HAND DELIVERED

January 12, 2004

Board of Commissioners
of Public Utilities
P.O. Box 21040
120 Torbay Road
St. John's, NF A1A 5B2

Attn: Ms. Cheryl Blundon
Board Secretary

Ladies and Gentlemen:

Re: Newfoundland and Labrador Hydro 2003 General Rate Application

Enclosed are the original and 10 copies of Newfoundland Power's Brief of Argument.

An electronic and paper copy will be forwarded to each registered intervenor directly.

We trust the enclosed are in order.

Yours very truly,

Ian F. Kelly, Q.C.
Counsel for Newfoundland Power

Enclosures

c. Ms. Maureen P. Greene, Q.C.
Newfoundland and Labrador Hydro

Mark Kennedy
Board Hearing Counsel

Mr. Colm Seviour and Ms. Meg Gillies/Mr. Joseph S. Hutchings
Counsel to the Industrial Customers

Mr. Dennis Browne, Q.C.
Consumer Advocate

Edward Hearn, Q.C.
Counsel to the Town of Labrador City

IN THE MATTER OF the *Public Utilities Act*, (R.S.N. 1990, Chapter P-47 (the "Act"), and

IN THE MATTER OF a General Rate Application (the "Application") by Newfoundland and Labrador Hydro for approvals of, under Section 70 of the Act, changes in the rates to be charged for the supply of power and energy to Newfoundland Power, Rural Customers and Industrial Customers; and under Section 71 of the Act, changes in the Rules and Regulations applicable to the supply of electricity to Rural Customers.

Brief of Argument
of Newfoundland Power

Ian Kelly, Q.C. and Brock Myles
Counsel to Newfoundland Power Inc.

January 12, 2004

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A. INTRODUCTION

The Application before the Board under sections 70 and 71 of the *Public Utilities Act* is Hydro's second general rate application as a fully regulated utility.

As revised, Hydro's Application seeks increases effective January 1, 2004 sufficient to recover an additional $36.6 million in rates. Hydro proposes that approximately $27.3 million of this increase be recovered from Newfoundland Power's 220,000 island customers. This translates into a base rate increase of approximately 12.0% to Newfoundland Power, and a price increase to Newfoundland Power's customers of approximately 6.5%.

Further, the operation of the new Rate Stabilization Plan will result in Newfoundland Power's customers bearing a further estimated price increase of approximately 3.1% on July 1, 2004.

If approved, the result to Newfoundland Power's customers is an overall rate increase in the year 2004 of approximately 9.9%.

Hydro states that its Application (and its request for an additional $36.6 million in rates) is focused to a large extent on the recovery of the cost of new sources of electricity supply. However, Hydro's **controllable** expenses have continued to increase. Opportunities remain for the achievement of cost reduction through additional productivity and efficiency gains.

It is also significant that Hydro is proposing that its rates be set on the basis of a return on equity of 9.75% instead of the 3.0% return on equity approved in 2002.

In its last general rate order respecting Hydro, the Board observed that Hydro did not have the characteristics of an investor owned utility and that there was no basis for regulating Hydro as an investor owned utility. In the intervening period, the factors identified by the Board as being relevant to that determination have either not changed or have deteriorated. In this hearing, the Board will also have to consider whether Hydro has a sound financial plan for its operation as a Crown owned utility.

In addition to addressing Hydro's cost of capital, Newfoundland Power's Brief of Argument makes specific recommendations to the Board relative to operating expenses and rate issues, including the proposed change to the wholesale rate structure.

This Application involves the regulatory oversight of the cost of providing service to Hydro's customers. It requires the balancing of the competing interests of consumers and investors through the application of regulatory principles for a utility that has not yet achieved all of the generally accepted hallmarks of a fully regulated utility under the applicable legislation.

Newfoundland Power submits that these considerations necessitate moderation and a balanced approach to the regulation of Hydro's rates over the near term.

B. REVENUE REQUIREMENT

B.1 General

Hydro's proposed 2004 revenue requirement is summarized in Table B-1 below:

Table B-1
Revenue Requirement
2004 Test Year[1]
($000)

Depreciation	33,672
Fuel	91,744
Power Purchased	33,594
Other Costs	91,661
Interest Expense	98,165
Return on Equity	18,674
Revenue Requirement	**367,510**

[1] Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, p. 1 of 8, column f

In this section of its brief, Newfoundland Power deals with depreciation, fuel, power purchased and other costs. Interest expense is addressed in section *C Return on Rate Base*, in the context of Hydro's cost of debt. Return on equity is also addressed in section *C Return on Rate Base*.

B.2 Depreciation Expense

Hydro's 2004 test year depreciation expense is largely uncontested in this hearing. However, a reduction in capital expenditures reduces depreciation expense in the test year.

Reference: Grant Thornton Financial Consultants Report, p. 18, lines 1-8

Grant Thornton's prefiled evidence states that actual capital expenditures by Hydro from 1998 through 2002 have been on average approximately 14% lower than budget. Its evidence goes on to say that the Board should consider the historical experience with respect to Hydro's capital expenditures and assess whether an adjustment to its 2004 revenue requirement is appropriate. A 14% downward adjustment to Hydro's 2003 and 2004 forecast capital expenditures would result in a reduction in depreciation expense of $85,000 and $169,000 respectively.

Reference: Grant Thornton Financial Consultants Report, p. 17, lines 3-6, p. 18, lines 1-8 and p. 19, lines 1-4
Transcript - Brushett, December 11, 2003, p. 12, line 2 to p. 13, line 22

Mr. Wells stated that Hydro is aware that there is an issue with respect to under spending on capital expenditures and that Hydro has not yet taken a policy position on this matter. Hydro confirms that no adjustment to its October 31st revised evidence has been made with respect to the potential under spending of its capital budget.

Reference: Transcript - Wells, October 7, 2003, p. 119, line 16 to p. 120, line 25
NP-306 NLH

Newfoundland Power submits that an allowance of 14% be applied to 2003 and 2004 forecast capital expenditures for determination of revenue requirement, as

suggested by Grant Thornton. Based on the evidence of Grant Thornton, the Board should therefore order a reduction of $169,000 in Hydro's 2004 test year depreciation expense.

Grant Thornton also suggests a similar adjustment to 2004 depreciation expense based on an analysis of forecast plant retirements. Hydro indicates that the impact of increasing plant retirements, as suggested by Grant Thornton, will be offset by potential losses on disposal. Mr. Brushett indicates that Hydro's subsequent estimate on losses on disposal is high. The evidence on this issue is unclear.

Reference: Grant Thornton Financial Consultants Report, p. 18, lines 31-39 and p. 19, lines 1-4
Transcript - Brushett, December 11, 2003, p. 12, line 2 to p. 13, line 22
NP-306 NLH
Transcript - Roberts, November 12, 2003, p. 48, line 9 to p. 51, line 23
Transcript - Brushett, December 11, p. 20, line 14 to p. 21, line 17

B.3 Fuel

B.3.1 General

Hydro's fuel cost is principally made up of No. 6 fuel burned at Holyrood. Diesel fuel, which for the most part is used in Hydro's isolated diesel generators, is the other material component of Hydro's annual fuel costs.

Hydro's test year 2004 forecast for the cost of No. 6 fuel to be embedded in rates is approximately $84.2 million. This is approximately a $3.0 million increase in the No. 6 fuel cost currently embedded in rates.

Reference: Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, p. 1 of 8, column b, line 5
Finance and Corporate Services Evidence, Roberts, Schedule II, 1st Revision, column b, line 5

Hydro's cost of No. 6 fuel in the test year is primarily dependent upon 3 factors. The primary factor is the actual price of fuel itself. Hydro is proposing a forecast average purchase price for No. 6 fuel for 2004 of $28.95/bbl. (compared to a forecast average purchase price of $25.91/bbl. for the 2002 test year). This will result in base rates reflecting fuel cost of $29.50/bbl. (representing a blended price of year-end 2003 inventory at cost and forecast 2004 purchases at $28.95/bbl.)

Reference: Production Evidence, Haynes, Schedule VIII, 1st Revision
Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, p. 8 of 8, and p. 5 of 8, lines 7-9
Order No. P.U. 7 (2002-2003), Summary of Board Decisions, p. 166, Item #13

The second factor that affects Hydro's annual cost of No. 6 fuel is the volume of fuel actually consumed, which is a function of the annual production of Hydro's hydraulic plants. Island Interconnected System production is predominantly hydraulic and has very low variable costs. Holyrood production, which has a much higher variable cost, is used to the extent necessary to meet system load not capable of being served by hydraulic production. For this reason, the forecast of hydraulic production for the test year can have a significant impact on Hydro's revenue requirement. A relatively low hydraulic production forecast means that a greater proportion of system energy needs will be met in the test year by more expensive thermal production at Holyrood.

