set a precedent (P.U. 7, p. 164). The Board further stated that, in normal circumstances, the Board is guided by an “ability to pay” principle in adjudicating requests for costs. Hydro submits, as it has in the past, that the Island Industrial Customers have adequate financial resources to cover their own costs and that costs should not be awarded in their favour in this proceeding.

Should the Board determine it appropriate that costs be paid to the Industrial Customers or to the Towns of Labrador City and Wabush, Hydro requests that

the Board provide it with an estimate of these costs so that the appropriate amount may be included with the costs of the hearing to be amortized over a three-year period with the appropriate amount being included in the 2004 Revenue Requirement.

SCHEDULE A

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

1998 CarswellNfld 150

Newfoundland (Board of Commissioners of Public Utilities), Re

In The Matter of Section 101 of the Public Utilities Act, R.S.N. 1990, c. P-47

In The Matter of a case stated by the Board of Commissioners of Public Utilities to the Court of Appeal for its hearing consideration and opinion on questions of law affecting the jurisdiction of the Board of Commissioners of Public Utilities

Newfoundland Court of Appeal

O'Neill, Cameron, Green JJ.A.

Heard: March 11, 1997
Heard: March 12, 1997
Judgment: June 15, 1998
Docket: 96/141

Counsel: V. Randell J. Earle, Q.C. Counsel for the Board of Commissioners of Public Utilities.

Ian F. Kelly, Q.C., Counsel for Nfld. Light & Power Co. Ltd.

Mark Kennedy, Counsel for the Consumer Advocate.

Subject: Public; Civil Practice and Procedure

Public utilities --- Regulatory boards -- Regulation of rates

Utilities board stated case to Court of Appeal for determination of "just and reasonable" return on rate base of utility -- Board had jurisdiction to fix rate of return that public utility could earn annually -- Board did not have jurisdiction to fix rate of return on common equity or shares -- Board had jurisdiction to set rate of return as range -- Board had broad jurisdiction to regulate how excess revenue was dealt with in situation where utility earned rate of return greater than that determined to be just and reasonable -- Board had jurisdiction to define excess revenue for purpose of maintenance of reserve account and set out how excess, if not ordered to be paid into reserve

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

account, was dealt with -- In setting rate, board had jurisdiction to consider type and level of projected expenses of utility and determine whether such expenses were reasonable -- Board did not have jurisdiction to require public utility to maintain debt-equity ratio or ratio within stated range -- Board did not have jurisdiction to require utility to obtain its capital requirements by issue of specific financial instruments -- Board did not have jurisdiction to intrude into day to day financial or managerial decision-making of utility with respect to capital structure.

The Board of Commissioners of Public Utilities stated at case to the Court of Appeal with respect to the jurisdiction and powers of the board as they affected the board's approach to the determination of a "just and reasonable" return on the rate base of a utility. A number of question were posed.

Held: The board had broad jurisdiction with respect to the determination of a just and reasonable return on the rate base of a utility.

Per Green J.A. (Cameron J.A. concurring): The board had jurisdiction to fix the rate of return that a public utility could earn annually but it did not have jurisdiction to fix the rate of return on common equity or shares. The board had jurisdiction to set the rate of return as a range and it had broad jurisdiction to regulate how any excess revenue was dealt with in a situation where the utility earned a rate of return greater than that determined to be just and reasonable. The board had jurisdiction to define what excess revenue was for the purpose of maintenance of a reserve account and had the jurisdiction to set out how that excess, if not ordered to be paid into the reserve account, was dealt with. In setting the rate, the board had jurisdiction to consider the type and level of projected expenses of a utility and to determine whether such expenses were reasonable. The board did not have the jurisdiction to require a utility to obtain its capital requirements by issue of specific financial instruments, nor did it have jurisdiction to intrude into the day to day financial or managerial decision-making of a utility with respect to its capital structure.

Per O'Neill J.A. (dissenting): The determination of the rate on common shares of a utility is very much a part of the rate making process. Rates to be charged should provide sufficient revenue to enable the producer or retailer of the power to earn a just and reasonable return so that it is able to achieve and maintain a sound credit rating in the world's financial markets. The board had the jurisdiction to fix the rate of return on the rate base as well as the rate on common shares. Revenues generated after the rates, tolls and charges were set belonged to the utility and thus the board did not have the jurisdiction to order rebates to customers. The Board did not have the jurisdiction to set rates in a manner that would compensate for prior excess earnings.

Cases considered by Green, J.A.:

Acker v. United States (1936), 298 U.S. 426, 56 S. Ct. 824, 80 L. Ed. 1257 (U.S. Ill.) -- considered

Bell Canada v. Canada (Canadian Radio-Television & Telecommunications Commission), 38 Admin. L.R. 1, [1989] 1 S.C.R. 1722, 60 D.L.R. (4th) 682, 97 N.R. 15, [1989] 1 R.C.S. 1722 (S.C.C.) -- considered

Bell Telephone Co. of Canada, Re (1966), 56 B.T.C. 535 -- considered

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia (1923), 262 U.S. 679, 43 S. Ct. 675, 67 L. Ed. 1176, P.U.R. 1923D 11 (U.S. W. Va.) -- considered

British Columbia Electric Railway v. British Columbia (Public Utilities Commission), [1960] S.C.R. 837, 33 W.W.R. 97, 82 C.R.T.C. 32, 25 D.L.R. (2d) 689 (S.C.C.) -- considered

Edmonton (City) v. Northwestern Utilities Ltd., [1929] S.C.R. 186, [1929] 2 D.L.R. 4 (S.C.C.) -- considered

Federal Power Commission v. Hope Natural Gas Co. (1944), 320 U.S. 591, 64 S. Ct. 281, 88 L. Ed. 333, 51 P.U.R. (N.S.) 193 -- considered

Montana-Dakota Utilities Co. v. Northwestern Public Service Co. (1951), 341 U.S. 246, 71 S. Ct. 692, 95 L. Ed. 912, 88 P.U.R. (N.S.) 129 (U.S. S.D.) -- considered

Newfoundland Light & Power Co. v. Newfoundland (Public Utilities Commissioners Board) (1987), 25 Admin. L.R. 180, 37 D.L.R. (4th) 35, 63 Nfld. & P.E.I.R. 335, 194 A.P.R. 335 (Nfld. C.A.) -- considered

Northwestern Utilities, Re (1978), [1979] 1 S.C.R. 684, 7 Alta. L.R. (2d) 370, 12 A.R. 449, 89 D.L.R. (3d) 161, 23 N.R. 565 (S.C.C.) -- considered

Union Gas Ltd. v. Ontario (Energy Board) (1983), 43 O.R. (2d) 489, 1 D.L.R. (4th) 698 (Ont. Div. Ct.) -- considered

Wabush (Town) v. Power Distribution District of Newfoundland & Labrador (1988), 71 Nfld. & P.E.I.R. 29, 220 A.P.R. 29 (Nfld. C.A.) -- considered

Statutes considered by Green, J.A.:

Electrical Power Control Act, 1994, S.N. 1994, c. E-5.1

s. 3(a) -- considered

s. 3(a)(i) -- considered

s. 3(a)(ii) -- considered

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

s. 3(a)(iii) -- considered

s. 3(b) -- considered

s. 3(b)(i) -- considered

s. 3(b)(ii) -- considered

s. 3(b)(iii) -- considered

s. 4 -- considered

Public Utilities Act, R.S.N. 1990, c. P-47

s. 16 -- considered

s. 37(1) -- considered

s. 58 -- considered

s. 59 -- considered

s. 59(2) -- referred to

s. 64(1) -- considered

s. 64(2) -- considered

s. 68(4) -- considered

s. 69 -- considered

s. 69(3) -- considered

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

s. 70 -- considered

s. 70(1) -- considered

s. 75 -- considered

s. 75(3) -- considered

s. 76 -- considered

s. 78(1) -- considered

s. 78(2) -- considered

s. 78(2)(h) -- considered

s. 80 -- considered

s. 80(1) -- considered

s. 80(2) -- considered

s. 80(4) -- considered

s. 84(1) -- considered

s. 84(2) -- considered

s. 87(1) -- considered

s. 91 -- considered

s. 91(1) -- considered

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

s. 91(3) -- considered

s. 91(5)(a) -- considered

s. 101 -- pursuant to

s. 102 -- referred to

s. 117 -- considered

s. 118 -- considered

s. 118(2) -- considered

Statutes considered by O'Neill, J.A.:

Electrical Power Control Act, 1994, S.N. 1994, c. E-5.1

Generally -- considered

s. 3 -- considered

s. 4 -- considered

Public Utilities Act, R.S.N. 1990, c. P-47

Generally -- considered

s. 16 -- considered

s. 37 -- considered

s. 37(1) -- considered

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

s. 58 -- considered

s. 59 -- considered

s. 69 -- considered

s. 69(1) -- considered

s. 69(2) -- considered

s. 69(3) -- considered

s. 69(4) -- considered

s. 70 -- considered

s. 70(1) -- considered

s. 76 -- considered

s. 80 -- considered

s. 80(1) -- considered

s. 80(2) -- considered

s. 80(4) -- considered

s. 84(1) -- considered

s. 85 -- considered

s. 86 -- considered

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

s. 87(1) -- considered

s. 91 -- referred to

s. 101 -- pursuant to

RULING on stated case.

***Green, J.A.*:**

1 The Board of Commissioners of Public Utilities has stated a case for the opinion of this Court, pursuant to s. 101 of the *Public Utilities Act*[FN1]. The questions posed concern the jurisdiction and powers of the Board as they affect the approach of the Board to the determination of a "just and reasonable return" on the rate base of a utility, as well as related matters.

The Stated Case in Context

2 The Board is the statutory body which has the authority and duty for the "general supervision of all public utilities" in Newfoundland and Labrador and in the course of exercising that supervisory role has general authority to "make all necessary examinations and inquiries and keep itself informed as to the compliance by public utilities with the law" and, as well, it has the right "to obtain from a public utility all information necessary to enable the Board to fulfil its duties"[FN2].

3 One of the Board's primary functions with respect to electrical utilities is the regulation and approval of rates, tolls and charges[FN3]. In so doing, the Board must take account of the statutory requirement that the utility is entitled to earn annually a "just and reasonable return" as determined by the Board on the rate base as fixed and determined by the Board. [FN4] The process essentially involves the fixing and determining of the appropriate rate base, the determination of a "just and reasonable return" on that rate base and then the approval of a schedule of rates, tolls and charges that would be appropriate to generate the revenue which, in the Board's estimation, would be necessary to provide the determined rate of return. Once rates, tolls and charges are set by the Board they continue to apply until altered under the Act, as a result of a reapplication by the utility for an increase, a complaint by the public or an order for a reexamination initiated by the Board itself.

4 It is important to remember, however, that in addition to its periodic adjudicative role which itself involves a large measure of policy implementation in arriving at its decisions, the Board has, because of its duty of "general supervision of all public utilities", an ongoing supervisory role of the activities of the utility between hearings as well, which is facilitated by statutory requirements for periodic reporting of financial information to the Board.

5 In 1991 the Board made Orders[FN5] determining a just and reasonable return for Newfoundland Light and Power Co. Ltd.[FN6] and approving a schedule of rates, tolls and charges based on estimated revenue requirements

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necessary to cover operating expenses and to provide that level of return. The essential features of the 1991 order determining the just and reasonable rate of return were that:

(a) The just and reasonable return was determined to be between a stated range (10.6% - 11.19%) of the company's average rate base;

(b) The rate base was determined on the basis of a hypothetical test year (1992);

(c) The Board determined that the just and reasonable return, as defined, would provide an opportunity to NLP to earn a rate of return on common equity between a certain stated range (13% to 13.5%);

(d) The schedule of rates, tolls and charges was determined applying a rate of return equal to the mid-point between the stated range of returns on rate base;

(e) The Board ordered that a particular capital structure of NLP be adopted and continue to be the basis of NLP's financial plan.

6 The Board had previously adopted a policy allowing NLP to retain earnings above the allowed range of return on rate base, provided those earnings were within the allowed range of rates of return on common equity. Where the earnings exceeded the allowed rate of return on common equity, the Board, in purported exercise of its statutory powers to regulate NLP's accounting procedures, as well as other powers, required NLP to set up a reserve account in which these excess earnings would be held and dealt with in accordance with subsequent direction by the Board.

7 In April of 1996, NLP petitioned the Board for another order fixing and determining a new rate base, determining a just and reasonable return and approving a revised schedule of rates, tolls and charges, amongst other matters. One of the parties represented at the hearing was the "Consumer Advocate", who was appointed [FN7] by the Government of Newfoundland and Labrador to represent the interests of domestic and general service consumers in respect of the rate hearing.

8 During the years between the making of the 1991 orders and the 1996 hearing, NLP had filed annual returns with the Board, as required by s-s. 59(2) of the Act, which indicated that in the years 1991, 1992 and 1993 the company's rate of return on rate base was in excess of the range determined in the 1991 Order. However, as calculated by NLP, the rate of return on common equity was always within the range that had been stipulated by the Board. The rates of return on rate base and on common equity were calculated based on actual expenses and on the actual capital structure of NLP.

9 In its periodic reports to the Board, NLP disclosed that its actual advertising costs in 1992 exceeded the amounts projected to the Board as a forecast for 1992 which had been approved as reasonable and prudent by the Board in its 1991 Order in the course of fixing and determining the rate base.

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10 During the course of the 1996 hearing, certain submissions were made to the Board respecting, amongst other things,

> (a) whether NLP should be regarded as having earned revenue in excess of its allowed range of rate of return where its rate of return on common equity was nevertheless within the stated allowable range;
>
> (b) whether the manner of calculation of excess revenue and the proposed manner of the disposition of any excess was permitted;
>
> (c) whether NLP could and should be required to alter its capital structure so as to obtain its capital requirements in a manner other than the way in which it was presently doing;
>
> (d) whether the Board could and should take account, in setting future rates, of past expenditures which were in excess of amounts deemed reasonable and prudent at the time of a previous hearing.

11 Questions arose as to the jurisdiction and power of the Board to entertain and act on the sorts of submissions that were made. This prompted the Board to state the current case to this Court. NLP and the Consumer Advocate were granted standing to appear and be heard at the hearing.

The Specific Questions

12 The Stated Case poses for consideration by this Court the following questions:

> (1) Does the Board have jurisdiction pursuant to the Act to set and fix the return which a public utility may earn annually upon:
>
> > (i) the rate base as fixed and determined by the Board for each type of service applied by the public utility; and/or
> >
> > (ii) the investment which the Board has determined has been made in the public utility by the holders of common shares.
>
> (2) Does the Board have jurisdiction to set the rates of return referred to in Question (1) as a range of permissible rates of return.
>
> (3) Should a public utility earn annually a rate of return which is in excess of the rate of return determined by the Board to be just and reasonable, either on:

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(i) the base rate as fixed and determined by the Board for each type of service applied by the public utility; or

(ii) the investment, which the Board has determined, has been made in the public utility by holders of common shares,

does the Board have jurisdiction to:

(i) require the public utility to use the excess earnings to reduce revenue requirements for the succeeding year; or

(ii) require the public utility to place the excess earnings in a reserve fund for the purpose of adjusting rates, tolls and charges of the public utility at a future date, or

(iii) require the public utility to rebate the excess earnings to customers of the public utility.

(4) Does the Board have jurisdiction to order that the rates, tolls and charges of a public utility shall be approved taking into account earnings in excess of a just and reasonable return upon,

(i) the rate base as fixed and determined by the Board for each type of service applied by the public utility, or

(ii) the investment, which the Board has determined, has been made in the public utility by the holders of common shares,

in prior years.

(5) Does the fact that the Board has advised the public utility that it is permitted to retain earnings in excess of the rate of return determined by the Board to be a just and reasonable return, upon the rate base as fixed and determined by the Board for each type of service supplied by the public utility, but not in excess of the return determined by the Board to be a just and reasonable return upon the investment which the Board has determined has been made in the public utility by the holders of common shares, affect the jurisdiction of the Board to approve rates, tolls and charges on the basis queried in Question (4).

(6) Does the Board have jurisdiction to order the rates, tolls and charges of the public utility shall be approved taking into account the amount of expenses previously incurred by the public utility which the Board may now consider inappropriate to be allowed as reasonable and prudent and properly chargeable to operating account notwithstanding that such classes of expenses were allowed as

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reasonable and prudent and properly chargeable to operating account.

(7) Does the Board have jurisdiction to require a public utility to maintain:

(i) a ratio; or

(ii) a ratio within a stated range of ratios

of equity and debt, as the means of obtaining the capital requirements of the public utility.

(8) Does the Board, upon an application pursuant to Section 91 or otherwise, have the jurisdiction to require a public utility to obtain its capital requirements by the issue of specific financial instruments, whether common shares, preferred shares, stocks, bonds, debentures or evidence of indebtedness payable in more than one year.