The third factor that affects the annual cost of No. 6 fuel is the conversion or efficiency factor for production at Holyrood. This is typically expressed in kWh/bbl and reflects forecast efficiency at the generating plant. Hydro is proposing to use a conversion factor of 624 kWh/bbl for Holyrood production for the 2004 test year.

Hydro's forecast of diesel fuel price is the only other material issue related to Hydro's test year fuel costs.

Reference: Production Evidence, Haynes, p.13, lines 6-16.

B.3.2 Test Year Price of No. 6 Fuel

Hydro's proposed test year price of fuel is determined based on the information provided by an external consultant, PIRA Energy Group of New York. PIRA's forecast is provided in $US. Hydro uses an average forecast $US/$CDN exchange rate for 2004 based on information provided by several financial institutions. Hydro's test year No. 6 fuel price forecast is based on purchasing fuel with 2.2% sulphur content.

Reference: NP-290 NLH
Production Evidence, Haynes, pp. 21-24

Newfoundland Power submits that Hydro's forecast price of No. 6 fuel for the 2004 test year is reasonable.

B.3.3 Hydraulic Forecasting Methodology

Hydro's Application reflects an estimate of hydraulic production for the test year 2004 of 4,582 GWh in Annual Average Energy. Hydro has based this estimate on the 30-year average of hydrology records.

In Order No. P.U. 7 (2002-2003) the Board ordered Hydro to use the 30-year average annual hydraulic production of 4,425 GWh as the basis for its 2002 test year hydraulic forecast. The Board also ordered Hydro to commission an independent study into its current forecasting methodology to address concerns raised during Hydro's 2001 GRA, including the issues of data reliability, long term trends and climate change.

Reference: Order No. P.U. 7 (2002-2003), p. 165, section II.6
Production Evidence, Haynes, Table 7, p. 30

The appropriate data stream to be used by Hydro in forecasting hydraulic production was addressed in the mediation report dated October 3, 2003 and filed with the Board as Consent No. 1. In this report all Parties agreed that the 30-year record is most appropriate at this time, and that the Board may consider using the full historic hydraulic record in Hydro's next GRA only after Hydro addresses discrepancies identified in the Acres Island Study and the Parties have had an opportunity to comment thereon.

Reference: Consent No. 1, p. 3, item r

If Hydro were to use the full historic hydraulic record to forecast production from its hydroelectric plants, it would result in a hydraulic production forecast of 4,458 GWh. Applying this forecast to the 2004 test year would increase the No. 6 fuel expense by $5.97 million. This would result in an additional rate increase of 2.1% for Newfoundland Power and 2.7% for the Industrial Customers.

Reference: Production Evidence, Haynes, p. 30, lines 1-5

The five most significant recommendations made in the Acres Island Study are:

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 sequences 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. The above-noted corrections to the inflow sequences should be completed prior to simulating operations under this model. Since system simulation models usually require a

common start date for all inflow sequences, data from the early years of some inflow sequences will have to be cut off.

5. Recognizing that rectification of the inflow sequences and selection of a computer model will require some time, Hydro should continue to use its present inflow sequences and methodology for energy estimates. The present records, even with minor inconsistencies, will give better estimates of expected flow than shorter records.

Reference: Production Evidence, Haynes, p. 28, line 24 to p. 29, line 18

Hydro has indicated that it will be correcting internal data inconsistencies and will also be investigating possible simulation models so that, if approved by the Board, the results of the simulation will be available to be used as the hydraulic production forecast in subsequent rate applications.

Reference: Production Evidence, Haynes, p. 29, lines 20-24

Newfoundland Power submits that the 30-year record continue to be used as the appropriate hydraulic data stream for both hydraulic production projections and RSP calculations. This is consistent with Hydro's application and the negotiated settlement agreed upon by all Parties in this proceeding.

Newfoundland Power also submits that the analysis in support of using a longer-term average for forecasting hydraulic production is not yet complete. Hydro should be requested to file this analysis for consideration upon completion. The Board should not make any determination as to the appropriate period of record for use in determining the Average Annual Energy for future hearings until Hydro has completed the required analysis and presented the results for review at a public hearing.

B.3.4 Conversion Factor at Holyrood

Hydro is forecasting to use approximately 2.9 million barrels of No. 6 fuel during 2004 to generate electricity at Holyrood. The average kWh output from the use of a barrel of oil depends on the efficiency at the generating plant.

Fuel conversion factor is a measure of how efficiently oil is converted to electricity in a thermal plant and directly impacts the number of barrels of oil required in the production of thermal energy.

Reference: Production Evidence, Haynes, Schedule VII, 1st Revision
Information Exhibit I-4, September 3, 2003, p. 7

The fuel conversion factor at Holyrood directly impacts Hydro's fuel expense, as well as Hydro's earnings and charges to the Rate Stabilization Plan.

An analysis of 2002 fuel consumption at Holyrood clearly demonstrates the impact of variations in the fuel conversion factor. At Hydro's 2001 GRA, the Board approved a fuel conversion factor of 615 kWh/bbl. In 2002 an actual fuel conversion factor of 648 kWh/bbl was achieved, resulting in a reduction in fuel costs of $6.1 million. Of the $6.1 million, approximately $3.7 million improved Hydro's earnings and $2.5 million was a saving to the Rate Stabilization Plan.

Reference: IC-207 NLH
Transcript - Roberts, October 16, 2003, p. 111, lines 6-16

Schedule V of the Production Evidence clearly indicates that higher average monthly unit loading yields a higher energy conversion factor. As shown in NP – 74 NLH, during the 1996 – 2002 period the fuel conversion factor ranged from a low of 577.1 kWh/bbl in 1999 to a high of 648.5 kWh/bbl in 2002. This increase in the fuel conversion factor is directly related to an increase in the net energy produced. Over the 1996 – 2002 period the weighted average conversion factor was 623.7 kWh/bbl. This calculation is the foundation of Hydro's proposal for a fuel conversion factor of 624 kWh/bbl for 2004. It is important to note that during this period average net energy produced at Holyrood was 1,510.285 GWh.

Table B-2 NP-74 NLH Holyrood Conversion Factor (1996 to 2002)			
Year	**Net Energy Produced (GWh)**	**No. 6 Fuel Consumed (Barrels)**	**Conversion Factor (kWh/bbl)**
1996	1,403.596	2,297,258	611.0
1997	1,531.301	2,432,538	629.5
1998	1,263.264	2,041,605	618.8
1999	919.802	1,593,932	577.1
2000	970.283	1,591,586	609.6
2001	2,098.490	3,315,853	632.9
2002	2,385.262	3,678,183	648.5
Total	10,571.998	16,950,955	
Average 1996 - 2002	1,510.285	2,421,565	623.7

Mr. Brushett testified that the 2004 "conversion factor should reflect the best estimate of what the operating conditions will be in 2004."

Reference: Transcript - Brushett, December 11, 2003, p. 55, lines 11-15

For 2004 Hydro is forecasting thermal production at Holyrood of 1,790.150 GWh or 18.5% higher than the average over the 1996 – 2002 period. Therefore, given the forecast operating conditions in 2004 the fuel conversion factor appears conservative.

Reference: Production Evidence, Haynes, Schedule VII

A closer examination of the data contained in NP-74 NLH for 1997 and 2001 indicates average net energy produced of 1,814.896 GWh with a fuel conversion factor of 631.4 kWh/bbl. (See table B-3 below). In 2004 net energy produced is forecast to be similar to the average for 1997 and 2001, at 1,790.150 GWh. Given the similar operating conditions, a fuel conversion factor of 631 kWh/bbl would be more appropriate.

Table B-3
Holyrood Conversion Factor
Average of 1997 and 2001

Year	Net Energy Produced (GWh)	No. 6 Fuel Consumed (Barrels)	Conversion Factor (kWh/bbl)
1997	1,531.301	2,432,538	629.5
2001	2,098.490	3,315,853	632.9
Average	1,814.896	2,874,196	631.4

Mr. Brushett indicated that in recent history the fuel conversion factor has been much higher than 624 kWh/bbl due to operating conditions and improvements in plant efficiency at Holyrood. As a result, recent experience is more relevant in determining the fuel conversion factor.

Reference: Transcript - Brushett, December 11, 2003, p. 56, lines 14-19
Transcript - Brushett, December 11, 2003, p. 137, line 21 to p. 138, line 11

The fuel conversion factor was 632.9 kWh/bbl in 2001, 648.5 kWh/bbl in 2002 and 636.2 kWh/bbl year to date November 2003.

Reference: NP-74 NLH
NP-310 NLH

The conversion factor is influenced by the operating unit, load level, unit fouling, fuel consumption measurements, heat content of the fuel and ambient conditions. These are the same common factors that vary from year to year and have impacted the fuel conversion factor since 1996.

Reference: IC-317 NLH
Transcript - Haynes, October 24, 2003, p. 79, line 9 to p. 80, line 6

The fuel conversion factor is also influenced by efficiency initiatives such as the controllable loss program (ETAPRO) that was installed in 1995.

Reference: Production Evidence, Haynes, p. 12, lines 21-24

Plant efficiency initiatives within the last five years will positively impact fuel efficiency at Holyrood. The installation of a water lance on Unit No. 3 in 2000 and the retubing of

Unit No. 3 reheater in 2001 are estimated to improve boiler efficiency by approximately 1%, or fuel conversion factor by approximately 2 kWh/bbl. These initiatives would only have impacted the fuel conversion factor after their completion in 2000 and 2001.

Reference: IC-199 NLH
IC-252 NLH

The Continuous Emissions Monitoring System at Holyrood completed in late 2003 is anticipated to result in a further increase in plant efficiency of 3 kWh/bbl.

Reference: IC-252 NLH
NP-89 NLH
Grant Thornton Financial Consultant's Report, p. 32, lines 31 – 33

Combined these initiatives will result in an increase in plant efficiency of approximately 5 kWh/bbl going forward. These efficiency improvements have not been substantially included in Hydro's proposed fuel conversion factor of 624 kWh/bbl for 2004. Mr. Brushett supports the position that improvements to plant efficiency should be reflected in the fuel conversion factor on a go forward basis.

Reference: Transcript - Brushett, December 11, 2003, p. 137, lines 9-20

Given the forecast operating conditions, the initiatives to improve plant efficiency and recent experience, it is Newfoundland Power's position that a fuel conversion factor of 636 kWh/bbl (631 + 5) is more appropriate for 2004. If the Board accepts

this position, Hydro's 2004 fuel expense will be reduced by approximately $1.6 million.

Reference: NP-269 GT, page 2 of 2, lines 1-8

B.3.5 Diesel Fuel Price

Hydro's Application reflects test year diesel fuel costs of approximately $6,801,000. This compares to approximately $6,508,000 currently embedded in rates.

Reference: Finance and Corporate Services Evidence, Roberts, Schedule II Column b, line 10

Newfoundland Power submits that Hydro's forecast of diesel fuel price for the 2004 test year is reasonable.

B.3.6 Conclusion

1) **The Board should accept Hydro's proposal to use a purchase price for No. 6 fuel of $28.95/bbl. for the 2004 test year as reasonable.**
2) **The Board should accept the use of a 30-year record for determining the Average Annual Energy for 2004 as agreed in the negotiated settlement.**
3) **The Board should not make any determination as to the appropriate period of record for use in determining the Average Annual Energy for future hearings until Hydro has completed the required analysis and presented the results for review at a public hearing.**

4) **The Board should approve the use of a Holyrood fuel conversion factor of 636 kWh/bbl for use in determining 2004 test year fuel costs.**

5) **The Board should accept Hydro's proposed diesel costs for the 2004 test year as reasonable.**

B.4 Power Purchased

Power and energy is provided by Hydro through a mix of hydraulic and thermal generation, supplemented by power purchased under long-term contracts with non-utility generators (NUGS). These power purchase arrangements, and the recovery of these costs by Hydro through rates, are the subject matter of Exemption Orders from the Lieutenant-Governor in Council issued under the *Public Utilities Act* and the *Electrical Power Control Act, 1994*. In 2003 and 2004, Hydro will be required to purchase increased energy from NUGS under these long-term contracts.

Reference: Production Evidence, Haynes, p. 5 lines 11-14
Production Evidence, Haynes, p. 7, lines 1-10
Production Evidence, Haynes, Schedule II
Production Evidence, Haynes, Schedule X, 1st Revision
IC-69 NLH

Newfoundland Power submits that Exemption Orders from the Lieutenant-Governor in Council issued under the Public Utilities Act and the Electrical Power Control Act, 1994 entitle Hydro to recover the cost of power purchased under long term contracts with non-utility generators.

B.5 Other Costs

From 1997 to forecast 2004, Hydro's gross controllable costs have risen 21.2%. Hydro's net controllable costs have risen 26.7%. These are substantial increases over that period.

References: Transcript - Roberts, October 14, 2003, p. 82, lines 1-21
CA-44 NLH

Hydro has proposed other 2004 test year costs of $91.7 million. Although this represents an increase of only 0.6% over 2002 actual, the increase over 2002 final test year costs is approximately $6.0 million or 7%.

Reference: Finance and Corporate Services Evidence, Roberts, Schedule II, 1st Revision, columns b and c, lines 14-33
Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, page 1 of 8, column f, lines 14-32

B.5.1 Productivity Initiatives

B.5.1.1 J.D. Edwards System

In 1998-1999, Hydro purchased and installed its J. D. Edwards computer software system, at a net cost to Hydro's regulated operations of $10.8 million.

Reference: Transcript - Roberts, October 14, 2003, p. 83, line 16 to p. 84, line 11

After three years of experience, the benefits to be derived from the J. D. Edwards System have not yet been fully achieved. Nevertheless, the J.D. Edwards System now gives management the ability to have real time, on-line information with respect to operations.

Reference: Transcript - Wells, October 7, 2003, p. 95, line 6 to p. 97, line 19
Transcript - Roberts, October 14, 2003, p. 84, line 3 to p. 88, line 23

Newfoundland Power submits that Hydro can achieve greater efficiencies and productivity improvements. Opportunities exist for Hydro to reorganize, leverage technology and manage its operations to further reduce costs. Newfoundland Power believes that Hydro should continue to have a strong incentive to seek productivity and efficiency gains.

B.5.1.2 Positions Eliminated in 2002

In 2002 Hydro had a net workforce reduction of 46 positions. This resulted in severance costs of $1.4 million in 2002. Hydro has testified that resulting salary savings in 2004 from the elimination of these 46 positions are forecast at approximately $2.6 million.

Reference: Finance and Corporate Services Evidence, Roberts, p. 7, lines 1-16
Information Exhibit I-11

B.5.1.3 Business Process Improvements

Mr. Wells described Hydro's Business Process Improvement Project stating that Hydro had not informed the Board at the 2001 GRA that this project had been initiated.

Reference: Transcript - Wells, October 7, 2003, p. 70, line 23 to p. 95, line 5
Transcript - Wells, October 10, 2003, p. 117, line 2 to p. 130, line 12

Expenditures by Hydro in 2002 with respect to this project totalled $1.8 million, of which $1.0 million was for external consultants. Additional internal salary costs of $1.0 million have been assigned to this project as of September 30, 2003, bringing the total expenditures to date to $2.8 million.

Reference: CA-46 NLH
Transcript - Roberts, October 14, 2003, p. 88, line 24 to p. 89, line 25
Transcript - Roberts, October 15, 2003, p. 9, line 21 to p. 10, line 12

Under the project, Hydro has completed reviews with respect to three internal business processes: (i) accounts payable, (ii) corporate purchasing card and travel, and (iii) consumables and inventory. Savings from these reviews are estimated at $600,000 annually. Additional meter reading improvements are anticipated to result in further savings of $128,000 (labour savings of $100,000 and travel expense savings of $28,000). This results in a total salary savings of $700,000.

Reference: Finance and Corporate Services Evidence, Roberts, p. 23, line 12 to p. 24, line 13
Transcript - Roberts, October 14, 2003, p. 105, line 8, to p. 106, line 9
Transcript - Roberts, October 15, 2003, p. 10, line 13 to p. 11, line 2

Mr. Roberts indicated that further opportunities exist within Hydro to leverage technology and reorganize in order to increase efficiency. However, Mr. Roberts acknowledged that:

- Hydro currently has the same number of departments (19) and business units (150) as it did in 1997;
- Hydro has no plans for corporate reorganization even though approximately 25% of its workforce will be eligible to retire over the next 5 years;
- Hydro has no plans to pro-actively reduce the number of FTEs;
- Hydro has no FTE targets for 2004, let alone targets for the longer term;
- The structure of Hydro is being dictated by the results of the various process reviews;
- Staff reductions are generally only done on a position-by-position basis, as they become vacant; and
- The potential for FTE reductions due to the 3 ongoing organizational process reviews outlined at page 24 of the Finance and Corporate Services Evidence has not yet been quantified.