Although the questions are stated above as they appear in the Stated Case filed with the Court, there are several obvious typographical errors in the language used. This was recognized by the participants in references to the questions in their written arguments. In particular "supplied" was at times substituted for the word "applied" in questions 1(i), 3(i) and 4(i) and "base rate" in Question 3(i) was replaced by "rate base." In addition, the phrase "In the event that a public utility should ..." at the beginning of Question 3 was used at times in the written submissions in preference to the phrase "Should a public utility ..." Nothing turns on these informal changes. They do, however, make the import of the questions clearer and I will interpret the questions in that light.

The Legislative Framework

13 The answers to the questions which have been posed must, of course, be given taking account of the legislative framework within which the Board operates. The Board is a creature of statute and its jurisdiction and powers to deal with matters brought before it, and the manner of dealing with such matters, must be found, either expressly or impliedly, within the statutes conferring jurisdiction on and governing the operation of the Board.

14 While a number of specific provisions of the Act and related legislation will have to be referred to in the course of this opinion, certain legislative provisions, which are central to this analysis, can be conveniently set forth here:

Public Utilities Act

58. The board may prescribe the form of all books, accounts, papers and records to be kept by a public utility and a public utility shall keep its books, accounts, papers and records and make its returns in the manner and form prescribed by the board and comply with all directions of the board relating to those

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books, accounts, papers, records and returns.

69.(1) A public utility, if so ordered by the board, shall, out of earnings, set aside all money required and carry it in a depreciation account.

(2) The depreciation account shall not, without the consent of the board, be spent otherwise than for replacements, new constructions, extensions or additions to the property of the company.

(3) The board may by order require a public utility to create and maintain a reserve fund for a purpose which the board thinks appropriate, including the improvement of the public utility's status as a borrower or seeker of funds for necessary maintenance or expansion of its operations.

(4) The board, in a case where it has made an order which has the effect of increasing a public utility's revenues, may require the public utility to refrain from distributing as dividends until further order the whole or a part of the extra revenue which is in the board's opinion attributable to the order.

(5) An order under this section shall be made only after hearing the public utility concerned.

70.(1) A public utility shall not charge, demand, collect or receive compensation for a service performed by it whether for the public or under contract until the public utility has first submitted for the approval of the board a schedule of rates, tolls and charges and has obtained the approval of the board and the schedule of rates, tolls and charges so approved shall be filed with the board and shall be the only lawful rates, tolls and charges of the public utility, until altered, reduced or modified as provided in this Act.

75.(1) The board may make an interim order unilaterally and without public hearing or notice, approving with or without modification, a schedule of rates, tolls and charges submitted by a public utility, upon the terms and conditions that it may decide.

(2) The schedule of rates, tolls and charges approved under subsection (1) are the only lawful rates, tolls and charges of the public utility until a final order is made by the board under section 70.

(3) The board may order that the excess revenue that was earned as a result of an interim order made under subsection (1) and not confirmed by the board be

(a) refunded to the customers of the public utility; or

(b) placed in a reserve fund for the purpose that may be approved by the board.

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76. The board may upon notice to the public utility and after hearing as provided in this Act, by order rescind, alter or amend an order fixing rates, tolls, charges or schedules, or other order made by the board, and certified copies of the order shall be served and take effect as provided in this Act for original orders.

78.(1) Except as otherwise provided in this Act, the board may fix and determine a separate rate base for each kind of service provided or supplied to the public by a public utility, and may revise the base.

(2) In fixing a rate base the board may, in addition to the value of the property and assets as determined under section 64, include

. . . . .

(h) other fair and reasonable expenses which

(i) the board thinks appropriate and basic to the public utility's operation, and

(ii) has, with the approval of the board, been charged to capital account,

but the expenses shall be allowed only to the extent not amortized in previous years.

80.(1) A public utility is entitled to earn annually a just and reasonable return as determined by the board on the rate base as fixed and determined by the board for each type or kind of service supplied by the public utility but where the board by order requires a public utility to set aside annually a sum for or towards an amortization fund or other special reserve in respect of a service supplied, and does not in the order or in a subsequent order authorize the sum or a part of it to be charged as an operating expense in connection with the service, the sum or part of it shall be deducted from the amount which otherwise under this section the public utility would be entitled to earn in respect of the service, and the net earnings from the service shall be reduced accordingly.

(2) The return shall be in addition to those expenses that the board may allow as reasonable and prudent and properly chargeable to operating account, and to all just allowances made by the board according to this Act and the rules and regulations of the board.

(3) Reasonable payments each year to former employees of a public utility who have retired and are receiving payments of supplemental income from the public utility are expenses that the board may allow as reasonable and prudent and properly chargeable to the operating account of the public utility.

(4) The board may use estimates of the rate base and the revenues and expenses of a public utility.

84.(1) Upon a complaint made to the board against a public utility by an incorporated municipal body or

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

the Newfoundland and Labrador Federation of Municipalities or by 5 persons, firms or corporations, that the rates, tolls, charges or schedules are unreasonable or unjustly discriminatory or that a regulation, measurement, practice or act affecting or relating to the operation of a public utility is unreasonable, insufficient or unjustly discriminatory or that the service is inadequate or unobtainable, the board shall proceed, with or without notice, to make the investigation that it considers necessary or expedient.

(2) The board may order the rates, tolls, charges or schedules reduced, modified or altered, and make other orders as to the reduction, modification or change of the regulation, measurement, practice or acts that the case may require, and may order on the terms and subject to the conditions that are just that the public utility provide reasonably adequate service and facilities and make extensions that may be required, but an order shall not be made or entered by the board without a public hearing or inquiry.

87.(1) Where upon an investigation the rates, tolls, charges or schedules are found to be unjust, unreasonable, insufficient or unjustly discriminatory, or to be preferential or in violation of this Act, the board has power to cancel those rates, tolls, charges or schedules and declare void all contracts or agreements, either oral or written, dealing with them upon and after a day named by the board, and to determine and by order substitute those rates, tolls or schedules that are reasonable.

91.(1) A public utility shall not issue shares, which for the purposes of this section shall include preferred shares, stocks, bonds, debentures or evidence of indebtedness payable in more than 1 year from the date of issue, except as provided in subsection (2) until it has obtained approval from the board for the proposed issue;...

. . . . .

(3) After hearing the application and where satisfied that the proposed issue by a public utility of its shares, stocks, bonds, debentures or other evidence of indebtedness is to be made in accordance with law and for a purpose approved by the board, it is the duty of the board to make an order approving the proposed issue to the amount that it considers appropriate, and also to prescribe the purpose to which the issue or the proceeds of the issue are applied.

. . . . .

(5) Without first obtaining the approval of the board,

(a) a public utility shall not make a material alteration in the characteristics of its stocks or shares, or its bonds, debentures, securities, or other evidence of indebtedness as those characteristics are described by the board in granting its approval of the issue;...

Electrical Power Control Act, 1994[FN8]

3. It is declared to be the policy of the province that

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

> (a) the rates to be charged, either generally or under specific contracts, for the supply of power within the province
>
> (i) should be reasonable and not unjustly discriminatory,
>
> (ii) should be established, wherever practicable, based on forecast costs for that supply of power for 1 or more years,
>
> (iii) should provide sufficient revenue to the producer or retailer of the power to enable it to earn a just and reasonable return as construed under the *Public Utilities Act* so that it is able to achieve and maintain a sound credit rating in the financial markets of the world, and
>
> . . . . .
>
> (b) all sources and facilities for the production, transmission and distribution of power in the province should be managed and operated in a manner
>
> (i) that would result in the most efficient production, transmission and distribution of power,
>
> (ii) that would result in consumers in the province having equitable access to an adequate supply of power,
>
> (iii) that would result in power being delivered to consumers in the province at the lowest possible cost consistent with reliable service,...
>
> . . . . .
>
> 4. In carrying out its duties and exercising its powers under this Act or under the *Public Utilities Act*, the public utilities board shall implement the power policy declared in section 3, and in doing so shall apply tests which are consistent with generally accepted sound public utility practice.

Approach to Interpretation

15 The Court was not referred to any decisions in this or other jurisdictions which directly addressed, let alone answered, the specific types of questions which have been posed. To answer the questions, therefore, it is necessary to develop a theoretical frame of reference within the context of the general language of the existing legislation so as to determine the approach to be taken to its application in concrete situations.

16 It is necessary to examine the specific legislative provisions in the larger regulatory context and against the

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background of the purposes of the legislation and the general principles which have been developed as part of regulatory practice[FN9]. This approach follows from s. 118 of the Act which provides:

> 118.(1) This Act shall be interpreted and construed liberally in order to accomplish its purposes, and where a specific power or authority is given the board by this Act, the enumeration of it shall not be held to exclude or impair a power or authority otherwise in this Act conferred on the board.
>
> (2) The Board created has, in addition to the power specified in this Act, all additional implied and incidental powers which may be appropriate or necessary to carry out the powers specified in this Act.
>
> (3) A substantial compliance with the requirements of this Act is sufficient to give effect to all the rules, orders, acts and regulations of the Board, and they shall not be declared inoperative, illegal or void for an omission of a technical nature.

17 In addition, the EPC Act[FN10], provides that the Board, in carrying out its duties and exercising its powers under the *Public Utilities Act* must implement the power policy of the province, as declared in s. 3 of the Act, and in so doing must "apply tests which are consistent with generally accepted sound public utility practice".

18 It follows from these provisions that a literal and technocratic interpretation and application of the provisions of the Act is to be avoided, in favour of an interpretation which will advance the underlying purpose of the legislation[FN11] as well as the power policy of the province and be consistent with generally accepted sound public utility practice.

19 In answering the questions posed, therefore, it is necessary to identify generally accepted principles of sound public utility practice and to give to the legislation an interpretation which follows those principles and advances the stated legislative policy of the Province.

20 The trade off for the regulation by the state of the rates, tolls and charges of monopolistic utilities in the interests of consumers is the statutory recognition that the utility should be entitled to earn a fair return for its efforts. Although differing in details, the regulatory statutory regimes existing throughout North America can, as a generalization, be said to be broadly similar in approach[FN12], although in recent years the regulatory schemes and their coverage are being affected more and more by the trends towards deregulation.

21 The regulatory body in question (in Newfoundland, the Board of Commissioners of Public Utilities) is generally charged with balancing the competing interests of consumers and the investors in the utility[FN13]. As deGrandpré[FN14] observed:

> This involves the Board attempting to make sure that, in the consumers' interests, the service provided is adequate and provided at just and reasonable rates and, for the utility and its investors, that those rates provide a sufficient income.

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

22 This balancing of interests is found in the province's stated power policy in s. 3 of the *EPC Act* where, emphasizing the interests of the utility, it is declared that the rates charged for the power should provide sufficient revenue to the utility to enable it to earn a just and reasonable return "so that it is able to achieve and maintain a sound credit rating in the financial markets of the world"[FN15] while at the same time declaring that the rates should be "reasonable"[FN16] and that the utilities' facilities should be managed and operated in a manner that would result in power being delivered to consumers "at the lowest possible cost consistent with reliable service" [FN17]. This policy finds legislative expression in the regulatory mechanisms of the Act itself, which provides that a utility must provide service and facilities which are "reasonably safe and adequate and just and reasonable" [FN18] and prohibits a utility from charging rates, tolls and charges unless they have been approved by the Board [FN19] while at the same time stating as a general principle that the utility is entitled to earn annually a just and reasonable return on its rate base[FN20].

23 This statutory entitlement of the utility to earn a "just and reasonable" return is the linguistic touchstone for the balancing exercise. This phrase emphasizes the fairness aspect, both to the utility, in earning sufficient revenues to make its continued investment worthwhile and to maintain its credit rating in financial markets, and to the consumer, in obtaining adequate service at reasonable rates. It also emphasizes the need for a tempering of each interest group's economic imperative by consideration of the interests of the other.

24 Having said that, the entitlement of the utility to a fair return on its investment is always regarded as of fundamental importance[FN21]. In the United States, controls which fail to allow a fair return have the potential of running afoul of constitutional strictures against confiscation of property without due compensation. While the same constitutional concerns may not be present in Canada, the case law has at times nevertheless referred to the entitlement to a fair return as a "common law right"[FN22] which should be read into the legislation even where it is not specifically expressed.

25 There is no uniform methodology employed in the regulatory jurisdictions in North America for the determination of a just and reasonable rate of return [FN23]. What recurs, however, is a theme that the process is not an exact science and depends on a variety of factors necessary to balance the competing interests involved. Rate setting is essentially a prospective exercise where determinations are made on the basis of estimates and information that will not necessarily remain static.

26 Most jurisdictions adopt a "multiple factor" approach. The *Bluefield Waterworks* case[FN24] in the United States emphasized early on that the determination of a fair rate of return

> ...depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts.[FN25]

27 Statements such as "the company will be allowed as large a return on the capital invested in the enterprise ... as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise"[FN26] often occur. For the rationale for such statements one need look no further than the provincial policy, stated in paragraph 3(a)(iii) of the *EPC Act* that the utility must be "able to achieve and maintain a sound credit rating in the financial markets of the world" so as to be able to raise the money necessary for the proper performance of its functions. To achieve such a goal of attracting capital, factors such as comparisons with other comparable enterprises, the respective costs of debt and equity, the capital

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Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act
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breakdown between debt and equity and general economic conditions, amongst other things, are considered.

28 In *Federal Power Commission v. Hope Natural Gas Co.*[FN27], another landmark United States case, the court emphasized that it is the "end result of the process which has to be judged as to whether the rate is "just and reasonable". As a result, in the words of deGrandpré:

> In stating that the end result was the only point of consideration, whatever the means of arriving thereat, the court opened the door to a wide variety of ways and means to arrive at a proper calculation of returns. In effect, it left the valuation of rate bases to the Commission's or Court's discretion.[FN28]

DeGrandpré's conclusion, based on his survey of North American regulatory regimes, is later stated as follows:

> The constantly changing economic conditions are perhaps a good reason why there should be no stringent rules for determining a rate of return. As was often stated, the process is one which calls for common sense, good judgment and a proper appreciation of all surrounding factors.[FN29]

29 This approach is also reflected in the decision of this Court in *Newfoundland Light & Power Co. v. Newfoundland (Public Utilities Commissioners Board)* where O'Neill, J.A., speaking for the Court in rejecting an argument that the Board of Commissioners of Public Utilities had exceeded its jurisdiction in determining a just and reasonable rate of return by not adopting a particular methodology (a "comparable earnings" test), stated:

> ...it is within the discretion of the Board, having heard all the evidence and giving consideration to the various tests which may be used, to make its ruling on the basis of what in the Board's opinion will give to the applicant a just and reasonable return and permit it to maintain a sound financial credit rating.[FN30]

The Board therefore has a broad discretion to adopt appropriate methodologies for the calculation of allowable rates of return. So long as the methodologies chosen are not inconsistent with generally accepted sound public utility practice and the purposes and policies of the Act, and can be supported by the available opinion evidence, the determination of what constitutes a just and reasonable return in a given case will generally be within the province of the Board and will not normally be interfered with[FN31]. The jurisdiction of the Board must therefore be defined to enable that process to occur.

30 Because setting the rate of return is not an exact science no matter what methodology is chosen, because the viewpoint is essentially prospective, it has been recognized that there is a "zone of reasonableness" within which a rate of return chosen by the Board should be regarded as just and reasonable. This has been expressed by the United States Supreme Court in the following language:

> Statutory reasonableness is an abstract quality represented by an area rather than a pinpoint. It allows a substantial spread between what is unreasonable because too low and what is unreasonable because too high[FN32].

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This notion has also at times been recognized in Canada[FN33].

31 This leads to another point: because the setting of the rate of return is based on projections, one cannot be sure that the rate of return will be achieved in practice. Although the utility is "entitled" by s. 80 of the Act to have the Board determine a just and reasonable rate of return based on appropriate predictive techniques and methodologies, it is not "entitled", in the sense of being guaranteed, to that rate of return[FN34]. The utility therefore takes the risk that its chosen management techniques and the future economic climate may not yield its expected success. Although some of the activities of the utility are regulated within the framework of the statutory objectives, the utility nevertheless remains subject to business risks and the effects of management decisions. To that extent, the financial risks associated with the operation of the utility, just as in the case of any private business, are to be born by the investors in the enterprise, not the consumer of the service.

32 The corollary of this position is that the utility must be accorded a degree of managerial flexibility in decision-making in order to be able to minimize the risks to which it must respond. Thus, it is often said that the powers of the Board must be regulative and corrective, but not managerial, and they do not therefore contemplate a retroactive adjustment of the actions of management.

33 This leads to the general principle of non-retroactivity which prevents a utility from recovering expenses incurred in the past out of current rates. The utility must live with the decisions it makes and the economic vicissitudes that occur.[FN35].

34 By the same token, it is sometimes argued that the occurrence of the reverse situation, of the utility doing better than expected, should mean that the utility should be able to reap the advantage of better and more efficient management techniques and favourable economic conditions and keep any surplus. The concern for the consumer interest is often put forward as a brake on this idea, however. The requirement that the consumer receive power "at the lowest possible cost"[FN36] consistent with the utility's requirement of earning a just and reasonable return for its purposes means, it is often argued, that the regulator ought to have power to ensure that excessive returns are somehow accounted and compensated for.

35 Another factor that is referred to in the cases is the recognition that the capital structure of the utility will often have a bearing on the total cost of capital and this will therefore be important where the determination of the rate base depends on the total debt and equity capital requirements. DeGrandpré observes that "the reasonableness of the ratio of debt to equity is a question of fact left to the appreciation of the Board or Court"[FN37]. Thus, issues such as whether the Board can dictate to the utility a particular mix of debt and equity or, for the purpose of setting the rate of return, do so on the basis of a notional blend of capital requirements if the actual blend is not in accordance with what the Board feels is optimal to ensure a fair return as well as low rates, tolls and charges, often surface. Indeed, this issue is presented in this case.

36 Having conducted this brief survey, I will now attempt to state some general principles to be used in the interpretation and application of the local legislation:

> 1. The Act should be given a broad and liberal interpretation to achieve its purposes as well as the implementation of the power policy of the province;

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

2. The Board has a broad discretion, and hence a large jurisdiction, in its choice of the methodologies and approaches to be adopted to achieve the purposes of the legislation and to implement provincial power policy;

3. The failure to identify a specific statutory power in the Board to undertake a particular impugned action does not mean that the jurisdiction of the Board is thereby circumscribed; so long as the contemplated action can be said to be "appropriate or necessary" to carry out an identified statutory power and can be broadly said to advance the purposes and policies of the legislation, the Board will generally be regarded as having such an implied or incidental power;

4. In carrying out its functions under the Act, the Board is circumscribed by the requirement to balance the interests, as identified in the legislation, of the utility against those of the consuming public;

5. The setting of a "just and reasonable" rate of return is of fundamental importance to the utility and must always be an important focus of the Board's deliberations; however, the "entitlement" of the utility to a just and reasonable rate of return does not guarantee it that level of return. The "entitlement" is to have the Board address that issue and to make its best prospective estimate, based on its full consideration of all available evidence, for the purpose of setting rates, tolls and charges.

6. The Board has jurisdiction, which will not generally be interfered with on judicial review, to make a determination of what is a just and reasonable rate of return within a "zone of reasonableness" and in so doing is not constrained in its choice of applicable methodologies, so long as they can be rationally justified in accordance with sound utility practice and are not inconsistent with the achievement of the purposes and policies of the legislation.

37 It is now necessary to consider each of the specific questions that have been posed. In approaching them, it is worth remembering that the questions have been posed in the abstract and ask for answers to broadly-identified issues of jurisdiction. The case is not an appeal and there can be no findings of fact made by this Court in arriving at its conclusions. The information provided by the Board as to past hearings was given as background only so as to assist the Court in better understanding the scope and potential importance of the questions. While the answers given may provide guidance with respect to specific issues that have arisen in hearings in the past, they cannot be taken as an adjudication of those issues in the specific factual context in which they arose.

Question No.1

(1) Does the Board have jurisdiction pursuant to the Act to set and fix the return which a public utility may earn annually upon:

(i) the rate base as fixed and determined by the Board for each type of service applied by the public utility; and/or

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

> (ii) the investment which the Board has determined has been made in the public utility by the holders of common shares.

38 It will become apparent from the ensuing discussion that a number of the questions posed on this stated case are interrelated in the sense that the answer to some of them will provide a strong impetus for a particular response in others. This is particularly evident in Question 1.

39 The answer to Question 1 in fact involves a consideration of two sub- issues. The first relates to the legal significance of a determination by the Board on a given application of the just and reasonable return to which the utility is entitled. The second sub-issue, which is affected by the decision on the first, relates to the powers of the Board to make determinations with respect to the rate of return on a utility's common equity portion of its capital structure.

(a) The Legal Significance of a "Determination"

40 It is to be noted that Question 1 asks whether the Board has jurisdiction to "set and fix" the utility's return whereas s-s. 80(1) of the Act speaks in terms of the utility being entitled to earn a return as "determined" by the Board. The use of this differing terminology in the question, as explained by counsel for the Board at the hearing, was designed deliberately to raise the issue as to whether the Board may, by determining the level of return, be said to be prescribing that level as an upper limit to the level of earnings to which the utility may be entitled and thereby exercise certain powers with respect to disposition of any excess that may in fact be earned. This issue becomes more focused when Question 3 is considered. The answer to that question will, to some extent, be influenced by the powe which the Board can be said to have unde s. 80 with respect to the setting of a level of return.

41 It is obvious, of course, that in the process of approving rates, tolls and charges under s-s. 70(1) the Board must determine what is a just and reasonable return on the utility's rate base in order to determine the level of revenue needed by the utility[FN38]. This flows from the utility's "entitlement" in s-s. 80(1) to earn that level of return. The determination of a just and reasonable return on rate base is therefore an essential component in the series of calculations which the Board must undertake in the process of approving rates, tolls and charges.

42 If the determination of a just and reasonable return is merely a step in the process of approving rates, tolls and charges under s-s. 70(1), that is, if it is only an intermediate calculation necessary to arrive at the final result of consumer rate approval, the "determination" of a just and reasonable level of return will have no independent legal significance, in the sense of prescribing the limit of the utility's return for other purposes of the Board's functions.

43 On the other hand, if the determination of a just and reasonable level of return has, as it were, an independent life of its own, in the sense of it not being a mere intermediate calculation but can be "set and fixed", in the sense of being prescribed, it could, for example, be used to support an argument that a utility is not entitled to earn in excess of a just and reasonable return. As indicated, this impacts directly on Question 3. While counsel for NLP suggested that there may be other mechanisms available to deal with excess earnings (by means of the use of a designated excess revenue reserve fund), that would not require the derivation of such a power from s. 80, counsel for the Board and the Consumer Advocate both indicated that they were concerned about the legal basis for the derivation of the operation of an excess revenue account from other parts of the legislation, such as the administrative and

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supervisory power of the Board to regulate a utility's accounts. It is appropriate therefore that this matter be addressed.

44 The issue boils down to this: If the power to "determine" the return encompasses the notion of fixing, in the sense of prescribing the limits of entitlement, one would be able to derive from s-s. 80(1) a power in the Board to say to the utility that it may earn that level of return and no more. If not, the power to determine would simply be part of a calculation that leads to consumer rate setting with no independent existence or significance for regulatory practice generally.

45 *Black's Law Dictionary*[FN39] explains "determine" in part as follows:

> To bring to a conclusion, to settle by authoritative sentence, to decide.... To adjudicate on an issue presented...
>
> To estimate...
>
> To decide, and analogous to "adopt" or "accept"...

46 The *Concise Oxford Dictionary*[FN40] defines the word in pertinent part as:

> 1. v.t. & i. settle, decide, (dispute, person's fate ...), come to a conclusion, give decision, be the decisive factor in regard to ...; ascertain precisely, fix;...
>
> 3. v.t. & i. (esp. Law) bring or come to an end.
>
> 4. v.t. limit in scope, define; fix (date) beforehand.

47 For what limited value these definitions can have in this context, it would appear that the primary meaning of the word determine, with its emphasis on coming to a final decision and amounting to a decisive factor as well as the notion of ascertaining something precisely and "fixing", encompasses something more than a mere calculation in a broader process.

48 Having said that, it is to be noted that s-s. 80(1) is structured in such a way that its emphasis is on the entitlement of the utility to a just and reasonable return, as determined by the Board, rather than involving the express conferral on the Board of a power to prescribe the level of return. The structure of the subsection could be said to be directed towards establishing a minimum base line of entitlement without saying anything expressly about the power of the Board to create a cap. To put the matter beyond doubt, the insertion of the words "and no more" after the language entitling the utility to a just and reasonable return would certainly have clearly indicated a prescriptive power in the Board, if that had been intended. Furthermore, although the return is referred to as being

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"determined" by the Board, the subsection goes on to indicate that the return so determined is applied to the rate base "as fixed and determined" by the Board. On a strict linguistic analysis alone, the use of the word "fixed" in conjunction with "determined" in one place would imply that its absence in the other was deliberate.

49 Notwithstanding these matters, I am not satisfied that a linguistic analysis of the subsection can provide the answer in this case. Even a cursory perusal of the remaining provisions of the Act indicates that there is no uniform terminology chosen to describe the various decision-making functions in which the Board may engage. For example, the Act provides that the Board may "inquire into and determine"[FN41] the valuation of a utility's assets and may "determine"[FN42] those values in accordance with a number of stated rules. It may "ascertain and determine"[FN43] what are proper and adequate rates of depreciation of classes of utility property. Its role with respect to the utility's rates, tolls and charges is one of "approval"[FN44]. Indeed, if there is any decision of the Board which is contemplated as having operative legal effect and to amount to a "fixing" of the utility's rates, tolls and charges from which the utility may not deviate, it is the "approval" contemplated in this regard; yet the word "fix" does not appear. In another context, the Board may "fix and determine"[FN45] a separate rate base for each kind of service supplied by a utility; yet when describing what is to be included in the calculation of rate base, the reference to "determine" is dropped and it is simply described as "fixing a rate base"[FN46]. Finally, the term "approval" surfaces again in the context of the power of the Board to authorize new stock issues of the utility [FN47].

50 To resolve this conundrum, resulting from inconsistency in terminology, resort must be had to the purposes of and policies underlying the legislation as mandated in s-s. 118 of the Act as well as s. 4 of the *EPC Act*. As indicated previously,[FN48] the Board is required, in carrying out its functions under the Act, to balance the interests, as identified in the legislation, of the utility against those of the consuming public. The notion of a "just and reasonable return" in s-s. 80(1) is the benchmark against which fairness to the utility and the consumer is to be measured. It is pivotal in the balancing exercise. The interests of the consuming public in obtaining power at the lowest possible cost consistent with reliable service[FN49] must accommodate the utility's interest in being afforded the opportunity to earn a fair rate of return for its efforts. In the methodology adopted by the Board, the approval of appropriate rates, tolls and charges necessarily factors the just and reasonable return, and only that level of return, into that calculation. Otherwise, the interests of the consumer would not be protected in obtaining power at the lowest possible cost. It is therefore inherent in the process that in determining a just and reasonable return for the utility, the utility should have the opportunity of earning that return but, other things being equal, should not expect to earn any more. Accordingly, determining the just and reasonable return necessarily involving prescribing the return and in that sense can be said to amount to "setting and fixing" the rate of return.

51 It follows from this that the use of the word "determine" can, in the context of the use of that and other terminology in the Act, encompass something more than the notion of mere calculation and extends to the idea of prescribing, or fixing, a level of return in the nature of a legal decision which can bind and have effect on the utility for other purposes related to the Act.

(b) The Power to Set and Fix the Level of Return on Common Equity

52 In order to determine the just and reasonable return on rate base to which the utility is entitled by s-s. 80(1), the Board must first determine the cost to the utility of the various components of its sources of funds. The costs associated with long term debt and preference shares are generally static over the period covered by a particular rate hearing. Accordingly, they are often described as "embedded costs". The rate of return necessary to be earned

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on rate base to cover the cost of debt and preference shares can therefore usually be easily determined based on the interest rates or dividend rates applicable to such instruments. In the case of common equity, however, the cost to the utility of this source of funds depends upon a number of factors, especially current market conditions which, by nature, can be volatile.

53 At a rate hearing, therefore, the Board usually faces a greater difficulty in determining the component of rate of return on common equity than on the other sources of funds because their embedded costs are usually well defined.

54 Since the rate base is financed by a combination of debt, preference shares and common equity, the rate of return on which is different for each component, the overall rate of return on rate base is calculated as a weighted average of the rates of return on the various individual components.[FN50]

55 As a generalization, it is sometimes said that the cost of common equity is often higher than that of debt [FN51]. The rate of return on common equity may therefore be expressed as a percentage which is higher than the overall rate of return on the full rate base because the higher equity cost will be weighted downwards by the rates for the other components.

56 The issue raised by Question 1(ii) is whether the Board may set and fix the rate of return on common equity, as a component of the overall rate of return on rate base in a manner such that it can be used as an independent benchmark for other purposes in the same way as the overall determination of return on rate base can be. Alternatively, is the "determination" of the rate of return on common equity to be treated in the narrower sense of a mere calculation leading to the final determination of overall return?

57 Subsection 80(1) makes no reference at all to determining, let alone setting and fixing, the rate of return on common equity. The calculation of an appropriate rate of return on common equity is truly a mere component in the overall process of determining a just and reasonable return on rate base. Furthermore, there is nothing in the purpose of the Act or the policies which the Board is to implement which would lead inexorably to the conclusion that the Board ought to have the power to prescribe a rate of return on common equity as a component of an overall return or rate base, any more than it ought to have a power to prescribe a return on any other component.

58 The Consumer Advocate submitted that inasmuch as s-s. 80(1), by its express language, contemplates that the only measure of what NLP may earn annually is to be determined by a just and reasonable return on rate base, to allow the utility to measure what it may earn annually based upon a different factor, such as a rate of return on common equity which could very well be higher than the overall rate of return on rate base and might lead to a higher overall return that could be said to be justified, would be to allow the utility to earn more than that to which it is statutorily entitled.

59 It is to be noted, however, that in its previous orders[FN52] the Board has not sought to determine the level of return on the basis of anything other than a rate of return on rate base. For example, in the 1991 Order, the Board ordered:

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

> A just and reasonable return for [NLP] is determined to be between 10.96% and 11.19% on its average rate base for 1992, which will provide an opportunity to earn a rate of return on common equity between the range of 13.00% to 13.50%.
>
> [Emphasis added]

The reference to the range of rates of return on common equity appears to have been inserted more as information in support of a rationale for the determination of the overall return on rate base, since the Board states that the determination of the return on rate base "will provide" an "opportunity" to earn a rate of return on common equity. Similarly, the 1996-97 Order simply described the rate of return on rate base as being "derived from" a given range of return on common equity. This is the correct approach.

60 As to whether the Board may make other decisions, for example relating to the manner in which an excess revenue fund should be maintained, by reference to the contemplated rate of return on common equity, is a separate matter which should be dealt with in that context.

61 I therefore conclude that the power to "determine" a just and reasonable return on rate base, as contained in s-s. 80(1) does not include within it a power to "set and fix a rate of return on common equity" but it obviously does contemplate that the analysis of appropriate rates of return on common equity will be undertaken and factored into the conclusion as to what is a just and reasonable return on rate base.

62 Accordingly, giving the words "set and fix" in the question a meaning which implies the notion of prescribing, I would answer Question 1 as follows:

> As to:
>
> 1. (i) - Yes
>
> 1. (ii) - No
>
> **Question No. 2**
>
> (2) Does the Board have jurisdiction to set the rates of return referred to in Question (1) as a range of permissible rates of return.

63 In light of my answer to the second part of Question 1, it is only necessary to address Question 2 in the context of whether the Board has jurisdiction to set the rate of return on rate base as a "range of permissible rates of return".

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

64 It has already been stressed that the determination of a just and reasonable return on rate base involves a consideration of the differing costs of the components of the utility's capital structure and that in arriving at the overall rate of return, it is permissible for the Board to use a weighted average of the rates associated with each individual component. It has also been pointed out that the cost of common equity is often difficult to estimate with precision. The best that experts are often able to do is estimate rates within a reasonable range. Inasmuch as the cost of common equity is weighted into the overall rate of return on rate base, that range would also have to be reflected in the ultimate rate of return on rate base, as determined by the Board.

65 In *Edmonton (City) v. Northwestern Utilities Ltd.*[FN53] Smith, J. emphasized:

> The question of a fair rate of return on a risky investment is largely a matter of opinion, and is hardly capable of being reduced to certainty by evidence, and appears to be one of the things entrusted by the statute to the judgment of the Board.

66 It is evident, as *Newfoundland Light & Power Co. v. Newfoundland (Public Utilities Commissioners Board)* [FN54] demonstrates, that the determination of a just and reasonable return is an area in which the Board is accorded a broad discretion as to the methodology to be adopted. Obviously, the striking of a balance between the interests of the utility and the consumer, whilst at the same time attempting to comply with the Board's obligation to approve rates which will produce a fair return to the utility, cannot be done with the precision of a simple mathematical calculation. Realistically, the balance can only be struck within a reasonable range. It is for that reason that the courts have, on subsequent appeal or applications for judicial review, generally deferred to the determinations of boards in this regard provided the determination is not arbitrary or capricious and can be said to fall within a reasonable range.[FN55] As indicated in the earlier discussion[FN56], in the United States the notion of a "zone of reasonableness" as an "area rather than a pinpoint" has been recognized. Whilst this notion has been enunciated as a justification for deference to Board decisions in the context of challenges on appeal or judicial review, it nevertheless indicates a recognition of what is inherent in the rate setting process.