Reference: Transcript - Roberts, October 14, 2003, p. 70, line 24, to p. 72, line 1
p. 111, line 21 to p. 112, line 21
p. 113, line 25 to p. 118, line 8
p. 126, lines 2-22
CA-10 NLH
PUB-80 NLH
PUB-81 NLH
PUB-104 NLH

Hydro has placed significant emphasis on business process improvement since 2002. Limited productivity gains have been realized as a result. However, the evidence suggests that additional productivity gains are possible given what has been expended to date, the limited gains achieved to date, the limited number of processes reviewed to date, the on-going and continuous nature of this initiative, and the potential for other changes within Hydro aimed at improving overall performance and reducing costs.

B.5.2 Salary and Fringe Benefits

B.5.2.1 General

Salary and Fringe Benefits comprise approximately 63% of Hydro's controllable operating costs for 2004.

Reference: Corporate Overview Evidence, Wells, p. 7, lines 13-14

Hydro's response to Request for Information NP-304 NLH provided a breakdown of 2002, 2003 and test year 2004 salary and fringe benefits based on the October 31, 2003 revised filing. This information is summarized in Table B-4 below.

Table B-4
Salary and Fringe Benefits
2002 – Test Year 2004
($000)

	2002 Actuals	2003 Forecast	2004 Test Year
Salaries	50,323	48,712	49,925
Directors Fees	23	62	62
Overtime	3,910	3,863	2,869
Employee Future Benefits	2,445	3,631	3,727
Fringe Benefits	6,630	6,944	7,110
Group Insurance	1,123	1,600	1,950
Labrador Travel Benefit	105	97	99
Vacancy Allowance	0	(220)	(2,500)
	64,559	**64,689**	**63,242**

B.5.2.2 Forecast Staffing Levels

Hydro's 2004 test year salaries ($49,925,000) continue to be based on full complement as of August 2003 as opposed to forecast full time equivalents (FTEs). Mr. Roberts testified that Hydro recognizes that there will be vacancies and staff reductions during the year by applying a vacancy credit ($2,500,000) that reduces the total forecast for salaries and fringe benefits.

Reference: Transcript - Roberts, October 14, 2003, p. 112, line 22 to p. 113, line 14
IC-39 NLH, p. 2 of 3, footnote 2

Hydro's continued practice of forecasting based on staff complement versus FTEs makes the evidence unclear as to real test year staffing requirements, and causes confusion with respect to how test year salary and fringe benefits have been determined.

Reference: Transcript - Haynes, October 24, 2003, p. 61, line 11 to p. 67, line 15
Transcript - Haynes, October 24, 2003, p. 81, line 20 to p. 84, line 3

B.5.2.3 Salaries

Table B-4 above shows 2004 test year salaries in the amount of $49,925,000.

Hydro attributes the change in salaries expense from 2002 to test year 2004 to two offsetting factors: annual savings of $2.6 million from the elimination of 46 positions in 2002, offset by 2003 and 2004 wage increases.

Reference: NP-243 NLH (Note 1)
Grant Thornton Financial Consultants Report, p. 38, lines 16-21

a) Forecast Wage Increase for 2004

Mr. Wells testified that Hydro has concluded a collective agreement that provides for a 3% bargaining unit wage increase effective April 1, 2004. Hydro also indicated that test year 2004 salary costs have been forecast based on existing wage rates increased by $1.2 million, or 3% effective January 1, 2004. Mr. Roberts stated that using an effective date of January 1, 2004 as opposed to April 1, 2004 was done for simplicity in terms of preparing the 2004 budget.

Reference: Transcript - Wells, October 9, 2003, p. 130, lines 6-10
NP-304 NLH (Note 9)
CA-41 NLH
Transcript - Roberts, October 15, 2003, p. 52, line 15 to p. 53, line 7
NP-14 NLH

Newfoundland Power submits that 2004 test year salary costs should be reduced by $300,000 ($1.2 million/12 x 3) to more appropriately reflect the April 1, 2004 effective date for bargaining unit wage increases.

b) Positions Eliminated in 2003

Hydro's forecast salaries for test year 2004 ($49,925,000) should reflect $600,000 in savings due to the elimination of 10 FTEs in 2003 and $100,000 in savings related to changes in the area of meter reading, referred to previously in section B.5.1.3.

Reference: NP-278 NLH
Transcript - Roberts, October 14, 2003, p. 101, line 21 to p. 107, line 4
Transcript - Roberts, October 15, 2003, p. 10, line 13 to p. 11, line 2

On October 15, 2003 Mr. Roberts was presented with Information item No. 11 (I-11), the purpose of which was to reconcile Hydro's actual salaries for 2002 with forecast salaries for the 2004 test year. I-11 was based on evidence with respect to the 46 positions eliminated by Hydro in 2002, severance payments in 2002 and Hydro wage increases for 2003 and 2004.

Mr. Roberts indicated during cross-examination that the reconciliation in I-11 should also reflect:

1. An add back of $1.6 million to reflect vacancies for 2002; and,
2. A reduction to reflect temporary labour costs eliminated by Hydro since 2002.

An adjusted reconciliation, based on Mr. Roberts' testimony is provided in Table B-5 below:

Table B5
Salaries Reconciliation
2002 Actual vs. 2004 Forecast
(000's)

2002 Actuals	$50,323	
Average of 32 Vacant Positions in 2002 at $50,000 each[1]	$ 1,600	
	$51,923	
Severance Payments	-$ 1,465	
Savings 46 positions	-$ 2,600	
	$47,858	(Roberts: $47,871)[2]
Wage Increases (approximately 8%)[1]	$ 3,800	
	$51,658	(Roberts: $51,700)[2]
Temporary Labour Eliminated since 2002[1]	-$ 1,733	(Roberts: $1,775)[2]
2004 Forecast	$49,925	

1 Adjustments to I-11 based on testimony of Mr. Roberts on October 15, 2003.
2 Amounts referred to by Mr. Roberts during cross-examination on October 15, 2003.

Reference: Information Item I-11
Transcript - Roberts, October 15, 2003 p. 48, line 24 to p. 51, line 7

On October 15 and 16, 2003 Mr. Roberts confirmed that the amount of temporary labour that Hydro has eliminated since 2002 is in the order of $1.6 million to $1.7 million, and that this reduction is in addition to the savings of $700,000.00 associated with the elimination of 10 FTEs and meter reading, as referred to above.

Reference: Transcript - Roberts, October 15, 2003, p. 153, line 4 to p. 158, line 6
Transcript – Roberts, October 16, 2003, p. 119, line 22 to p. 120, line 2

In updating the reconciliation, however, Mr. Roberts made no mention of the $700,000.00 in savings already realized. This suggests that these savings are not reflected through a reduction in salaries, but rather are included in Hydro's $2.5 million vacancy allowance. This was confirmed by Mr. Brushett.

Reference: Transcript - Brushett, December 11, 2003, p. 101, line 20 to p. 104, line 18

Newfoundland Power submits that the salary savings of $700,000 related to the elimination of 10 FTEs and meter reading changes in 2003 should not form part of Hydro's vacancy allowance. Hydro has not satisfactorily proven that these savings have been reflected in its 2004 test year salaries expense totalling $49,925,000. The Board should order Hydro to reduce its 2004 test year salaries

by $700,000 to reflect the fact that these positions have already been eliminated from Hydro's workforce in 2003.

2004 test year salary costs also do not reflect savings associated with the elimination of cash handling processes in St. Anthony and Wabush. However, the amount of these salary savings has not been provided in evidence.

Reference: Transcript - Roberts, November 12, 2003, p. 63, line 21 to p. 65, line 13

B.5.2.4 Vacancy and Productivity Allowances

Hydro has testified that its proposed $2.5 million vacancy allowance for 2004 consists of $1.0 million for normal vacancies and $1.5 million for future staffing reductions resulting from process improvement initiatives.