67 I see no reason, therefore, why, instead of attempting to justify a particular decision ex post facto by an argument that a particular rate falls within a zone of reasonableness, the Board could not expressly indicate what it believes that area of reasonableness to be by expressing what it believes to be a just and reasonable return in terms of a range of rates of return. This indeed is a practice that has been adopted elsewhere[FN57]

68 It is to be noted that s-s. 80(1) does not speak in terms of a "rate" or "rates" of return; rather, it speaks of a just and reasonable "return". It is not limited by its language to the pinpointing of a particular rate of return. I conclude that a liberal construction of the word "return" in the context of s-s. 80(1) leads to the conclusion that it can include a range of rates of return.

69 Of course, in applying the rate of return to the rate base, as ascertained by the Board, a single figure will have to be used since rates, tolls and charges are expressed as finite numbers. The Board in practice has chosen the mid-point of its stated range of rates of return as the figure to be used for this purpose. This is a perfectly acceptable practice for the purpose of setting the rates. By expressing a range, however, the Board leaves open to the utility the flexibility of earning more than the mid-point up to the maximum end of the range so as, in effect, to give the benefit of the doubt to the utility that the expert evidence favouring the upper end of the range turns out to be the more accurate and to provide an incentive to the utility towards managerial efficiency.

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

70 The Consumer Advocate expressed concern in argument that the use of the word "permissible" in Question 2, as qualifying the phrase "rates of return", might be misleading. As I understand the argument, the concern is that the adoption of a range approach might lead to the conclusion that the "entitlement" of the utility to a just and reasonable return would be regarded as an entitlement, or guarantee, of earning up to the maximum end of the range. While the utility, if it earned as much as the maximum would be entitled to keep that amount of earnings, it is not, for reasons already given, guaranteed that level of return if it is not in fact successful in earning them. The Board is under no obligation to adjust future rates or to take other steps to make up any such shortfall. Any rate of return earned within the range would be regarded as permissible and it is only when a rate of return exceeds the upper limit of the range that it would be regarded by the Board as subject to any excess revenue regulation.

71 Accordingly, recognizing that, on my analysis, Question 2 only relates to whether the Board has jurisdiction to set rates of return as a range in relation to its determination of a just and reasonable return on rate base, the answer I would give to Question No. 2 is: "Yes".

Question Nos. 3 and 4

> (3) Should a public utility earn annually a rate of return which is in excess of the rate of return determined by the Board to be just and reasonable, either on:
>
> > (i) the base rate as fixed and determined by the Board for each type of service applied by the public utility; or
> >
> > (ii) the investment, which the Board has determined, has been made in the public utility by holders of common shares,
>
> does the Board have jurisdiction to:
>
> > (i) require the public utility to use the excess earnings to reduce revenue requirements for the succeeding year; or
> >
> > (ii) require the public utility to place the excess earnings in a reserve fund for the purpose of adjusting rates, tolls and charges of the public utility at a future date, or
> >
> > (iii) require the public utility to rebate the excess earnings to customers of the public utility.
>
> (4) Does the Board have jurisdiction to order that the rates, tolls and charges of a public utility shall be approved taking into account earnings in excess of a just and reasonable return upon,
>
> > (i) the rate base as fixed and determined by the Board for each type of service applied by the

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

> public utility, or
>
> (ii) the investment, which the Board has determined, has been made in the public utility by the holders of common shares,
>
> in prior years.

72 The analysis leading to the answers to Questions 3 and 4 can be considered together since they both address the same general theme: the scope of the Board's powers to deal with situations where a utility in fact earns a rate of return that is greater than that determined to be a just and reasonable return.

73 It was suggested by counsel for NLP that the concept of "excess earnings" does not exist under the Act other than by reference to a definition of what is to be deposited into a reserve fund which the utility may be ordered to create and maintain pursuant to s-s. 69(3) of the Act. This submission follows from the position taken by NLP that the Board has no power under s-s. 80(1) to "set and fix", in the sense of prescribing, a maximum rate of return. NLP had submitted that the Board's power to deal with excess earnings comes solely from its statutory powers to prescribed the form of accounts to be maintained by the utility[FN58] and to create a reserve fund "for a purpose which the Board thinks appropriate"[FN59] which could include the purpose of dealing with excess returns. This argument has already been rejected in the analysis relating to Question 1. It follows, therefore, that the issue of excess earnings may present itself for consideration by the Board in circumstances even where a reserve account has not been ordered to be set up. For the purpose of regulation by the Board, the concept of excess earnings is derived from the process of prescribing a just and reasonable return on rate base and not by the decision to require the creation of a reserve account. The question to be considered is what enforcement mechanisms the Board may use to deal with excess earnings so identified.

74 If, as determined in the answer to Question 1, the Board has jurisdiction flowing from s-s. 80(1) to prescribe the maximum rate of return which a utility may earn in a given year, it is a necessary consequence of such a determination that revenue earned in excess of the maximum of the prescribed range of return is excess revenue to which, by definition, the utility will not be entitled. The Board accordingly must have jurisdiction to regulate how that excess revenue is to be dealt with.

75 Question 3 requires the Court to consider the range of enforcement mechanisms which the Board may employ to ensure that the utility does not benefit from any windfall profits resulting from earnings in excess of the just and reasonable return to which it is entitled. Three scenarios are proposed:

> (1) use excess earnings to reduce revenue requirements for the succeeding year ("Revenue Reduction Approach");
>
> (2) place the excess earnings in a reserve fund to enable an adjustment of rates, tolls and charges at a future date ("Reserve Fund Approach");

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

(3) require a rebate of excess earnings to consumers ("Rebate Approach").

Question 4 is really a subset of the Revenue Reduction Approach. In one sense it really asks the same question as in Question 3(i) but does not limit the process to the application of excess earnings to only the year next succeeding the year in which the excess earnings have been achieved. It appears to ask the Court to address the question of whether, in the absence of the existence of a reserve account, the Board may, upon being made aware of excess earnings in prior years, reach back into those prior years and take account of those excess earnings by using them to reduce rates, tolls and charges in subsequent periods below what would otherwise be indicated.

76 In approaching these questions, it is important to bear in mind the nature of the rate setting process and the general principles which are recognized as being applicable to govern the manner in which that process is carried out.

77 The process of rate setting is generally prospective by nature. Although the Board must set rates for the future, it only has data from past experience, the evidence from utility officials as to planned changes in operations and the opinions of experts as to future economic trends as a guide to what the revenue requirements of the utility will likely be. It is, therefore, necessarily speculative. In developing the utility's requirements, the Board focuses on a "test year" as the basis for its estimates and adjustments. Traditionally, in North America the test year was chosen as the latest 12 month period for which complete data were available.[FN60] More recently, due largely to inflation, boards adopted a forward-looking test year which in effect amounts to a forecast of what expenses and costs, and hence revenue requirements, will be. This has been the practice of the Board[FN61] and is supported by the Act [FN62] and the *EPC Act*[FN63]. Past experience of course remains relevant, however, insofar as it gives insight into the possibility of forecasting error. [FN64]

78 Because the process is prospective, there is a good possibility that all of the assumptions will not be achieved in practice. The actual rate of return may therefore differ from the rate, or range of rates, prescribed at a previous hearing. On paper, this difference may appear to redound to the benefit or detriment of the utility depending upon whether the actual rate is greater or less than the rate or range prescribed.

79 When, as a result of actual experience, it appears that the actual rate of return was greater than the rate prescribed for the same period, it becomes necessary to address what the Board can do, if anything, to ensure that the earnings in excess of the prescribed level, (which by definition will be regarded as greater than a just and reasonable return on the rate base), are not allowed to remain with the utility or its investors. In the *Bell Rebate* case [FN65], Gonthier, J. observed that differences between projected and actual rates "call for a high level of flexibility in the exercise of the [Board's] regulatory duties".

80 Those opposing a broad jurisdiction on the part of the Board to define and deal with excess revenue couch the objection, at least in part, in terms of a violation of the non-retroactivity principle.[FN66] In its narrow sense, it is a principle of benefit to consumers, that "today's rate payers should pay the cost of today's services and not the cost of past or future services" [FN67]. More broadly, it also yields a presumption (which is of benefit to the utility as well), flowing from the idea that the Board acts prospectively in setting rates, that the Board cannot or, even if it has jurisdiction, should not as a general rule, make orders that have the retroactive effect of disturbing existing rights already enjoyed by the utility. In practical terms, it leads to the argument that where rates, tolls and charges have been approved by the Board as being permissible for the utility to charge, the Board cannot or should not

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make a subsequent order that has the direct or indirect effect of reducing or otherwise changing those rates. In other words, changing past transactions or attaching new consequences to past transactions would be prohibited.

81 As Penning points out[FN68] the retroactivity rule has its genesis in general rules of statutory interpretation that guard against interpreting a statutory provision as having a retrospective operation unless it is clear that such an effect was intended. It is not an immutable rule but can give way to contrary legislative intention.

82 Doctrinally, in the context of utility rate regulation, the retroactivity principle is described by Penning in this way:

> ...the rule is concerned more with issues of fairness, both to customers and to utility shareholders. The customer-related fairness issue is often referred to as the "inter-generational equity" problem, which, broadly stated, means that today's customers ought not to be held responsible for expenses associated with services provided to yesterday's customers. The fairness concern in terms of utility shareholders arises because to attract and maintain reasonably-priced equity investment in a utility, shareholders require some certainly that matters already dealt with by the regulator have some degree of finality associated with them. [FN69]

83 It was argued that one of the questions that is theoretically presented in this case is the degree to which the Board is authorized to trespass on the no-retroactivity principle in fulfilment of its legislative powers, specifically, to enforce a prescription that a utility may earn a just and reasonable return and no more.

84 In reality, however, in light of the prospective nature of this Opinion, the non-retroactivity principle is not, in practical terms engaged by Question No. 3. The answers to previous questions have already established that the concept of excess revenue is to be determined by reference to the meaning of a "just and reasonable return" as that phrase is understood in ss. 80(1); and not by the definition used to operate an excess revenue account. All participants in the regulatory process must therefore take account of that concept and conduct their activities accordingly. The "rules of the game" are known.

85 Section 59 of the Act requires the utility, unless otherwise ordered by the Board, to close its accounts at the end of each calendar year and to file with the Board its balance sheet, together with such other information as may be required by the Board, before April 2nd of the following year. Effectively, therefore, within 3 months after the utility's year end, both the utility and the Board will know the financial position of the company for the previous year and from that, as well as any other information which the Board may require, a determination of the actual level of return earned by the utility in the previous year can be made. Applying the known definition of excess revenue, by reference to the upper end of the range of return on rate base, as determined by the Board's prior orders under ss. 80(1), it can be determined whether there has been any excess revenue earned. There is no revisiting and revision of a prior order respecting the allowable return on rate base. The examination of actual results in the context of a comparison with the previously prescribed rate merely leads to enforcement of the original order. Any decision by the Board with respect to disposition of excess revenue will therefore not retroactively interfere with past revenues which the utility assumes belong to it and which may be disbursed to shareholders or otherwise spent. Given the concept of excess revenue, as explained in this option, the utility knows in advance that it is not entitled to excess revenue so defined and may institute whatever accounting practices are necessary to segregate and deal with such revenues pending direction from the Board.

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

86 The situation is conceptually no different from the concept behind an excess revenue account set up under ss. 69(3), which the utility accepts as a legitimate way of dealing with such revenue. Just as in the case of an excess revenue account, the definition of excess revenue is known in advance and the utility can account for such revenue accordingly.

87 The scenario contemplated by Questions 3 & 4 is unlike the situation which arises where an interim order setting rates, tolls and charges is subsequently superseded by a final order, resulting in excess revenue being earned in the intervening period because the rates, tolls and charges charged in that period pursuant to the interim order were higher than those which were ultimately found to be justified in the final order. In that situation, if the final order is treated as being operative as and from the date of the interim order that was superseded, the final order will, indeed, have a retroactive effect. In the context of the Newfoundland legislation, that situation is specifically contemplated and authorized by ss. 75(3) of the Act.

88 In the situation presently under consideration, however, there is no subsequent order of the Board which retroactively changes previously-approved rates, tolls or charges or revises the prescribed level of return to which the utility is entitled. All that occurs is the subsequent examination of actual results and a determination of whether excess revenue was in fact earned by applying a pre-existing standard derived from a previous Board order made under ss. 80(1).

89 I recognize that, to the extent that the utility in the past may have been operating under the impression, perhaps engendered by positions taken by the Board, that excess revenue need only be calculated by reference to the excess over the rate of return on common equity as defined for the purpose of operating the existing excess revenue account, it may consider that if the concept of excess earnings as discussed in this Opinion is applied at this stage to those previous years, there may effectively be a change in the "rules of the game". In that practical sense, there would be a "retroactive" readjustment.

90 The Court is not being asked, however, to determine the position of the utility specifically in relation to the years 1991 through 1996 and to determine the entitlement of the utility to excess revenues as calculated by reference to the current definition. The degree of NLP's misapprehension, if any, the actions of the Board in dealing with the excess revenue issue in the past, the degree to which NLP may have acted to its prejudice, and the degree to which the utility may nevertheless be required to disgorge excess revenues in previous years in accordance with presently understood concepts raise complex issues of mistake of law in the law of restitution and the defence of change of position which require for their resolution a detailed factual base. It would be inappropriate to attempt to answer such questions in this Opinion.

91 The issue, therefore, is not whether the Board may revise the definition of excess revenue and then apply the revised definition to the results of previous years. That might well engage the principle of non-retroactivity. Here, assuming (without deciding) there was a misapprehension in the past as to how excess revenue should be calculated, the "change" in calculation method comes about, not because of a retroactive change in the rule by the Board but by a (perhaps) unanticipated declaration and clarification by the Court of what the law is and how it is or should be applied.

92 I turn now to the determination of the powers of the Board to deal with excess revenue once it has been determined to exist.

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

93 The only express provisions of the Act dealing with excess revenue are s-s. 69(4) which provides a power to require a utility to refrain from distributing extra revenue as dividends until further order, and s-s. 75(3) which enables the Board to order that excess revenue earned as a result of an "interim order" made under s-s. 75(1) and not confirmed by final order be either refunded to customers or placed in a reserve account for an approved purpose. Does the fact that similar powers are not expressed in respect of "final" orders mean that they were not intended to be available?

94 I do not believe so. The power to deal with excess revenue is inherent in the nature of the regulatory scheme the Board is required to administer. The starting point is the power, found to exist in the answer to Question 1, that the Board may prescribe a rate of return under s-s. 80(1) which carries with it the necessary corollary that the utility is only entitled to earn that level of return, as determined by the Board to be just and reasonable. It follows that unless the Board is to be a "toothless tiger" it must be accorded the means by which revenues earned in excess of the prescribed level of return are used in furtherance of the objectives and policies of the legislation and not simply for the benefit of the utility's investors. Such policies as the maintenance of a sound credit rating by the utility [FN70], the efficient production, transmission and distribution of power[FN71], the delivery of power at the lowest possible cost[FN72] and the provision of reliable service[FN73] are all candidates for the use of the excess. It does not follow, as the Consumer Advocate argued, that any dealing with the excess should involve only a return or rebate to consumers so as to ensure that the goal of delivery of low cost power is vindicated. While the maintenance of low rates is an important objective of the legislation, it is not the only one. As emphasized earlier, [FN74] the Board is always engaged in a balancing exercise between the interests of the consumer and the interests of the utility. It is not correct to say that any revenues earned in excess of a just and reasonable return belong to the consumer. Just as the utility is not "entitled" to earn and retain revenues in excess of such a level of return, so also the consumer is not absolutely "entitled" to the excess. The Board, having identified that an excess exists, must deal with it in furtherance of the objectives of the legislation.

95 The means whereby the excess is dealt with should not be, unless expressly limited by the legislation, rigidly prescribed provided the means chosen comport with the objectives and policies of the legislation. It is worth repeating Gonthier, J.'s observation in the *Bell Rebate* case that the fact that the differences between projected and actual rates of return are common calls for "a high level of flexibility in the exercise of the [Board's] regulatory duties".[FN75]

96 Counsel for NLP argued that the only power of the Board to deal with excess revenue, aside from interim order situations, flows from its power in s. 58 to prescribe the form of books and accounts to be kept by the utility and that, if it ordered, pursuant to s-s. 69(3), the creation of a reserve fund "for a purpose which the Board thinks appropriate", it could stipulate that the accounts should be kept in such a way as to require excess revenues to be accounted for in such a reserve account. I do not find the jurisdiction to deal with excess revenue in the power to prescribe the utility's accounts. That is only a procedural means of exercising powers, the jurisdiction for which must be found elsewhere. Whilst the creation, pursuant to s-s. 69(3), of a reserve fund to deal with excess revenues could be said to be "a purpose which the Board thinks appropriate" (provided that purpose is consistent with the powers otherwise conferred on the Board), there is nothing in the language of s-s. 69(3) which expressly makes it applicable to an excess revenue situation and there is certainly nothing there which would purport to make the use of a reserve fund for the purpose of dealing with excess revenue as the only mechanism which would be at the Board's disposal to deal with this issue.

97 I conclude that, bearing in mind the approach to interpretation mandated by s-s. 118(2) of the *Act*, the Board must of necessity have broad powers to deal with revenue earned by a utility in excess of the prescribed rate of

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

return. Inasmuch as the ascertainment of the existence of excess revenue can only be made following a subsequent review, any order dealing with excess revenue will of necessity have certain retrospective elements about it. But that is not the same as saying that an order dealing with excess revenue ascertained by application of a pre-existing concept of what constitutes excess revenue is a retroactive order. It was argued by NLP that the setting up of a reserve account would be the only method that would not involve any trespass on the principle of non-retroactivity because the utility would know in advance that it had to set up its reserve account and could therefore provide for it without running the risk of spending or distributing excess revenues in ignorance of the fact that they would have to be held accountable for them.

98 For reasons already given, this argument is unconvincing. By virtue of the answers given to Question 1, the utility knows that it is only entitled to earn a just and reasonable rate of return pursuant to any order made by the Board to that effect under s-s. 80(1). It can monitor its financial progress and can organize its accounts in such a way as to account for excess revenue so as to prevent the possibility of it being disposed of before any subsequent order dealing with the excess may be made. The utility does not need an express order of the Board requiring it, as a general rule, to set up a reserve account for this purpose. Nevertheless, the use of a reserve account is a convenient way of doing this. It may well be, however, that the Board may, through other directions with respect to the manner of keeping accounts, develop other accounting procedures that will enable the utility to identify excess returns and to segregate them for other use.

99 A reserve fund could be ordered by the Board to be used in the future to improve service, or to keep rates low or for some other purpose that is consistent with the objectives and policies of the legislation. Whether the advancement of these policies is done formally through the use of a reserve fund or through some other mechanism such as an order setting further rates, tolls and charges taking the prior excess revenue into account, the utility should not be prejudiced, in light of the fact that it knows that it is not entitled to earn a return in excess of a just and reasonable return.

100 A rebate to consumers would also be permissible since it would have the indirect effect of ex post facto keeping the rates low. While it is true that any rebate would not, because of the fluid nature of the customer base, result in a return to exactly the same body of consumers who had paid the original rates, this is not an insuperable objection to using this type of mechanism. Penning[FN76] observes:

> As a practical matter, however, at least some of this concern appears misplaced. By far the majority of today's rate payers for the majority of regulated public service utilities were also yesterday's rate payers - especially since the time frames at issue are typically not more than a year or two. So the unfairness argument about cost allocation loses some of its force. Furthermore, to the extent it is still present, it can be dealt with through the choice of mechanism design - so instead of adjusting all rates, through either surcharges or refunds, the individual customers who met the timing criteria would receive an adjustment to their bill.

101 This recognition was echoed by Gonthier, J. in the *Bell Rebate* case [FN77] as follows:

> ...it is true that the one time credit ordered by the appellant will not necessarily benefit the customers who are actually billed excessive rates. However, once it is found that the appellant does have the power to make a remedial order, the nature and extent of this order remain within its jurisdiction in the absence of

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164
Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act
(Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

> any specific statutory provision on this issue. The appellant admits that the use of a one time credit is not the perfect way of reimbursing excess revenues. However, in view of the cost and the complexity of finding who actually paid excessive rates, where these persons reside and of quantifying the amount of excessive payments made by each, and having regard to the appellant's broad jurisdiction in weighing the many factors involved in apportioning respondent's revenue requirement among its several classes of customers to determine just and reasonable rates, the appellant's decision was imminently reasonable...

102 Accordingly, I conclude that each of the Revenue Reduction, Reserve Fund and Rebate approaches to dealing with excess returns are within the jurisdiction of the Board and could, in particular circumstances, all constitute reasonable responses to a finding that the utility has earned in excess of a just and reasonable return.

103 I would also add that the setting up of a reserve fund in a given case does not exhaust the ways in which the Board may deal with excess revenue. The methodologies proposed are not mutually exclusive. The Board has jurisdiction to deal with all revenue in excess of a just and reasonable return on rate base using one, or a judiciously blended combination, of the methodologies identified.

104 Having said that, it must be emphasized that just because the Board has the jurisdiction to use these approaches, the particular circumstances may well dictate that one or more of them may be inappropriate in a given case. For example, the ordering of a rebate to consumers of the total amount of an excess return might not, in the light of the general financial condition of the utility, be appropriate when measured against such legislative objectives as the maintenance of the utility's sound credit rating. It might be appropriate, when all of the interests are properly balanced, for the Board, for example, to order that only the excess over a stipulated rate of return on equity, or some other measure, be refunded or otherwise dealt with. These are all matters to be considered by the Board in a given case.

105 The answers to Questions 3 and 4 can be given as follows:

As to: 3(i) - Yes

3(ii) - Yes

3(iii) - Yes

106 The answer to Question 4 is also "yes" on the assumption that what is being asked is not whether the Board may retroactively revise a previous order but merely whether, applying a defined and understood concept of excess revenue, (ie. an excess of a just and reasonable return on rate base) the excess so determined to have existed in prior years may then be taken account of and applied in setting future rates, tolls and charges.

Question 5

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

> Does the fact that the Board has advised the public utility that it is permitted to retain earnings in excess of the rate of return determined by the Board to be a just and reasonable return, upon the rate base as fixed and determined by the Board for each type of service supplied by the public utility, but not in excess of the return determined by the Board to be a just and reasonable return upon the investment which the Board has determined has been made in the public utility by the holders of common shares, affect the jurisdiction of the Board to approve rates, tolls and charges on the basis queried in Question (4).

107 In order to understand the import of this question, it is necessary to review the approach taken by the Board to the definition of excess earnings in past years.

108 In correspondence passing between NLP, Newfoundland Telephone Company Limited (which at that time was regulated by the Board) and the Board during the late 1980's, there was considerable discussion as to the manner of defining "excess revenue" for the purpose of the operation of the reserve account which the Board had required the utilities to maintain for that purpose. As a result of these discussions, the Board approved a change in the utilities' systems of accounts to recognize a new definition of excess earnings. As indicated, this was accomplished by defining the excess revenue account in the utilities' system of accounts as follows:

> This account shall be credited with any revenue in excess of the maximum return on common equity determined by the Board at the previous rate hearing to be refunded to customers or used for such purposes as the Board may order.

109 By the operation of this definition, the situation could occur whereby the utility might earn a rate of return on rate base in excess of the maximum range of returns determined by the Board pursuant to s-s. 80(1) but could nevertheless be within the range of return on common equity used by the Board for the purpose of determining a just and reasonable return on rate base under s-s. 80(1). If that eventuality occurred, there would be no requirement on the utility to pay anything into the excess revenue account; yet, the result would be that the utility would have earned more than a just and reasonable return on rate base. In light of the answer given to Question 1, the benchmark for determining excess revenue is the range of return on rate base determined by the Board to be just and reasonable. Does the Board have jurisdiction to deal with this money as excess earnings in light of the fact that it has defined excess earnings for the purposes of the utility's accounting by reference to the maximum return on common equity?

110 Question 5, we were told, attempts to address this issue. As phrased, however, the question merely asks whether the fact that the Board has "advised" (presumably, in the form of its order changing the definition of excess revenue for the purposes of the establishment of the excess revenue account) the utility of this new definition of excess revenue "affect" the jurisdiction of the Board to approve rates, tolls and charges. The short answer to this question, strictly construed, is "no". The Board cannot limit its jurisdiction, in the sense of its legal power, by determinations made in exercise of its powers. It either has the jurisdiction or it does not. Whether it chooses to exercise the jurisdiction is another matter.

111 As a result of the discussions at the hearing, however, it is apparent that there is a more fundamental issue at stake. The assumption appears to be that if the Board chooses to define excess revenue for the purpose of establishment of the excess revenue account in terms of revenue earned in excess of the maximum return on common equity, it is in effect saying that revenue earned below that maximum but which happens to be in excess of

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the just and reasonable return on rate base as determined by the Board under s-s. 80(1) is necessarily money which the utility can keep. This position is obvious from the arguments made by counsel for NLP since his position has been throughout that excess revenue has no meaning other than by reference to the definition used for the purposes of the excess revenue account. As indicated previously, [FN78] this is not a correct interpretation of the situation. The same assumption is also apparent from the position taken by the Consumer Advocate who argues that the decision of the Board to define excess revenue for the purpose of the excess revenue account in terms of exceeding the return on common equity, as opposed to rate base is ultra vires the Board because the Board must determine excess revenue by reference to revenues which are earned in excess of a just and reasonable return on rate base.

112 The assumption that the definition of excess revenue for the purpose of the operation of the reserve account is equivalent to the concept of excess revenue flowing from earnings in excess of a just and reasonable return on rate base as prescribed under s-s. 80(1), is false. I agree with the Consumer Advocate, for reasons already given [FN79], that any revenues earned in excess of the maximum range of a just and reasonable return on rate base are revenues to which the utility is not automatically entitled. It does not follow, however, that for the purposes of regulating the accounts of the utility, the Board is prevented from requiring payment into an excess revenue account on a different basis (provided it does not deprive the utility of the level of return on rate base to which it has been determined to be entitled). The Board can and should deal with all revenue earned in excess of a just and reasonable return on rate base; however, it does not have to require that all of it be paid into an excess revenue account.

113 As indicated in the answer to Question 3 and 4, the Board has a broad jurisdiction as to how to deal with the excess and it may well be that, in the circumstances obtaining, it will determine that only a portion (i.e. that portion above the maximum return on common equity) should be paid into a reserve account. It might determine that the rest should be rebated to consumers or used by the utility in furtherance of the objective of ensuring that it maintains a sound credit rating in the financial markets of the world. In short, there is nothing wrong in principle with the Board defining excess revenue for the purposes of a reserve account differently from the notion of excess revenue as determined by a comparison with a just and reasonable return on rate base as determined by s-s. 80(1). In so doing, however, the Board ought not to assume that any additional excess revenue ought necessarily to be returned to the utility to be used as it sees fit. The Board has jurisdiction, and in exercise of its legislative mandate it ought to exercise that jurisdiction, to make a determination as to how that remaining excess revenue, if any, should be dealt with consistent with the objectives and policies of the legislation.

114 Accordingly, the technical answer to Question 5 is "no" but so as to limit any confusion over the implications of the wording of the question, I would add that the Board has jurisdiction to define excess revenue for the purposes of maintenance of a reserve account by reference to the maximum level of return on common equity (or any other appropriate measure for that matter) but that does not mean that the Board may for all purposes define the level of excess revenue to which the utility is not entitled by reference to that measure; rather, the Board must determine, on the specific circumstances of the case, what is to be done with respect to any excess revenue measured against a just and reasonable return on rate base. If all or a portion of the excess revenue, measured against the return on rate base, is not ordered to be paid into a reserve account, it must nevertheless be dealt with in some other manner consistent with the objects and policies of the legislation. It should not be simply assumed that such excess revenue if not required to be paid into a reserve account belongs to the utility to be dealt with as it sees fit.

Question 6

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

> Does the Board have jurisdiction to order the rates, tolls and charges of the public utility shall be approved taking into account the amount of expenses previously incurred by the public utility which the Board may now consider inappropriate to be allowed as reasonable and prudent and properly chargeable to operating account notwithstanding that such classes of expenses were allowed as reasonable and prudent and properly chargeable to operating account.

115 The just and reasonable return on rate base which the Board determines that the utility is entitled to earn annually is "in addition to those expenses which the Board may allow as reasonable and prudent and properly chargeable to the operating account..."[FN80]. Thus, in the process leading up to the prospective setting of rates, the Board may look at the type and level of projected expenses of the utility in the test year and determine whether they are reasonable and, if not, only allow, for the purposes of calculation of a just and reasonable return on rate base, such types and levels of expenses as are, in the opinion of the Board, reasonable.

116 In the 1991 rate hearing, certain types and levels of projected advertising expenses were approved by the Board. At the 1996 rate hearing, it was suggested that in the light of what actually happened in the years subsequent to 1991, the utility had in fact incurred advertising expenses well in excess of the amounts approved as reasonable and also of a type different from those which were approved, i.e. for corporate image building rather than related to the supply of service. The issue posed by Question No.6 is whether expenses of a class which were previously approved as reasonable but which are in excess of the projected amounts can be disallowed by the Board for the purposes of rate regulation.

117 The level of operating costs is obviously an important factor in fixing rates. It is generally accepted that Board supervision as to reasonableness of such costs is therefore essential to effective regulation.[FN81] Phillips describes the matter thus:

> Commissions seldom challenge expenditures controlled by competitive forces, such as those for plant maintenance, raw materials and labor. Conflicts do arise over whether certain expenditures should be charged to operating expenses or paid for by owners out of earnings.
>
> Management might vote itself high salaries and pensions. Payments to affiliated companies for fuel and services might be excessive. Expenses for advertising, rate investigations, litigation and public relations should be closely scrutinized by the commissions to determine if they are extravagant or if they represent an abuse of discretion. In all cases, moreover, the commissions should require proof as to the reasonableness of a utility's charges to operating expenses.[FN82].

Accordingly, the power to determine reasonable rates necessarily requires supervision of operating expenses.

118 In defining the parameters of such supervisory power, however, the Board must account for a competing principle, namely, that the Board is not the manager of the utility and should not as a general rule substitute its judgment on managerial and business issues for that of the officers of the enterprise [FN83].

119 Nevertheless, it is recognized that regulatory boards have a wide discretion to disallow or adjust the

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components of both rate base and expense [FN84]. In an American case[FN85] the matter was put as follows:

> The contention is that the amount to be expended for these purposes is purely a question of managerial judgment. But this overlooks the consideration that the charge is for a public service, and regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs for these or any other purposes.

120 Having said that, however, there will normally be a presumption of managerial good faith and a certain latitude given to management in their decisions with respect to expenditures. In the United States, the test for disallowance is usually "abuse of discretion" showing "inefficiency or improvidence" or "extravagant or unnecessary costs".[FN86].

121 When the issue becomes a retrospective examination of actual expenses as compared with what was projected and determined to be reasonable and prudent, there ought, similarly, to be caution exercised before determining that an expense was improperly incurred. The circumstances facing a utility are not static and a considerable latitude has to be given to the decisions of management in making expenditures to respond to the new situations as they present themselves.

122 Nevertheless, it is still within the jurisdiction of the Board to supervise and review both the type and level of expenses incurred by the utility in respect of its operations. If it did not have that jurisdiction, the actual rate of return earned on rate base in a given year would be subject to manipulation by the utility as, for example, in a year where near the close of the fiscal period it appears that the rate of return will be more than anticipated, the utility, if totally unsupervised, could make large expenditures, unrelated to the delivery of service, simply to bring the rate of return in line with what had been projected.

123 The jurisdiction of the Board to take account of deviations from estimates of expenses when setting future rates does not differ from that pertaining to its jurisdiction with respect to taking account of excess revenue. The disallowance of an expense may lead, in effect, to a greater rate of return, and potentially to excess revenue if the resulting actual adjusted rate of return is in excess of the previously determined acceptable range of return. The excess revenue over a just and reasonable range of return on rate base can be dealt with by the Board as discussed in the answers to Questions 3 and 4. It does not remain the property of the company.

124 Accordingly, the answer to Question 6 is "yes". In giving this answer, however, I would emphasize that the question that was asked is a jurisdictional one. It does not give, in the circumstances of a particular case, a wide unfettered power to "second guess" managerial decisions with respect to expenses. In this regard, I agree with the comments of Phillips:

> Public utilities ... cannot spend freely and expect all expenditures to be included as allowable operating expenses. In effect, this means the commissions are permitted to question both the judgment and integrity of management. And if rates must be high enough to yield sufficient revenue to cover all operating expenses, the consumer has the right to expect that such expenditure will be necessary and reasonable.

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

> At the same time, managerial good faith is presumed. Public utilities must be given the opportunity to prove the necessity and reasonableness of any expenditure challenged by a commission (or intervenor). To justify an expenditure, a company must show that the expenses was actually incurred (or will be incurred in the near future), that the expense was necessary in the proper conduct of its business or was of direct benefit to the utility's rate payers, and that the amount of the expenditure was reasonable. Moreover, it must be emphasized again that a public utility may still spend its money in any way it chooses. Management's function is to set the level of expenses; the commission's duty is to determine what expense burden the rate payer must bear.