Reference: Transcript – Roberts, October 15, 2003, p. 54, line 23 to p. 55, line 12

The question therefore becomes twofold:

1. What is a normal vacancy allowance for Hydro?
2. Does the additional $1.5 million vacancy allowance proposed by Hydro represent a reasonable target for **future** staff reductions, and therefore a reasonable productivity allowance for 2004?

a) Normal Vacancy Allowance

Hydro's normal vacancy allowance for the 2004 test year is calculated as 2½% of permanent salaries:

$$2\tfrac{1}{2}\% \times \$40{,}000{,}000 = \$1{,}000{,}000$$

Reference: Transcript - Roberts, October 15, 2003, p. 56, line 15 to p. 57, line 9

In its 2001 General Rate Application, Hydro also proposed a $1.0 million allowance to cover normal vacancies. However, in Order No. P.U. 7 (2002 – 2003) the Board stated:

> "NLH has not convinced the Board that a 2½% vacancy allowance is adequate and reflects recent experience. The Board finds in the circumstances that a vacancy credit in the amount of $1,500,000 should be used in the test year 2002. This is $500,000 more than proposed by NLH."

Reference: Order No. P.U. 7 (2002 – 2003), p. 66

Evidence in this hearing continues to suggest that a $1.0 million allowance for normal vacancies is inadequate and does not reflect recent experience. Hydro's response to NP-34 NLH indicates that from 1993 through 2001 the normal vacancy rate has averaged approximately 3.5%. Mr. Roberts also testified that Hydro averaged approximately 32 vacancies in 2002 for a vacancy amount of approximately $1.6 million.

Reference: NP-34 NLH
Transcript - Roberts, October 15, 2003, p. 48, line 24 to p. 50, line 20
p. 51, lines 13-17
p. 56, line 15 to p. 63, line 18
p. 57, line 15 to p. 58, line 9

Hydro's 29 vacant positions as of October 2003, at an estimated average annual salary for 2004 of $54,000 per position, also indicate a potential normal vacancy allowance for 2004 of approximately $1.6 million.

Reference: Transcript - Roberts, November 12, 2003, p. 67, line 1 to p. 70, line 4
Brushett, 2003 GRA Report, p. 39, lines 6-9
Transcript - Brushett, December 11, 2003, p. 107, line 8 to p. 108, line 2

Newfoundland Power submits that the Board should increase Hydro's normal vacancy allowance from $1.0 million to $1.6 million. This would be in keeping with the Board's decision in Order No. P.U. 7 (2002-2003) and, based on recent experience, reflects the best estimate of what Hydro's normal vacancy will be in 2004.

b) Productivity Allowance

In Order No. P.U. 7 (2002-2003), the Board determined that a $2.0 million productivity allowance for Hydro was appropriate for the 2002 test year. Mr. Wells has testified in this proceeding that the Board was indeed justified in establishing the productivity allowance in 2002 because Hydro had not provided evidence as to how operational efficiencies were to be achieved. However, Hydro did not actually achieve the productivity allowance in 2002, citing it as one of the reasons why controllable operating costs for 2002 exceeded the final 2002 test year forecast by approximately $6.0 million.

Reference: Order No. P.U. 7 (2002-2003), p. 74
Transcript - Wells, October 9, 2003, p. 117, lines 20 to p. 124, line 8 and p. 131, line 25 to p. 133, line 18
Finance and Corporate Services Evidence, Roberts, Schedule II, 1st Revision, Column (b), line 32
CA-44 NLH

Hydro states that the additional $1.5 million vacancy allowance proposed for 2004 provides for future staffing reductions resulting from process improvement initiatives. In essence, therefore, this represents Hydro's proposed productivity allowance for the 2004 test year.

Reference: Transcript - Roberts, October 14, 2003, p. 112, line 22 to p. 113, line 14
Transcript - Roberts, October 15, 2003, p. 54, line 23 to p. 55, line 12

As testified by Mr. Brushett , the Board needs to determine whether the $1.5 million represents a reasonable reflection of what should be the **expected or targeted** improvements in efficiency.

Mr. Brushett's comments:

1. suggest that the savings already realized due to staff reductions in 2003 should not be included in this allowance, and should therefore be treated as a direct reduction in forecast salaries (as proposed in section B.5.2.3 (b) above).
2. recognize that it is the Board who should decide the amount of the productivity allowance to be imposed.

Reference: Transcript - Brushett, December 11, 2003, p. 111, line 20 to p. 114, line 3

Table B-6 below provides a comparison of Hydro's controllable operating costs for the 2004 test year versus Hydro's final 2002 test year as per Order No.P.U. 7 (2002-2003).

Table B-6
Controllable Operating Costs
($000)

	2002 Final Test Year	2004 Test Year	Increase	% Increase
Salaries and Fringe Benefits	59,926[1]	63,242[4]	3,316	5.5%
Non-Labour Costs	36,317	38,165	1,848	5.1%
Allocations	(10,546)[2]	(9,746)[5]	800	7.6%
Total Other Costs	85,697[3]	91,661[6]	5,964	7.0%

[1] Finance and Corporate Services Evidence, Roberts, Schedule II, 1st Revision, Column (b), lines 15 and 25

[2] Finance and Corporate Services Evidence, Roberts, Schedule II, 1st Revision, Column (b), line 31

[3] Finance and Corporate Services Evidence, Roberts, Schedule II, 1st Revision, Column (b), line 33

[4] Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, Column (f), line 15

[5] Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, Column (f), line 31

[6] Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, Column (f), line 32

Table B-6 indicates that Hydro's controllable costs for 2004 have increased by $6.0 million or 7% from the final 2002 test year. Notwithstanding wage increases over this period, productivity initiatives undertaken by Hydro since its 2001 GRA have not been effective in reducing overall costs.

The Board should exercise its regulatory judgment in determining what is an appropriate productivity allowance for Hydro, given its performance since the 2001 GRA and Hydro's current operating characteristics. In making its determination the Board may wish to give consideration to the following:

- **Increases in 2004 test year costs as compared to the final 2002 test year, as indicated in Table B-6 above.**
- **The productivity allowance should not include the $700,000 in salary savings that will be realized in 2004 as a result of positions already eliminated in 2003 (as referred to in section B.5.2.3 (b) above).**
- **The degree of confusion around the continued use of staff complement as opposed to FTEs in forecasting salaries for 2004 (as referred to in section B.5.2.2 above).**
- **Hydro could not provide any estimate of the savings anticipated from the business process reviews underway for 2003-2004 relating to (i) the acquisition of goods and services, (ii) work management, and (iii) asset management.**

Reference: Transcript - Brushett, December 11, 2003, p. 93, line 21 to p. 94, line 8

- **Hydro should experience further efficiency gains based on the continuous nature of its business process reviews and other productivity initiatives.**

Newfoundland Power submits that a productivity allowance of $2.0 million remains appropriate for Hydro in setting its 2004 test year revenue requirement.

B.5.3 Hydro Capitalized Expenses

Hydro's method of determining capitalized expenses is subjective. In Order No. P.U. 7 (2002-2003), the Board noted that a review of the methodology and approach used by Hydro to determine its capitalized expenses would be appropriate at some point in the future. Since the previous hearing, there have been no changes in Hydro's methodology for capitalizing expenses nor has a study been completed to determine the appropriateness of the existing methodology.

Reference: Order No. P.U. 7 (2002-2003), p. 76, paragraph 4
Transcript - Roberts, October 16, 2003, p. 133, line 22 to p. 136, line 22

Both Mr. Roberts and Mr. Brushett have noted the significance of under-estimating capitalized expenses in determining revenue requirement. Under-estimating capitalized expenses in the test year results in an increase in forecast net operating expenses and test year revenue requirement on the one hand, and an increase in earnings to Hydro when higher actual capitalized expenses are recorded.

Reference: Transcript - Roberts, October 14, 2003, p. 151, lines 6-17
Transcript - Brushett, December 11, 2003, p. 114, line 24 to p. 115, line 21

Information Exhibit No. 25 provides an historical comparison of Hydro's actual capitalized expenses to budget for the years 1998 to 2002[1] and forecast 2003. Information Exhibit No. 25 shows that actual capitalized expenses have exceeded budget (after adjustment for capitalized overtime) by an average of $2.2 million over the five-year period from 1998 to 2002. The revised 2003 forecast for capitalized expenses in the October filing again demonstrates the conservative nature of Hydro's methodology with respect to budgeting capitalized expenses with an increase of approximately $1.0 million in forecast capitalized expenses since the August filing (after adjustment for capitalized overtime). Conversely, the 2004 test year forecast for Hydro capitalized expenses has been reduced in the October filing by $260,000.