Question Nos. 7 and 8

> (7) Does the Board have jurisdiction to require a public utility to maintain:
>
> (i) a ratio; or
>
> (ii) a ratio within a stated range of ratios
>
> of equity and debt, as the means of obtaining the capital requirements of the public utility.
>
> (8) Does the Board, upon an application pursuant to Section 91 or otherwise, have the jurisdiction to require a public utility to obtain its capital requirements by the issue of specific financial instruments, whether common shares, preferred shares, stocks, bonds, debentures or evidence of indebtedness payable in more than one year.

125 These two questions will be considered together because the issues they raise are interrelated.

126 In theory, both the overall level of capitalization and the individual components of a utility's structure are of interest to regulatory boards. Clearly, if a utility is allowed to engage in financing practices which result in overcapitalization, the whole viability of the enterprise may be threatened with consequent impact on the delivery of service to the public.

127 Furthermore, unlike in competitive conditions where the enterprise would not be able effectively to raise its prices over those of its competitors even if its costs of capital were excessive, overcapitalization of a regulated utility may well affect rates. That is because, in principle, rates must be set at such a level as to allow for recovery of the utility's costs, including its costs of capital, as well as a just and reasonable return. Overcapitalization, if uncontrolled, would increase the utility's costs and hence its rates. If the utility is not permitted to recover its costs in this regard it will, like any unregulated business, face bankruptcy with the consequence of disruption of service to customers. Overcapitalization may therefore indirectly put an upward pressure on rates to ensure the continued viability of the utility to enable service to be maintained. Alternatively, service may suffer.

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

128 Arguably, the purpose of s. 91 of the *Act* is to enable the Board to control the risk of overcapitalization and its impact on the viability of the utility, or at least on its credit standing. By examining each proposed new security issue in advance, the Board has a chance of minimizing the adverse effects of overcapitalization before the occur.

129 The composition of a utility's capital structure, that is, the mix of debt and equity, is also a matter that is necessarily of interest to regulatory boards.

130 Because the costs of the individual components of a utility's capital structure, i.e. the embedded costs of debt and preference shares and the reasonable rate of return on common equity, are given a weighted cost, proportional to their share of the total capital structure, for the purpose of deriving a reasonable rate of return on rate base, the level of the actual proportional share of each component will necessarily have an effect on the result of the overall determination of a just and reasonable return on rate base. The makeup of the utility's capital structure can therefore influence that determination.[FN87]

131 Phillips[FN88] expresses it this way:

> ...the traditional theory of business finance holds that the average cost of capital to a firm varies with the capital structure upon which it is based. The interest rate on debt is normally lower than the cost of equity capital. Consequently, within limits determined by such factors as the risk of a business, the overall cost may be somewhat lower when the debt-equity ratio is high than when the debt-equity ratio is low.

It is too simplistic, however, to say that in all cases, the higher the debt equity ratio, the lower will be the overall costs of capital. As deGrandpré [FN89] points out:

> It is often argued that if utilities increased their debt ratio, their cost of capital would be reduced since the cost of debt is less than the cost of equity. This may be true, but then the rate of return would have to be increased under the risk factor since the interest has to be paid before dividends and the investor might find himself deprived of dividends because of insufficient earnings.

The debt equity ratio can, therefore, have a complicated effect. What is undeniable, however, is that the debt-equity mix does have an effect on the rate of return. Hence, it is something which, in principle, should come within the regulatory umbrella in fulfilment of the policies of keeping the costs to consumers low and of ensuring a sound credit rating for the utility. The higher the cost of capital, the higher will be the return necessary to be awarded to the utility to enable it to maintain a sound credit rating in world financial markets. This would inevitably lead to higher rates, tolls and charges which would work against the policy of providing power to consumers at the lowest possible cost consistent with reliable service.

132 From this, the Consumer Advocate and the Board itself argued that it is a necessary and appropriate power on the part of the Board to regulate the ratio of debt to equity in a utility's capital structure. Without such a power, the Board is limited, it was suggested, in its ability to ensure that sources and facilities for the production, transfer and distribution of power are managed and operated in a manner that would result in power being delivered to consumers at the lowest possible cost consistent with reliable service.

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

133 In like manner, it was argued that the Board has the power, as a necessary incident of the legislative scheme, to stipulate, from time to time, that a public utility must obtain its capital requirements by the issue of financial instruments of a specified nature.

134 Granting that the level of overall capitalization and the composition of the capital structure of a utility are both matters of regulatory concern, at least insofar as they affect the utility's rate of return on rate base and hence the cost to consumers of the delivery of reliable service, the question to be determined is the degree of intrusion which the Board may undertake into the financial affairs of the utility. Can it be proactive and, as Question 7 suggests, "require" the utility to maintain a particular debt-equity ratio or, as Question 8 implies, "require" the utility to finance its activities in a particular way, or is it limited to passive disallowance of particular financing in a particular financing proposals either in the process of setting rates or in the course of other applications?

135 In approaching these questions, it has to be remembered that there is no such thing as one ideal capital structure. It is a function of economic conditions, business risks and "largely a matter of business judgment". [FN90] Furthermore, a given capital structure cannot be changed easily or quickly. As well, the long-term effects of changes on capital structure on the enterprise and on the future cost of capital may not be easily predictable. Capitalization decisions also have other business dimensions that transcend the considerations relevant to this issues directly presented in the regulatory process.

136 All of these considerations favour an approach that, in principle, should limit the degree of intrusion by the Board into the managerial control by the utility over financial decision-making. As emphasized earlier[FN91] the powers of the Board should be generally regulatory and corrective, not managerial. A debate has nevertheless occurred over whether regulatory agencies can and should "fix" debt-equity ratios and restrict new financing techniques to specified types of instruments.[FN92] Phillips notes that:

> These methods, however, have limitations. For example, since the financial conditions of individual utilities vary, no one ratio of debt to equity is correct. The refusal to approve a bond issue may lead to no issue at all, since, if a utility's earnings are insufficient to maintain its stock at par, it is in no position to issue more stock; bonds are the only way new capital can be raised. As a result of these problems, few commissions are willing to substitute their judgments for those of management...[FN93]

137 An alternative to actual intrusion into the utility's financial affairs in the form of a direction as to how the enterprise should be structured is for the regulator, *for the purpose of setting rates*, to base its estimates of the cost of capital on a hypothetical appropriate capital structure, thereby disregarding the utility's actual capitalization [FN94]. The justification for this approach is given by Phillips who, citing other authors, states:

> Locklin has argued that most commissions 'disregard actual capital structures and set up an ideal or normal structure for the purpose. To do otherwise would burden the public with the higher costs of obtaining capital that result from a capital structure that is something less than ideal, and may, in fact be quite unsound'. And Rose argues: 'When a commission in determining cost of capital disregards the actual capital structure or a capital structure proposed by management it is no more invading the domain of management than when it disregards unreasonable expenses for labor, fuel, or other productive factors in prescribing rates'.[FN95].

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

It appears, however, that actual capitalization has also been used as a basis [FN96]. Nevertheless, the arguments in favour of the ability of the Board to disregard the actual capital structure in an appropriate case and base its determination upon a hypothetical structure are convincing. Indeed, this has occurred in Canada.[FN97] Without such a power, the Board would not be able effectively to fulfill its mandate of promoting the delivery of reliable service to consumers at the lowest possible cost and at the same time maintaining a sound credit rating for the utility in the financial markets of the world. Having said that, in exercising that power, it goes without saying that the Board ought to have a healthy respect for managerial judgment[FN98] in such matters since if a hypothetical capital structure is used that is too far off the mark of the actual structure, it may in practical terms make the utility unable to meet its actual commitments, thereby threatening its credit standing and possibly affecting service to customers.

138 It is not necessary to go further, for the purpose of promotion of the objectives and policies of the legislation, and accord to the Board a power of actual intrusion into the capital structure of the utility. The distinction between actual intrusion and disallowance for rate making purposes is justified in the context of the existing legislation and enables the Board o respect the principle of general deference to managerial decisions.

139 The question that remains is whether s. 91 of the Act, which is the only provision expressly dealing with the powers of the Board respecting capital structure, can be said, either expressly, or by necessary implication, to accord greater powers to the Board.

140 On its face, s. 91 appears to be limited to a situation where the Board may approve or disapprove of a particular proposal from the utility for the issuance of a proposed form of securities. It is expressed in terms of a power of negative disallowance rather than positive direction.

141 As noted previously[FN99], s. 91 enables the Board to control the level of overall capitalization. Is that the only purpose for which a disallowance under s. 91 can be made? Obviously, an indirect effect of an approval or refusal of a particular security issue could be to affect the utility's future proposed debt-equity ratio and hence the composition of its capital structure. In practical terms, the power to disallow a specific proposal will enable the Board to exercise at the very last, by means of moral suasion in discussion, a degree of positive influence over total capitalization as well as capital structure. The power of disallowance under s.91 may, in my view, be used, in appropriate cases, to further such objectives. Subsection 91(3) requires the Board, before approving a security issue, to be satisfied that it is in accordance with law and "for a purpose approved by the Board". Accordingly, so long as the power of approval or disallowance under s. 91 is exercised in a manner that is consistent with and in furtherance of any of the policies which the legislation was designed to serve, it will be within the jurisdiction of the Board to so act. In what way, the Board may influence the total level of capitalization as well as the particular debt-equity ratio. It does not, however, permit the Board to direct the utility to raise money in a particular way or to maintain a particular debt-equity ratio. In other words, it cannot be used as a springboard for an aggressive intrusion into the day to day financial and managerial decision making of the utility with respect to the capital structure of the enterprise. Nor can the general policies underlying the legislation justify such a power. As indicated, financing is undertaken for considerations that are not necessarily directly related to utility regulation. Furthermore, it has also been noted that, within the regulatory context, the utility is still subject to business risks and the effects of management decisions and the utility, other things being equal, ought to have the power to respond to that zone of risk. To that extent, the utility must be able to make financial decisions related to the overall health of the enterprise for reasons other than strictly regulatory ones, provided that in so doing it does not trespass on the objectives and policies of the legislation.

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

142 Accordingly, while recognizing that a degree of influence over the utility's capital structure and over the choice of financial instruments to be used in financing the enterprise can be exercised by means of the powers conferred by s. 91 and the powers inherent in the regulatory scheme itself, the answers to Questions 7 and 8, insofar as the questions imply an ability to directly stipulate particular financing results, is, in each case, "no".

General Observations

143 In answering the foregoing questions, it is worth emphasizing that the answers are given in terms of the jurisdiction of the Board. The fact that the Board may have jurisdiction, in the sense of legal power, to do something does not mean that, in a particular case, the power ought to be exercised. In the arguments which were presented on the hearing of the stated case, it was apparent that some of the positions taken by a party were being advanced out of a concern that if the jurisdiction was conceded, it would necessarily follow that the Board would exercise its power in a manner adverse to that party.

144 The question of whether the Board should in fact exercise powers within its sphere of jurisdiction and the question of the manner in which those powers should be exercised raise very different considerations. It must always be remembered that, as has been emphasized throughout this opinion, the Board is charged with balancing the competing interests of the utility and the consumers of the service it provides. Neither set of interests can be emphasized in complete disregard of the interests of the other. Thus, in choosing to exercise a particular power within the Board's jurisdiction, the Board must always be mindful of whether, in so acting, it will be furthering the objectives and policies of the legislation and doing so in a manner that amounts to a reasonable balance between the competing interests involved.

Opinion

145 Pursuant to s. 101 of the *Act*, I would summarize my opinion on the questions posed as follows:

Question 1(i) Yes

Question 1(ii) No

Question 2 Yes

Question 3(i) Yes

Question 3(ii) Yes

Question 3(iii) Yes

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

Question 4 Yes

Question 5 No

Question 6 Yes

Question 7 No

Question 8 No

I emphasize that inasmuch as the import of the answers given depends on my interpretation of the questions posed, it is necessary to read the answers in the context of the rest of this Opinion.

146 Pursuant to s. 102, the Deputy Registrar of the Court is directed to remit this Opinion to the Board.

***O'Neill, J.A.*:**

147 The Board of Commissioners of Public Utilities (the Board) is a statutory body existing under the provision of the Public Utilities Act, R.S.N. 1990, c. P-47, as amended (the Act).

148 The general powers of the Board are set out in s. 16 of the Act:

> The board shall have the general supervision of all public utilities, and may make all necessary examinations and inquiries and keep itself informed as to the compliance by public utilities with the law and shall have the right to obtain from a public utility all information necessary to enable the board to fulfil its duties.

149 In addition to the powers and obligations given to and imposed on the Board by the Act, the Board has certain duties and powers under the Electrical Power Control Act, 1994, Chapter E-5.1, as amended and, by s. 4 of that Act, is specifically directed to "implement the power policy" of the Province, as set out in s. 3 of that Act, and in doing so to apply tests "which are consistent with generally accepted sound public utility practice".

150 By s. 101 of the Act, the Board may, of its own motion, state a case in writing for the opinion of the Court upon a question which in the opinion of the Board is a question of law.

151 On August 14, 1996, the Board stated a case requesting the opinion of the Court with respect to certain specific questions as set out therein. Following an application for directions, the court ordered that, inter alia,

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

certain parties be notified of the proposed hearing. Subsequently Newfoundland Light & Power Co. Ltd., a utility, and "the Consumer Advocate" were granted status to appear and be heard at the hearing before the court.

152 In its application to the Court, the Board stated that in the course of a hearing before it, the submissions of various parties raised questions as to the jurisdiction of the Board under the Act and the Board thereupon stated a case for the Court upon the following questions:

> (1) Does the Board have jurisdiction pursuant to the Act to set and fix the return which a public utility may earn annually upon:
>
> > (i) the rate base as fixed and determined by the Board for each type of service supplied by the public utility; and/or
> >
> > (ii) the investment which the Board has determined has been made in the public utility by the holders of common shares.
>
> (2) Does the Board have jurisdiction to set the rates of return referred to in Question (1) as a range of permissible rates of return.
>
> (3) Should a public utility earn annually a rate of return which is in excess of the rate of return determined by the Board to be just and reasonable, either on:
>
> > (i) the rate base as fixed and determined by the Board for each type of service supplied by the public utility; or
> >
> > (ii) the investment, which the Board has determined, has been made in the public utility by holders of common shares,
>
> does the Board have jurisdiction to:
>
> > (i) require the public utility to use the excess earnings to reduce revenue requirements for the succeeding year; or
> >
> > (ii) require the public utility to place the excess earnings in a reserve fund for the purpose of adjusting rates, tools and charges of the public utility at a future date; or
> >
> > (iii) require the public utility to rebate the excess earnings to customers of the public utility?

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

(4) Does the Board have jurisdiction to order that the rates, tolls and charges of a public utility shall be approved taking into account earnings in excess of a just and reasonable return upon:

(i) the rate base as fixed and determined by the Board for each type of service supplied by the public utility, or

(ii) the investment, which the Board has determined, has been made in the public utility by the holders of common shares,

in prior years.

(5) Does the fact that the Board has advised the public utility that it is permitted to retain earnings in excess of the rate of return determined by the Board to be a just and reasonable return, upon the rate base as fixed and determined by the Board for each type of service supplied by the public utility, but not in excess of the return determined by the Board to be a just and reasonable return upon the investment which the Board has determined has been made in the public utility by the holders of common shares, affect the jurisdiction of the Board to approve rates, tools and charges on the basis queried in Question(4).

(6) Does the Board have jurisdiction to order the rates, tolls and charges of the public utility shall be approved taking into account the amount of expenses previously incurred by the public utility which the Board may now consider inappropriate to be allowed as reasonable and prudent and properly chargeable to operating account notwithstanding that such classes of expenses were allowed as reasonable and prudent and properly chargeable to operating account.

(7) Does nhe Board have jurisdiction to require a public utility to maintain:

(i) A ratio; or

(ii) A ratio within a stated range of ratios

of equity and debt, as the means of obtaining the capital requirements of the public utility.

(8) Does the Board, upon an application pursuant to Section 91 of the Act or otherwise, have the jurisdiction to require a public utility to obtain its capital requirements by the issue of specific financial instruments, whether common shares, preferred shares, stocks, bonds, debentures or evidence of indebtedness payable in more than one year.

Question #1

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

> (1) Does the Board have jurisdiction pursuant to the Act to set and fix the return which a public utility may earn annually upon:
>
> (i) the rate base as fixed and determined by the Board for each type of service supplied by the public utility; and/or
>
> (ii) the investment which the Board has determined has been made in the public utility by the holders of common shares.