Reference: Information Exhibit I-25
Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, pp. 1-8
Transcript - Roberts, November 12, 2003, p. 75, line 8 to p. 76, line 3

One of the primary reasons indicated by Hydro for the increase in actual capitalized expenses to budget has been additional involvement by Hydro staff in capital work and new projects that were unplanned and not budgeted. Mr. Martin points out that it is fair to say that unexpected projects will continue to occur in future years.

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[1] Since the amount of capitalized overtime budgeted was not known, all capitalized overtime was removed from the analysis. As a result, the budget variances shown in the analysis are considered to be conservative.

Reference: Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, p. 4 of 8, lines 11-17
Transcript - Roberts, October 14, 2003, p. 139, line 24 to p. 140, line 8
Transcript - Martin, October 24, 2003, p. 170, line 10 to p. 171, line 14

Mr. Brushett testified that it is appropriate and relevant for the Board to look at Hydro's past experience in terms of the impact that capitalized expenses have had upon determining revenue requirement for Hydro.

Reference: Transcript - Brushett, December 11, 2003, p. 116, line 10 to p. 118, line 9

Newfoundland Power submits that Hydro's capitalized expenses in the 2004 test year should be increased by as much as $2.0 million to reflect Hydro's consistent under-budgeting of this amount. This would provide a more representative forecast of capitalized expenses and resulting impact on revenue requirement based on Hydro's actual experience since 1998.

B.5.4 Transportation Costs

Transportation costs in the 2004 test year are approximately $300,000 higher than in 2003. A portion of this increase is due to a reduction in capitalized vehicle expenses. The remaining increase is primarily due to increased costs related to aircraft usage.

Reference: Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, p. 1 of 8, line 18
NP-261 NLH
Transcript - Martin, October 27, 2003, p. 11, line 2 to p. 12, line 14

B.5.4.1 Vehicle Costs

Over the period 1998 to 2002, there has been a reduction of 88 permanent staff at Hydro. Over the same period the number of vehicles at Hydro has increased by 8.

Table B-7
Vehicles and Permanent Staff
1998 – 2002

Year	Permanent Staff[1]	Number of Vehicles[2]
1998	889	274
1999	901	267
2000	891	282
2001	847	285
2002	801	282

[1] From NP-10 NLH.
[2] From NP-24 NLH.

While there have been slight reductions in medium duty and heavy duty trucks over this period, there have been increases in the number of light passenger vehicles.

Reference: NP-24 NLH

Hydro has stated that the increase in vehicles from 1998 to 2002 is primarily related to 15 units purchased for capital projects offset by 7 units eliminated as a result of fleet rationalization. Hydro is currently conducting a review of its vehicle fleet, but has not adjusted its 2004 test year costs for any items arising from this review.

Reference: NP-193 NLH
Transcript - Martin, October 27, 2003, p. 13, line 12 to p.15, line 9

Hydro's operating vehicle costs have increased 25.6% from 2002 to forecast 2004. Vehicles that were purchased for larger capital projects such as Granite Canal are now being charged to operations and maintenance, resulting in a reduction in capitalized vehicle costs. Operating vehicle costs in 2004 are forecast to increase by $185,000, or 23.4% from 2002 for this reason alone. This reduction in capitalized vehicle costs is shown in Table B-8 below.

Table B-8
Capitalized Vehicle Expenses
2001 – Forecast 2004

	Capitalized Vehicle Expenses[1]
2001 Actual	$ 473,546
2002 Actual	$ 485,470
2003 Forecast	$ 400,000
2004 Forecast	$ 300,000

[1] From NP-261 NLH.

Reference: Transcript - Martin, October 27, 2003, p. 10, line 17 to p. 12, line 14
Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, p. 1 of 8, line 18
Grant Thornton Financial Consultants Report, p. 47, lines 10-18
NP-8 NLH, p. 5 of 5, lines 12-13
NP-261 NLH
NP-263 NLH

Hydro has shown an increase in the number of vehicles over the period 1998-2004. However, there has been a significant reduction in the number of employees over this same period. Hydro is conducting a review of its vehicle fleet, but has not adjusted its 2004 test year costs for any items arising from this review. The Board should therefore disallow the $185,000 increase in Hydro's 2004 operating vehicle costs since 2002 caused by a decrease in the utilization of vehicles on capital projects.

B.5.4.2 Aircraft Usage

On October 27, 2003 Mr. Martin testified that savings would be realized based on a reduction in helicopter usage. The amount of savings was estimated at between $70,000 and $75,000.

Reference: Transcript - Martin, October 27, 2003, p. 21, line 1 to p. 22, line 6

In its October 31, 2003 revised evidence, Hydro forecast a $150,000 reduction in its 2003 transportation expense based on year-to-date experience with respect to overall aircraft usage. However, Hydro states that there is no basis to reduce 2004 test year costs for aircraft usage from the August filing.

Reference: Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, p. 3 of 8, lines 19-21
Transcript - Roberts, November 12, 2003, p. 84, line 4 to p. 87, line 3

Newfoundland Power submits that a reduction of $150,000 in 2004 test year aircraft usage costs is warranted given Hydro's 2003 year to date experience.

B.5.5 Loss on Disposal of Capital Assets – Davis Inlet

Hydro indicated to the Board at the 1995 Rural Rate Inquiry that,

> "should the proposed relocation of Davis Inlet go ahead, Hydro will insist on infrastructure capital through Federal funding to fully defray any incremental capital expenditures forced on Hydro's customers should Hydro continue to be the operating utility for the relocated community".

Reference: NP-53 NLH, p. 34

Hydro is now requesting that a forecast loss on disposal of capital assets in Davis Inlet of $725,000 be included in 2004 test year operating costs to be charged to Hydro's customers. Mr. Roberts indicated the Federal Government would not reimburse Hydro for this loss.

Reference: Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, p. 1 of 8, line 25 and p. 6 of 8, lines 16-17
Transcript - Roberts, November 12, 2003, p. 96, lines 4-10
Transcript - Roberts, November 12, 2003, p. 124, lines 3-18

Newfoundland Power recognizes that benefits will accrue to Hydro in the form of cost reductions in future years due to the relocation from Davis Inlet to Natuashish. As testified by Mr. Roberts, the cost of constructing the new plant at Natuashish has been borne by the Federal Government, not Hydro. This will result in reduced depreciation and interest expense for Hydro in future years. Operating costs and perhaps some future capital costs may also be shared between Hydro and the Federal Government based on discussions currently underway between them.

Reference: Transcript - Roberts, November 12, 2003, p. 105, line 21 to p. 107, line 25
Transcript - Roberts, November 12, 2003, p. 123, line 22 to p. 125, line 13
Transcript - Roberts, November 12, 2003, p. 126, line 25 to p. 129, line 6

Mr. Brushett indicates, however, that it is inappropriate to charge the full $725,000 loss to operating costs in the test year and that an amortization period of three to five years would be more appropriate. Newfoundland Power agrees with a five-year amortization of this loss on disposal in light of the future costs savings that will accrue to Hydro, as referred to above.

Reference: Grant Thornton Supplementary Evidence, p. 7, lines 1-9

Newfoundland Power agrees with Grant Thornton's recommendation regarding the $725,000 forecast loss on disposal of capital assets in Davis Inlet in 2004. Newfoundland Power submits that the Board order this amount be amortized over a five-year period beginning in 2004. This will reduce Hydro's 2004 test year revenue requirement by $580,000 ($725,000 x 4/5).

B.5.6 Miscellaneous Costs

B.5.6.1 Travel and Training

Actual training costs for the 2002 test year were approximately $200,000 less than budgeted. As of the end of October 2003, actual training costs were $380,000 against an annual budget for 2003 of $633,000.

Reference: Transcript - Roberts, October 15, 2003, p. 79, line 5 to p. 80, line 1
NP-305 NLH

Through its review of business processes and the implementation of purchasing credit cards in 2003, Hydro began charging travel costs associated with training directly to travel. Previously these costs would have been charged to training. This change has resulted in a reduction to training costs under the category *'Miscellaneous Expenses'* in the October filing of approximately $300,000 in both 2003 and 2004.

Reference: Finance and Corporate Services Supplementary Evidence,
Roberts, Schedule II, 2nd Revision, p. 1 of 8, lines 22 and 24
Transcript - Roberts, November 12, 2003, p. 90, line 23 to p. 92, line 22

In 2003, these savings have resulted in a $300,000 reduction in miscellaneous expenses, with no offsetting increase in forecast travel costs. In the 2004 test year, however, these savings in training costs have been reallocated to provide an offsetting increase in travel, and therefore no reduction in overall costs.