153 It may be useful to set out here the relevant parts of ss. 37, 70 and 80 of the Act:

> 37 (1) A public utility shall provide service and facilities which are reasonably safe and adequate and just and reasonable.
>
> 70.(1) A public utility shall not charge, demand, collect or receive compensation for a service performed by it whether for the public or under contract until the public utility has first submitted for the approval of the board a schedule of rates, tolls and charges and has obtained the approval of the board and the shall be the only lawful rates, tolls and charges of the public utility, until altered, reduced or modified as provided in this Act.
>
> 80.(1) A public utility is entitled to earn annually a just and reasonable return as determined by the board on the rate base as fixed and determined by the board for each type or kind of service supplied by the public utility but where the board by order requires a public utility to set aside annually a sum for or towards an amortization fund or other special reserve in respect of a service supplied, and does not in the order or in a subsequent order authorize the sum or a part of it to be charged as an operating expense in connection with the service, the sum or part of it shall be deducted from the amount which otherwise under this section the public utility would be entitled to earn in respect of the service, and the net earnings from the service shall be reduced accordingly.
>
> (2) The return shall be in addition to those expenses that the board may allow as reasonable and prudent and properly chargeable to operating account, and to all just allowances made by the board according to this Act and the rules and regulations of the board.
>
> (4) The board may use estimates of the rate base and the revenues and expenses of a public utility.

154 In the past, the Board has ordered that a just and reasonable return for a utility is "determined" to be between two stated percentages of its annual rate base for a test year, and ordered the utility to file, for examination by the Board, a schedule of rates, tolls and charges which will comply with the Board's determination, and, if so found to comply, approval is granted for those rates, tolls and charges.

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

155 The rate base is arrived at by calculating the utility's net investment in plant and equipment required for the rendering of the regulated service.

156 While not having fixed the return which the utility may earn, the Board has, in its orders, directed that a utility establish an "excess revenue reserve" into which revenue exceeding a certain rate of return on equity is to be deposited.

157 The Board, in its order dated December 4, 1991, having fixed the average rate base for Newfoundland Power for the year 1992, and having determined a just and reasonable return for Newfoundland Power on its average rate base for that year, noted that that return would provide an opportunity for it to earn a somewhat higher rate of return on common equity:

> A just and reasonable return for [Newfoundland Power is determined to be between 10.96% and 11.19% on its average rate base for 1992, which will provide an opportunity to earn a rate of return on common equity between the range of 13.00% to 13.50%.

158 The Board's position before the court was that since what is a just and reasonable return on rate base is influenced by the proportion of the various financing components, including long term and short term debt and preferred shares, it is imperative that the Board be able to set and fix the return which the holders of the common shares in the utility may earn since the market conditions for debt could alter the return to the holders of the common shares significantly.

159 Although s. 80 does not specifically provide for a rate of return for common shares, the determination of a rate of return on the common shares of a utility is very much a part of the rate making process. Further, it must be noted that by s. 3 of the Electrical Power Control Act, the policy of the Province is declared to be that the rates to be charged, either generally or under specific contracts, for the supply of power within the Province "should provide sufficient revenue to the producer or retailer of the power to enable it to earn a just and reasonable return as construed under the *Public Utilities Act* so that it is able to achieve and maintain a sound credit rating in the financial markets of the world...".

160 For Newfoundland Power it was argued that the Board has the jurisdiction to determine the just and reasonable return on the rate base and, as part of that process, the jurisdiction to determine the return on common equity, it being one of its sources of funds. I see no distinction between "determine" and "set and fix" insofar as the jurisdiction of the Board here is concerned. The calculations and projections made by the Board in arriving at the rate of return, whether specifically on rate base or the return on common equity, involve by their very nature, looking into the future, estimating as best can be done the revenues and expenditures contemplated for the utility's operations, the costs of money which may vary substantially, up and down, and then to fix a rate base, and a just and reasonable return on that base upon which the rates, tolls and charges will be based and approved.

161 Although the Board is supplied on a regular basis and has the authority to demand all the financial information it requires of a utility, the rates are, in effect, established for relatively long periods, (in excess of one year) and the likelihood of the accuracy of the forecasts which are necessarily made in setting the rate base and the rates of return is somewhat diminished.

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

162 For the Consumer Advocate it was argued that s. 80(1) only gives the Board the jurisdiction to calculate the rate of return on rate base and does not allow a calculation of what return the common equity shares will have.

163 As noted earlier, common shares constitute one of the components of the financial make-up of a utility and, as argued by counsel for the Board, while, theoretically, the Board only determines a just and reasonable return on the rate base as fixed and determined by it, in a practical sense, the return on common equity must be considered as part of the mix in setting the return on rate base, just as are the rates of interest paid on preferred shares, bonds and other financial obligations.

164 In the result, in my opinion, questions 1(i) and 1(ii) should be answered in the affirmative.

Question #2

Does the Board have jurisdiction to set the rates of return referred to in question (1) as a range of permissible rates of return?

165 There is no question but that the rate setting process of the Public Utilities Board is prospective and is performed by the Board's making estimates of the myriad of factors which have to be considered. The problem is exacerbated by the fact that the process is not one which is contemplated to be reviewed regularly or on a short term basis. The meaningful interpretation of the word "return" as it appears in s. 80(1) allows for and, in the circumstances, contemplates a range of rates of return. It follows then that a just and reasonable return, though it may be stated as a fixed percentage, may be a range of rates which is determined to be just and reasonable. In making such a determination, the Board is clearly acting within its jurisdiction. As noted earlier, a consideration of a just and reasonable return on common equity as one of the components of the financial investment in the company is a necessary part of the process of arriving at a just and reasonable return on rate base, and this return may also be stated as a range.

166 I would answer question 2 in the affirmative.

Question #3

Should a public utility earn annually a rate of return which is in excess of the rate of return determined by the Board to be just and reasonable, either on;

(i) the rate base as fixed and determined by the Board for each type of service supplied by the public utility; or

(ii) the investment, which the Board has determined has been made in the public utility by holders of common shares,

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

> does the Board have jurisdiction to:
>
> > (i) require the public utility to use the excess earnings to reduce revenue requirements for the succeeding year; or
> >
> > (ii) require the public utility to place the excess earnings in a reserve fund for the purpose of adjusting rates, the tolls and charges of the public utility at a future date, or
> >
> > (iii) require the public utility to rebate the excess earnings to customers of the public utility?

167 Under s. 69 of the Act, the Board has very broad powers including requiring a public utility to set aside from earnings monies in a depreciation account and creating and maintaining a reserve fund. Section 69 of the Act is as follows:

> 69.(1) A public utility, if so ordered by the board, shall, out of earnings, set aside all money required and carry it in a depreciation account.
>
> (2) The depreciation account shall not, without the consent of the board, be spent otherwise than for replacements, new constructions, extensions or additions to the property of the company.
>
> (3) The board may by order require a public utility to create and maintain a reserve fund for a purpose which the board thinks appropriate, including the improvement of the public utility's status as a borrower or seeker of funds for necessary maintenance or expansion of its operations.
>
> (4) The board, in a case where it has made an order which has the effect of increasing a public utility's revenues, may require the public utility to refrain from distributing as dividends until further order the whole or a part of the extra revenue which is in the board's opinion attributable to the order.

168 The answer to the question also requires a consideration of the powers of the Board as set out in ss. 58 and 59 of the Act.

169 By ss. 58 and 59, the Board may prescribe the form of all books of account and records to be kept by the public utility and to make its returns to the Board on such forms as may be prescribed by it. By s. 59, unless otherwise ordered by the Board, the utility shall close its accounts at the end of each calendar year and shall file with the Board its balance sheet, together with such other information as may be required by the Board, before April 2nd of the year following. In effect, approximately three months after the close of the utility's financial year, the Board is made aware of the exact financial position of the company at the end of the previous year and of any other information which it may require.

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

170 It will be seen from s. 69(3) that the Board has the power to direct a utility to set up reserves out of revenue to be used for replacement of equipment, new construction, extensions or additions to the property of the company. As well, reserves may be ordered to be created which would have the effect of "improving the status of the utility as a borrower or seeker or funds for necessary maintenance or expansion". There is a further power which comes to the Board from s. 69(4) and that is to require the utility to set up a reserve of monies which may have been in excess of those anticipated by the Board at the time of setting the rate of return and to prevent the distribution of that money or any part of it as dividends until the further order of the Board.

171 In the setting of rates, the Board is looking into the future and addressing the anticipated revenues and expenses of the utility with the many variables which may occur. It follows then that it must have the authority to anticipate that there will be variations from what was forecast. While the rates, tolls and charges are set following a hearing and only by an order following a hearing, the constant reporting which a utility must make to the Board allows the Board to be kept informed as to the financial operations of the utility and, in the result, to be aware of how these revenues and expenditures affect the rate of return anticipated by the Board and set out in its order. At the same time, as stated earlier, the rate of return on rate base and on common equity are set not as specific percentages but as a range.

172 In order P.U. 6-1991, the following appears at p. 56:

> The applicant has applied for a rate of return on common equity in the range of 13.5% to 14.0%, with rates set at 13.75%. The midpoint of the range was chosen since it is consistent with past practice and gives the Company the motivation to strive for a higher range (up to 14.0%) while giving them an opportunity to remain within the range if they are unable to come in on forecast (i.e. earn 13.5%)

And later at p. 72:

> The Board orders a range of 13.00% to 13.50% be adopted as the Company's rate of return on common equity with rates being set at the mid-point of the range, 13.25%. In the Opinion of the Board this will give [Newfoundland Power] the opportunity to earn a fair and reasonable return and will increase [Newfoundland Power's] interest coverage in 1992 to 2.87 times.
>
> The Board believes that [Newfoundland Power's] interest coverage in 1991 of 2.81 times at existing rates, which is an increase from 2.7 times in 1990, together with the increase to 2.87 in 1992 is satisfactory.

173 In my view, when rates, tolls and charges are set, the revenues generated belong to the company. If the net revenues are less than forecast and result in a return on rate base or on common equity less than as set out in the Board's order, then that loss is the company's loss. Revenues which are greater than anticipated belong to the company and any revenues in excess of those forecast by the Board as reflected in its order belong to the company and cannot be used, except as discussed in the following paragraph, to reduce the revenues of the utility in the future.

174 I see nothing to preclude the Board's directing that those revenues of a utility in excess of the top of the

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164
Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act
(Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

range allowed by the Board in its order as a return on common equity, be set aside and maintained in a reserve fund by an order of the Board, as contemplated by s. 69 "for a purpose which the [B]oard thinks appropriate, including the improvement of the public utility's status as a borrower or seeker of funds for necessary maintenance or expansion of its operations." I do not view any revenues of a utility in excess of those required to achieve the higher point of the range of return either on rate base or on common equity as becoming excess funds unless and until they are set aside by an order of the Board as authorized by s. 69. Until such order, these funds remain the property of the utility and may be treated as such. The creation of a reserve fund is a power given to the Board to be exercised as it sees fit. Indeed, s. 69(4) gives the Board the authority to "require the utility to refrain from distributing as dividends until further order the whole or a part of the extra revenue which is in the [B]oard's opinion, attributable to the order". Indeed, it may happen from time to time that circumstances may so change following the making of an order that a utility may need to and may actually earn revenues in excess of those contemplated by the Board when the last order was issued.

175 It follows from what I have said that the Board does not have the power to order rebates to the customers of the utility other than out of such a reserve fund. To order a rebate from revenues other than those which have been placed in a reserve fund and, in that sense, not available to the company directly, would be to make a retroactive order. A sufficiently good reason for this is that just as additional billings are not permitted to be made to customers because of revenues which have fallen below the range set when the order was made, so any additional revenues may not be paid out. The role of rate making is prospective and this is itself in my view would preclude any reaching back.

176 Reference should also be made to s. 80(1) which in may view contemplates, by the use of the words "earn annually", that each year becomes a separate unit and the revenues from one year may not be applied to another year so as to effect any change in the financial makeup of the utility, except through the use of the reserve fund, which, on its creation by order of the Board, has the effect of removing funds from the particular financial year affected by the order of the Board creating or ordering the placing of funds in the reserve fund and, in effect, makes those monies unavailable for the general use of the utility, including the payment of dividends to the holders of common equity.

177 I would answer question 3(i) in the negative, 3(ii) in the affirmative and 3(iii) in the negative.

Question #4

Does the Board have jurisdiction to order that the rates, tolls and charges of a public utility shall be approved taking into account earnings in excess of a just and reasonable return upon,

(i) the rate base as fixed and determined by the Board for each type of service supplied by the public utility; or

(ii) the investment which the Board has determined has been made in the public utility by the holders of common shares,

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164 Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

in prior years?

178 Although the Board's jurisdiction is to fix and determine a rate base which will enable the utility to earn annually a just and reasonable return on that rate base, it follows that, depending on the range settled upon by the Board in its order and considering that the rates, tolls and charges are set using the mid-point of that range as a basis, the utility may, from time to time, record net revenues which are less than or more than that contemplated by the range as set. Although the wording of s. 80 of the Act states that the utility is entitled to earn a just and reasonable return, it does not follow that it may not nor should not have revenues in excess of those contemplated. At the same time, for reasons which may be beyond the complete control of the utility, the revenues received might be substantially below those anticipated when the rates, tolls and charges were set and approved.

179 In my view, the Board cannot set rates, as argued by counsel for the Board, in a manner that would compensate for prior "excess" earnings. At the same time, in setting rates, as it must do prospectively, the Board must be alive to the various factors which may have caused the utility in any previous year to earn more or less than that anticipated by the Board in its order, and it must factor those causes into the percentages and ranges for return on rate base and for return on common equity in future orders.

180 I would answer question 4 in the negative.

Question #5

Does the fact that the Board has advised the public utility that it is permitted to retain earnings in excess of the rate of return determined by the Board to be adjust and reasonable return, upon the rate base as fixed and determined by the Board for each type of service supplied by the public utility, but not in excess of the return determined by the Board to be a just and reasonable return upon the investment which the Board has determined has been made in the public utility by the holders of common shares, affect the jurisdiction of the Board to approve rates, tolls and charges on the basis queried in Question 4.

181 Counsel for the Board argued that the authority of the Board to amend, alter or rescind any order made by it is plenary and the Board has full power to reconsider any order made previously by it, notwithstanding that there is a right of appeal in respect of its decisions on questions of law. Further, he argued that the fact that the Board has previously ruled or ordered a particular basis for the calculation of excess revenue does not preclude the Board from considering the effect of such earlier decisions in determining what revenues will be required by the utility in setting new rates based on a just and reasonable return in accordance with a new method of calculation.

182 Counsel further argued that since there is no fixed term for the continuing application of any approved rates, tolls or charges, the Board is not precluded from altering its previous order and assessing what is a just and reasonable return based upon its current assessment of the utility. Counsel argued that s. 87(1) of the Act clearly sets out that power:

87.(1) Where upon an investigation the rates, tolls, charges or schedules are found to be unjust, unreasonable, insufficient or unjustly discriminatory, or to be preferential or in violation of this Act, the

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Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act
(Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

> board has power to cancel those rates, tolls, charges or schedules and declare void all contracts or agreements, either oral or written, dealing with them upon and after a day named by the board, and to determine and by order substitute those rates, tolls or schedules that are reasonable.

183 The investigation undertaken under s. 87(1) follows upon a complaint made to the Board as set out in s. 84(1) and following upon the procedures set out in ss. 85 and 86 of the Act.

184 The legislation empowers and indeed directs the Board to conduct a constant monitoring of the financial position of the utility and gives the Board the authority to institute a correction process at any time. It does not, in my opinion follow, as argued by counsel for the Board, that the Board in setting new rates, tolls and charges may take into account earnings of the utility in previous years in excess of a just and reasonable return upon the rate base or upon the investment which the Board has determined has been made in the public utility by the holders of common shares. This is so notwithstanding that the Board has previously ordered or advised a utility that it is permitted to retain earnings in excess of the rate of return determined by the Board to be a just and reasonable return upon the rate base as fixed and determined by the Board where not in excess of the return determined by the Boards to be a just and reasonable return upon the investment made by the holders of common shares.

185 Counsel for the utility argued that the Board does not have jurisdiction to order that the rates, tolls and charges shall be approved taking into account earnings in excess of a just and reasonable return, either on rate base or on common equity, in prior years. Counsel further argued that such a power would "constitute retroactive appropriation of past revenues for future purposes". He further argued that the only mechanism available to the Board, where a utility earns in excess of the rate of return on rate base or on common equity, is to require the utility to deposit excess revenue, as defined by the Board, into a reserve account in the year earned. It is then, he argued, that the Board may approve the application of these funds as revenue in determining the rates, tolls and charges for a future period but any funds not ordered to be deposited in the reserve account are funds of the utility, belong to the utility, and cannot be considered in setting future rates. To do so, he argued, would be to change the system of accounts so that funds which were not excess in a previous year will then become excess and be brought forward - a retroactive order which is beyond the jurisdiction of the Board.

186 For the Consumer Advocate it was argued that although the Board had advised the utility that it was permitted to retain earnings in excess of the rate of return as determined by the Board, it is not precluded from later making an order under s. 80(1) and s. 76 of the Act rescinding, altering or amending any existing order and in declaring these earnings as excess revenue. The Consumer Advocate also argued that in light of its position taken in response to question 4, the Board does not have jurisdiction to order that the "excess revenue" earned in previous years by the utility should be taken into account in setting rates, tolls and charges in subsequent years but that the Board must order that it be rebated to customers of the utility.

187 I agree with the position taken by the utility. I would answer question 5 in the negative.

Question #6

> Does the Board have jurisdiction to order the rates, tolls and charges of the public utility shall be approved taking into account the amount of expenses previously incurred by the public utility which the

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> Board may now consider inappropriate to be allowed as reasonable and prudent and properly chargeable to operating account notwithstanding that such classes of expenses were allowed as reasonable and prudent and properly chargeable to operating account.

188 The example given by the Board in its factum illustrative of the situation giving rise to question 6 is as follows:

> In determining in 1991 what was a just and reasonable return on the basis of projection for test year, 1992, the Board was presented with projections for the future cost of operating expenses including advertising. The actual cost of advertising for 1995 exceeded the projection for 1992 by some $314,000.00. As such, the amounts for advertising contemplated by the Board as being reasonable, prudent and properly chargeable to operating account vary significantly for the year 1995 from the estimate upon which the Board determined a just and reasonable rate of return.

189 Counsel for the Board argued that "the circumstances of a significant increase in expenses over the estimates used for the test year is indistinguishable from the circumstances of an increase in net earnings. For the same reasons as advanced by it in question 5, it argued that the Board had jurisdiction to order that the rates, tolls and charges could be approved taking into account these expenses, previously incurred, but now considered inappropriate to be allowed as reasonable and prudent.

190 For the utility, it was argued that once rates, tolls and charges are set, the resulting revenue belongs to the utility except for any amounts which the Board may order to be deposited into an excess revenue account. Further, although the Board has the authority to determine whether the expenses comply with s. 80(2), which jurisdiction is necessary to ensure the integrity of the excess revenue account, the Board does not have jurisdiction to disallow the amount of any operating expenses which is reasonable or which had previously been allowed as a just allowance. Further, it argued that the Board may not disallow an expenses because it is of the opinion that had it been the manager, it would not have made that expenditure. The question is whether the expenditure is one that could have been made by a reasonable and prudent manager.

191 The utility further argued that there should be no "microscopic review" especially with the benefit of hindsight. Counsel argued that the Board makes its annual review of the returns made by the utility and, in the specific example here, the Board had obviously made the decision that that expense, although it exceeded predictions, was reasonable (or at least the fact that it didn't say anything about it would indicate that it was reasonable). That expense should not, except in very rare circumstances, be later held to be unreasonable. The utility's position was stated in its factum as follows:

> The Board does not have jurisdiction to order that rates, tolls and charges shall be approved taking into account the amount of such "disallowed" expenses. The Board's jurisdiction is limited to disallowing expenses which it determines not to be "reasonable and prudent and properly chargeable to operating account" or otherwise not a "just allowance" under s. 80(2). The disallowance of an expense would lead to the company earning a somewhat greater return on common equity for the purpose of the excess revenue account for the year in which the expense was incurred. However, this revenue remains the property of the company and its shareholders unless the amount disallowed would mean that the company's return on common equity would exceed the maximum return on common equity previously allowed by the Board. If

(sub nom. Reference re s. 101 of the Public Utilities Act (Nfld.)), 164
Nfld. & P.E.I.R. 60, (sub nom. Reference re s. 101 of the Public Utilities Act
(Nfld.)) 507 A.P.R. 60, 164 Nfld. & P.E.I.R. 60

> that were to occur, the amount which would be beyond the maximum return on common equity would be deposited into the "excess revenue account".

192 For the Consumer Advocate, it was argued that the Board may take into account past expenses in order to forecast more accurately future revenues and expenditures. However, its counsel argued that the Board does not have jurisdiction to set future rates, tolls and charges designed to compensate for past expenses that the Board may now consider inappropriate to be allowed as reasonable and prudent and properly chargeable to operating account.

193 I agree with the arguments proferred by the utility and the Consumer Advocate.

194 I would answer question 6 in the negative.

Questions #7 & 8

Question #7

Does the Board have jurisdiction to require a public utility to maintain:

(i) A ratio; or

(ii) A ratio within a stated range of ratios

of equity and debt, as the means of obtaining the capital requirements of the public utility.

Question #8

Does the Board, upon an application pursuant to Section 91 or otherwise, have the jurisdiction to require a public utility to obtain its capital requirements by the issue of specific financial instruments, whether common shares, preferred shares, stocks, bonds, debentures or evidence of indebtedness payable in more than one year.

195 In his decision which I have read in draft, Green, J.A. considered questions 7 and 8 together because, as he stated, the issues they raise are interrelated. I agree with the reasoning of Green, J.A. in dealing with these questions and I would answer both questions, as he did, in the negative.

196 I would also agree with the comments made by Green, J.A. in that part of his decision, entitled "General Observations".

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Conclusion

197 In the result then I would answer the questions posed as follows: 1(i) yes, 1(ii) yes, question 2 - yes, question 3(i) - no, question 3(ii) - yes, question 3(iii) - no, question 4 - no, question 5 - no, question 6 - no, question 7 - no, and question 8 - no.

Order accordingly.

FN1. R.S.N. 1990, c. P-47 as amended (hereinafter the "Act")

FN2. *Act*, s. 16

FN3. *Act*, s. 70

FN4. *Act*, s. 80

FN5. Board Orders P.U.6 (1991) and P.U.7 (1991)

FN6. Hereinafter, "NLP"

FN7. Pursuant to s. 117 of the Act. See OC 96-226; OC 96-236

FN8. S.N. 1994, c. E-5.1, as amended (hereinafter, the "EPC Act")

FN9. I acknowledge a large indebtedness to the following sources for much of the information referred to herein about general regulatory principles and practice in North America: Charles F. Phillips, Jr. *The Regulation of Public Utilities* (Arlington: Public Utilities Reports Inc., 1993); A.J. deGrandpré, "Fair Returns for Utilities-Concept or Reality?" (1970), 16 McGill L.J. 19; A.B. Jackson, "The Determination of the Fair Return for Public Utilities" (1964), 7 Canadian Public Administration 343.

FN10. s. 4

FN11. See *Bell Canada v. Canada (Canadian Radio-Television & Telecommunications Commission)*, [1989] 1 S.C.R. 1722 (S.C.C.) (hereinafter referred to as the "Bell Rebate case") where Gonthier, J. in response to an argument that a regulatory board did not have a particular power because it was not expressly provided for in the legislation stated at p. 1758: "This approach to the interpretation of statutes conferring regulatory authority over rates and tariffs is only the expansion of the wider rule that the Court must not stifle the legislator's intention by reason only that a power has not been explicitly provided for."

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FN12. "Nearly all the boards and commissions in the United States and Canada that regulate public utility rates do so on the basis of allowing a public utility a 'return' on the 'value' of the public utility property. The return that must be allowed is usually referred to as the 'fair return' ..." per Jackson, op.cit. fn.9, p. 343. See also *Union Gas Ltd. v. Ontario (Energy Board)* (1983), 1 D.L.R. (4th) 698 (Ont. Div. Ct.) per Anderson, J. at page 710: "By way of general observation ... there are substantial similarities between the situation here and in the United States, and authorities of courts in the United States are frequently referred to and considered..."

FN13. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (U.S. 1944), per Douglas J. at page 603: "The rate-making process under the Act, i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests"; *Edmonton (City) v. Northwestern Utilities Ltd.*, [1929] S.C.R. 186 (S.C.C.), per Lamont, J. at pages 192- 193: "The duty of the Board was to fix fair and reasonable rates; rates which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other hand, would secure to the company a fair return for the capital invested".

FN14. deGrandpré, op.cit. fn. 9, p. 20. See also *Union Gas Ltd. v. Ontario (Energy Board)* (1983), 1 D.L.R. (4th) 698 (Ont. Div. Ct.) per Anderson, J. at page 710: "...it is the function of the [Board] to balance the interest of the [utility] in earning the highest possible return on the operation of its enterprise (a monopoly) with the conflicting interests of its customers to be served as cheaply as possible". See also *Bell Canada v. Canada (Canadian Radio-Television & Telecommunications Commission)*, [1989] 1 S.C.R. 1722 (S.C.C.) per Gonthier, J. at p. 1748.

FN15. *EPC Act*, s. 3(a)(iii)

FN16. *EPC Act*, s. 3(a)(i)

FN17. *EPC Act*, s. 3(b)(iii)

FN18. *Act*, s. 37(1)

FN19. *Act*, s. 70(1). Although, unlike the legislation of some other jurisdictions, s. 70 does not expressly state that the rates approved by the Board must be "reasonable" or "just and reasonable", that standard is nevertheless imported into the approval process by virtue of the *EPC Act*, s. 3(a)(i) which declares the policy of the province to be that rates must be "reasonable".

FN20. *Act*, s. 80(1)

FN21. *British Columbia Electric Railway v. British Columbia (Public Utilities Commission)*, [1960] S.C.R. 837 (S.C.C.), per Locke, J. at page 848: "The obligation to approve rates which will produce the fair return to which the utility has been found entitled is, in my opinion, absolute..."

FN22. Ibid., per Locke, J. at pages 845, 847.

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FN23. Ibid., per Locke, J. at page 848: "I do not think it is possible to define what constitutes a fair return upon the property of utilities in a manner applicable to all cases ...". This observation was adopted and followed by this Court in *Newfoundland Light & Power Co. v. Newfoundland (Public Utilities Commissioners Board)* (1987), 25 Admin. L.R. 180 (Nfld. C.A.) at page 193.

FN24. *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (U.S. W. Va. 1923). (This case has often been referred and relied upon in subsequent decisions in the United States and Canada, including in this Court. See *Newfoundland Light & Power Co. v. Newfoundland (Public Utilities Commissioners Board)* supra, fn. 23 at page 193.)

FN25. Ibid., page 692.

FN26. *Edmonton (City) v. Northwestern Utilities Ltd.*, [1929] S.C.R. 186 (S.C.C.), per Lamont, J. at page 193.

FN27. 320 U.S. 591 (U.S. 1944)

FN28. deGrandpré op.cit. fn. 9, page 28

FN29. Ibid., page 37

FN30. supra, fn. 23 at page 194

FN31. Ibid. page 194

FN32. *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.* , 341 U.S. 246 (U.S. S.D. 1951), per Jackson, J. at page 251

FN33. *Bell Telephone Co. of Canada, Re* (1966), 56 B.T.C. 535 at page 731: "We are ... not persuaded that reasonableness can, in practical terms, be expressed as a fixed point from which there can be no deviation. We therefore propose to use a range of percentage earnings on total average capitalization."

FN34. *Federal Power Commission v. Hope Natural Gas Co.* Supra fn. 13 per Douglas, J. at page 603

FN35. In *Northwestern Utilities, Re* (1978), 89 D.L.R. (3d) 161 (S.C.C.), Estey, J. stated at p. 164: "The statutory pattern is founded on the concept of the establishment of rates *in futuro*... [T]he Board must act prospectively and may not award rates which will recover expenses incurred in the past and not recovered under the rates established for past periods." [Of course, such an approach assumes that without such rates, the utility will continue to be economically viable. If poor management leads to losses that threaten the very continued existence of the utility,

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the Board may well have to set future rates at a level that will enable the utility to remain operative so as to ensure continued service to customers. This is an unlikely scenario in view of the close monitoring that the Board should exercise between rate hearings.]

FN36. *EPC Act*, s. 3(1)(b)(iii)

FN37. deGrandpré op.cit. fn. 9, page 26

FN38. "The fixing of tolls and tariffs that are just and reasonable necessarily involves the regulation of the revenues of the regulated entity": per Gonthier, J. in *Bell Canada v. Canada (Canadian Radio-Television & Telecommunications Commission)* supra, fn. 11 at page 1747

FN39. 4th ed. rev., 1968

FN40. J.B. Sykes (ed), 7th ed.

FN41. s. 64(1)

FN42. s. 64(2)

FN43. s. 68(4)

FN44. s. 70(1). This provision makes the scheme administered by the Board a "positive approval scheme" (requiring advance approval of rates as being reasonable) rather than a "negative disallowance scheme" (permitting the utility to set its own rates subject to user objection, which would only then trigger a review into reasonableness), as those terms were explained by Gonthier, J. in the *Bell Rebate* case, supra, fn. 11 at p. 1758.

FN45. s. 78(1)

FN46. s. 78(2)

FN47. s. 91(1), (3)

FN48. supra, paragraphs [21]-[23]

FN49. *EPC Act*, s. 3(b)(iii)

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FN50. See, e.g., Board Order P.U.6 (1991), page 72

FN51. Phillips, op.cit., fn. 9, p. 389

FN52. See, e.g. P.U. 6 (1991) and P.U. 7 (1996-97)

FN53. Supra fn. 13 at p.199

FN54. supra fn. 23

FN55. *Union Gas Ltd. v. Ontario (Energy Board)*, supra fn. 12

FN56. para.[30]

FN57. See *Bell Canada v. Canada (Canadian Radio-Television & Telecommunications Commission)*, supra, fn. 11 at page 1733. Yvonne Penning, "The 1986 Bell Rate Case: Can Economic Policy and Legal Formalism be Reconciled" (1989), 47 U of T Fac. L.R. 607 observes at p. 617: "The CRTC has developed the practice of setting the allowed ROE on the basis of a one percentile range. While only one actual ROE - usually the middle of the range - is used in the calculation of rates to be charged customers, all rates encompassed by the range, in theory, represent a reasonable return. One reason for setting such a range is that it explicitly provides some incentive for the company to be efficient; financial rewards due to efficiency or productivity gains would accrue to the company's shareholders, rather than being passed on to consumers through lower prices." Another rationale for a range approach is given by Penning later in her article at p. 621 where, after noting that the U.S. Federal Communications Commission also employs ranges, states: "...it also serves a very useful administrative function in that it limits the circumstances under which it would be necessary to alter rates on a prospective basis, within the time period for which the range of rates of return was deemed to be reasonable, in response to changing economic circumstances."

FN58. s. 58

FN59. s. 69(3)

FN60. Phillips, op cit. fn. 9, page 196

FN61. See, eg. Board Order P.U.6(1991), page 81

FN62. S. 80(4)

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FN63. S. 3(a)(ii)

FN64. *Northwestern Utilities, Re*, supra fn. 35, per Estey, J. at p. 170: "...the Act does not prevent the Board from taking into account past experiences in order to forecast more accurately future revenues and expenses of a utility".

FN65. supra, fn. 11 at p. 1734.

FN66. See supra, para. [33]

FN67. *Wabush (Town) v. Power Distribution District of Newfoundland & Labrador* (1988), 71 Nfld. & P.E.I.R. 29 (Nfld. C.A.), per Goodridge, C.J.N. at p. 33.

FN68. op cit. fn. 57, pp. 608-610

FN69. Ibid, p. 610

FN70. *E.P.C. Act*, s. 3(b)(iii)

FN71. s. 3(b)(i)

FN72. s. 3(b)(iii)

FN73. s. 3(b)(iii)

FN74. Paras. [21]-[23]

FN75. Supra fn 11, at p. 1734

FN76. Op.cit. fn. 57 at page 619

FN77. supra, fn. 11 at page 1762 - 3

FN78. para.[73]

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FN79. paras.[31], [50]

FN80. *Act*,s.80(2)

FN81. Phillips, op.cit. fn. 9, pages 256-257

FN82. Ibid. page 256

FN83. supra, para. 32

FN84. *Union Gas Ltd. v. Ontario (Energy Board)* supra fn. 12 per Anderson, J. at page 712.

FN85. *Acker v. United States*, 298 U.S. 426 (U.S. Ill. 1936), per Roberts, J. at pages 430-431

FN86. Phillips, op. cit. fn. 9, at page 258

FN87. deGrandpré op cit. fn. 9, page 26; Phillips op. cit. fn. 9, page 233

FN88. Phillips, op. cit. fn. 9, pages 388-389

FN89. op. cit. fn. 9, page 26. See also to the same effect Phillips, op. cit. fn. 9, page 233

FN90. Phillips, op. cit. fn. 9, p. 234

FN91. paragraphs [31] - [32]

FN92. Phillips, op. cit. fn. 9, p. 236

FN93. Ibid.

FN94. Phillips, op. cit. fn. 9, pages 388-392

FN95. Ibid., page 389

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FN96. Ibid., page 391

FN97. *Bell Telephone Co. of Canada, Re*, supra. fn. 33 at page 723: "...the Board has, when the circumstances so warrant it, seen fit to adjust the company's debt-ratio *for rate making purposes*."

FN98. No doubt as a practical matter, the Board would also be hesitant to make assumptions respecting a utility's capital structure for rate-making purposes, that are different from the actual structure which will have been created as a result of previous approvals given by the Board (though perhaps in not as focused a context as a rate hearing and without the benefit of argument from rate hearing participants, such as the Consumer Advocate) to the issuing of individual share or other financial instruments in the past pursuant to s. 91.

FN99. paragraph [128]

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