Reference: Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, p. 1 of 8, lines 22 and 24
Transcript - Roberts, November 12, 2003, p. 90, line 23 to p. 95, line 18

Newfoundland Power submits that the $300,000 increase in travel costs in 2004 to offset savings in training is unjustified based on actual 2002 and forecast 2003 expenditures in this expense category. The Board should order Hydro to reduce 2004 test year travel costs by $300,000.

B.5.6.2 Inventory Write-offs

In 2001, an initiative was undertaken by Hydro to identify excess and obsolete inventory. This initiative resulted in the write-off of excess and obsolete inventory in 2001 of approximately $1.0 million.

Reference: NP-253 NLH
NP-255 NLH
Finance and Corporate Services Evidence, Roberts, p. 23, lines 24-28
Grant Thornton Financial Consultants Report, 1999, pp. 31-32

Actual inventory write-offs in 2002 totaled $288,000 as opposed to forecast 2002 test year write offs of $594,000, a reduction of $306,000.

Reference: Grant Thornton Financial Consultants Report, p. 43, line 11

In response to Request for Information NP-269 NLH, Hydro has indicated that the value of obsolete items remaining in inventory is insignificant. However, forecast inventory write-offs for 2003 and 2004 are $370,000 and $420,000 respectively. These amounts are significantly higher than the amount of inventory write-offs experienced in 2002.

Reference: NP-269 GT
Grant Thornton Financial Consultants Report, p. 43, line 11 and p. 44, lines 12-19

Newfoundland Power submits that Hydro has not provided sufficient justification to increase inventory write-offs in the 2004 test year. The Board should order Hydro to reduce its forecast inventory write-offs in 2004 to an amount that is consistent with 2002 actual expense. This will reduce Hydro's 2004 test year revenue requirement by approximately $132,000 ($420,000 - $288,000).

B.5.6.3 Wabush Terminal Station

In response to NP-291 NLH, Hydro indicated that forecast purchased power expenses related to the Wabush Terminal Station in 2004 have increased over the original filing by over $331,000. The increase is due to previously unbudgeted costs related to synchronous condenser maintenance and control upgrades. These expenses, which may be regarded as capital in nature, are treated as an operating expense by Hydro. The expenses will not be capitalized because Hydro does not own the assets. Hydro confirms that the treatment of these expenses as operating expenses does impact proposed rates in Labrador.

Reference: NP-291 NLH
Transcript - Roberts, November 12, 2003, p. 81, line 12 to p. 82, line 18 and p. 129, line 7 to p. 132, line 1

In the interest of rate stability, Newfoundland Power submits that costs incurred by Hydro for synchronous condenser maintenance and control upgrades at the Wabush Terminal Station be deferred and amortized over a five year period beginning in 2004. This will reduce Hydro's 2004 test year revenue requirement by approximately $265,000 ($331,000 x 4/5).

B.6 Summary

Newfoundland Power submits that:

The Board should accept Hydro's proposal to use a purchase price for No. 6 fuel of $28.95/bbl. for the 2004 test year as reasonable.

The Board should accept the use of a 30-year record for determining the Average Annual Energy for 2004 as agreed in the negotiated settlement.

The Board should not make any determination as to the appropriate period of record for use in determining the Average Annual Energy for future hearings until Hydro has completed the required analysis and presented the results for review at a public hearing.

The Board should approve the use of a Holyrood fuel conversion factor of 636 kWh/bbl for use in determining 2004 test year fuel costs.

The Board should accept Hydro's proposed diesel costs for the 2004 test year as reasonable.

Exemption Orders from the Lieutenant-Governor in Council issued under the Public Utilities Act and the Electrical Power Control Act, 1994 entitle Hydro to recover the cost of power purchased under long term contracts with non-utility generators.

Newfoundland Power submits that specific 2004 test year costs be reduced as shown in the following Table B-9.

Table B-9 **Proposed Hydro Cost Reductions** **2004 Test Year**	
Depreciation	$ 169,000
Fuel[1]	$1,600,000
Salaries	
Forecast Wage Increase for 2004	$ 300,000
Positions Eliminated in 2003	$ 700,000
Increase in Normal Vacancy Allowance[2]	$ 600,000
	$1,600,000
Hydro Capitalized Expense	$2,000,000
Transportation Costs	
Vehicle Costs	$ 185,000
Aircraft Usage	$ 150,000
	$ 335,000
Loss on Disposal of Capital Assets - Davis Inlet	$ 580,000
Travel	$ 300,000
Inventory Write-offs	$ 132,000
Wabush Terminal Station	$265,000
Reduction in 2004 Revenue Requirement	$6,981,000

[1] Based on Fuel Conversion factor at Holyrood of 636 kWh/bbl.
[2] $1,600,000 minus $1,000,000.

In addition, with respect to Hydro's proposed productivity allowance (or additional vacancy allowance as referred to by Hydro) of $1.5 million, the Board should exercise its regulatory judgment in determining what is an appropriate productivity allowance for Hydro, given its performance since the 2001 GRA and Hydro's current operating characteristics. Newfoundland Power submits that

> **Hydro can achieve greater efficiencies and productivity improvements. Opportunities exist for Hydro to reorganize, leverage technology and manage its operations to further reduce costs. Newfoundland Power believes that Hydro should continue to have a strong incentive to seek productivity and efficiency gains.**
>
> **Hydro has placed significant emphasis on business process improvement since 2002. Limited productivity gains have been realized as a result. However, the evidence suggests that additional productivity gains are possible given what has been expended to date, the limited gains achieved to date, the limited number of processes reviewed to date, the on-going and continuous nature of this initiative, and the potential for other changes within Hydro aimed at improving overall performance and reducing costs.**
>
> **The Board should consider:**
>
> **i) Increases in 2004 test year costs as compared to the final 2002 test year, as indicated in Table B-6 above.**

ii) The productivity allowance should not include the $700,000 in salary savings that will be realized in 2004 as a result of positions already eliminated in 2003 (as referred to in Section B.5.2.3 (b) above).

iii) The degree of confusion around Hydro's continued use of staff complement as opposed to FTEs in forecasting salaries for 2004 (as referred to in Section B.5.2.2 above).

iv) Hydro could not provide any estimate of the savings anticipated from the business process reviews underway for 2003-2004 relating to (i) the acquisition of goods and services, (ii) work management, and (iii) asset management.

v) Hydro should experience further efficiency gains based on the continuous nature of its business process reviews and other productivity initiatives.

In Order No. P.U. 7 (2002-2003), the Board determined that a $2.0 million productivity allowance for Hydro was appropriate. Hydro was not successful in achieving the productivity allowance established by the Board in 2002.

Newfoundland Power submits that a productivity allowance of $2.0 million remains appropriate for Hydro in setting its 2004 test year revenue requirement.

C. RETURN ON RATE BASE

In this section of its brief, Newfoundland Power addresses the 2004 test year forecast average rate base and Hydro's entitlement to earn a just and reasonable return on rate base.

C.1 General

Section 80 of the *Public Utilities Act* entitles Hydro to earn a just and reasonable return on its rate base. Hydro's return on rate base represents the sum of the return to Hydro's investors, being its debt holders and its common equity holder, the Government of Newfoundland and Labrador.

The *Electrical Power Control Act, 1994*, section 3 (a) (iii) sets out the power policy of the province. A utility shall have its rates set

> "…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."

C.2 Rate Base

In paragraph 6 (14) of its Amended Application, Hydro proposes a forecast 2004 Average Rate Base of $1,485,468,000. In its 2nd Revision, Hydro filed evidence showing a lower revised forecast for its 2004 Average Rate Base of $1,483,381,000.

Newfoundland Power submits that the Board should rely upon the revised forecast Average Rate Base of $1,483,381,000 in determining Hydro's revenue requirement for the test year.

Reference: Finance and Corporate Services Evidence, Roberts, Schedule III, 2nd Revision

If the Board orders Hydro to reduce its forecast capital expenditures, as suggested in section B of this brief, Hydro must also be required to make the appropriate adjustments to its forecast average rate base.

In paragraph 7 (1) of its Amended Application, Hydro requests that the Board make an order "fixing and determining the 2004 rate base of the Applicant at $1,485,468,000." It is premature to fix and determine Hydro's 2004 Rate Base at this time.

C.3 Return on Rate Base

C.3.1 Cost of Debt

Hydro's borrowings include short-term promissory notes and longer-term debentures.

Reference: Finance and Corporate Services Evidence, Roberts, p. 17, lines 10-20

Hydro's 2004 forecast cost of debt is provided in Mr. Robert's Supplementary Evidence dated October 31, 2003, Schedule VII, 2nd Revision. The forecast cost of debt reflects interest expense for the 2004 test year of $98,165,000, as shown in Mr. Roberts Schedule II, 2nd Revision, p. 1 of 8, line 33.

Reference: Supplementary Evidence, Roberts, Schedule VII, 2nd Revision
Supplementary Evidence, Roberts, Schedule II, 2nd Revision, p. 1 of 8, line 33

C.3.1.1 Short-Term Interest

On October 15, 2003, Mr. Roberts testified that Hydro's pending revised evidence would reflect more current forecasts of promissory notes outstanding for 2003 and 2004, and short term interest expense for the 2004 test year.

Reference: NP-100 NLH
Transcript - Roberts, October 15, 2003, p. 36, line 23 to p. 38, line 9.

Hydro's revised evidence dated October 31, 2003 reflects a reduction in forecast short-term interest rates in the 2004 test year from an average of 5.0% to 2.78%. The total reduction in forecast short-term interest expense for test year 2004 was approximately $2.8 million. Approximately $3.5 million was related to savings from lower short-term interest rates (as expected based on testimony by Mr. Roberts on October 15, 2003), offset by approximately $0.7 million in increased interest costs related to a $23 million average increase in promissory notes for 2004.

Reference: Finance and Corporate Services Evidence, Roberts, Schedule II, 2nd Revision - October 31, 2003, p. 1 of 8, line 33 and p. 6 of 8, lines 23-24
NP-300 NLH, p. 5 of 5

Transcript - Roberts, November 12, 2003, p. 107, line 24 to p. 110, line 13
Finance and Corporate Services Evidence, Roberts, Schedule VIII, 2nd Revision
NP-100 NLH, p. 3 of 3

In PUB-191 NLH, Hydro indicated that the increase in promissory notes was primarily due to higher forecast borrowing requirements in 2003 and therefore an increase in the amount of promissory notes as of January 1, 2004. These increased borrowing requirements were identified as being comprised of increased fuel expense ($10 million), lower proceeds from long-term debt issue ($14 million) and other factors (-$1 million).

Reference: PUB-191 NLH

Mr. Roberts corrected a number of inaccuracies in Hydro's response to Request for Information PUB-191 NLH during cross-examination on November 12, 2003. Mr. Roberts confirmed that the significant items contributing to the $23 million increase in forecast promissory notes were:

Increased fuel expense	$ 7.5 million
Lower proceeds for long-term debt issue	$ 10.4 million
Increase in cash from operations	$(2.4 million)
Reduction in long-term debt	$ 1.2 million
Changes in non-cash working capital	$ 9.0 million

Mr. Roberts confirmed that the $9 million increase in promissory notes due to changes in non-cash working capital was due largely to forecast reductions in accounts payable and accrued liabilities in 2003 and 2004 of approximately $10.0 million and $13.0 million respectively. However, Mr. Roberts could not fully explain the change in accounts payable and indicated that this was only a balancing number. The unexplained increase in accounts payable indicates that interest expense in the 2004 test year is overstated by approximately $278,000.

Reference: Finance and Corporate Services Supplementary Evidence, Roberts, Schedule II, 2nd Revision, p. 6 of 8, lines 23-24 and Schedule VIII, 3rd Revision
Transcript - Roberts, November 12, 2003, p. 109, line 23 to p. 118, line 9
NP-308 NLH

Mr. Brushett confirmed that accounts payable is one of the factors related to the determination of borrowing requirements. Mr. Brushett also testified that Hydro's methodology of using accounts payable as a balancing number in determining borrowing requirements appears contrary to standard practice. Mr. Brushett stated that Grant Thornton had not completed a detailed review of Hydro's test year borrowing requirements and interest costs.

Reference: Transcript - Brushett, December 11, 2003, p. 119, line 2 to p. 123, line 9
NP-300 NLH
Exhibit WW #1, Tab 2, Financial, p. 2
Exhibit WW #2, Tab 2, Financial, p. 2
Information Exhibit 26, p. Tab 2, Financial, p. 2

Transcript - Brushett, December 11, 2003, p. 124, line 11 to p. 125, line 3

Newfoundland Power submits that the Board should order a $278,000 reduction in Hydro's 2004 interest expense based on Hydro's unjustified and unexplained decrease in forecast accounts payable for 2003 and 2004, and related impacts on short term promissory notes and test year interest expense.

C.3.2 Cost of Equity

C.3.2.1 Introduction

In order to determine the appropriate rate of return on equity (ROE) to be used in determining Hydro's rate of return on rate base, the Board will need to consider the following issues:

a) whether Hydro should be regulated as an investor owned utility or as a Crown owned utility; and

b) what consideration should the Board give to the following factors:

1. the lack of a sound financial plan for Hydro in this proceeding to achieve an appropriate capital structure;

2. the payment of the guarantee fee; and

3. the social policy benefits obtained from Hydro's operations.

In determining an appropriate ROE for Hydro, the Board will need to exercise regulatory judgment in tempering normal market returns for an investor owned utility to achieve and balance other regulatory objectives.

C.3.2.2 Order No. P. U. 7 (2002-2003)

The Board considered Hydro's financial and operating characteristics in Order No. P.U. 7 (2002-2003). The Board determined that Hydro did not have the characteristics of an investor owned utility and that there was no basis for regulating Hydro as an investor owned utility. The Board identified several relevant factors, including Hydro's debt/equity ratio, dividend payouts, debt guarantee, government directives and corporate income tax exempt status.

Reference: Order No. P.U. 7 (2002-2003), pp. 39-42

The Board accepted Hydro's proposed debt equity ratio of 83/17 for the 2002 test year and target short term debt equity ratio of 80/20. The Board did not find evidentiary support for the principle of Hydro moving to a capital structure of 60/40.

Reference: Order No. P.U. 7 (2002-2003), pp. 42-43

The Board accepted Hydro's request for a 3% ROE in the 2002 test year, while acknowledging that this level of ROE was below normal market returns. The Board deferred consideration of a more normal return to a future application by Hydro.

Reference: Order No. P.U. 7 (2002-2003), pp. 43-45

C.3.2.3 Basis of Regulation

Hydro does not have the financial structure of an investor owned utility.

Reference: Transcript - McShane, December 3, 2003, p. 92, line 24 to p. 93, line 10

Hydro has not presented to the Board in this proceeding any plan to achieve financial targets similar to an investor owned utility.

In the 2001 GRA, Hydro proposed a 60/40 long term capital structure, as would be the case for an investor owned utility. Hydro has since abandoned the 60/40 capital structure as being not practically achievable in the foreseeable future.

Reference: Order No. P. U. 7 (2002-2003), p. 43
Transcript - Roberts, October 15, 2003, p. 126, line 8 to p. 127, line 22
Transcript - McShane, December 3, 2003, p. 85, line 7 to p. 86, line 8 and p. 94, lines 6-14

Newfoundland Power submits that Hydro does not have the financial or operating characteristics of an investor owned utility. Newfoundland Power submits that Hydro should be regulated as a Crown owned utility, not as an investor owned utility.

C.3.3 Capital Attraction and Creditworthiness

Hydro's ability to attract capital is entirely dependent upon Government's guarantee of its debt. In this respect, Ms. McShane stated:

> "Hydro would not be financially viable at either its forecast capital structure or its target capital structure in the absence of a guarantee."

> Reference: Cost of Capital Evidence, McShane, p. 19, lines 6-7

As a result of the Government guarantee, combined with Hydro's current capital structure, Hydro's credit rating is based largely upon that of its guarantor and shareholder, Government.

> Reference: Finance and Corporate Services Evidence, Roberts, 1st Revision, p. 10, lines 3-5

Accordingly, Newfoundland Power submits that in assessing a fair ROE for Hydro at this time, the record is clear that the level of Hydro's ROE will have no current impact upon Hydro's ability to attract capital or its credit rating.

C.3.4 Capital Structure and Dividend Policy

In Order No. P.U. 7 (2002-2003), the Board accepted Hydro's target short-term debt/equity ratio of 80/20. This target was in keeping with the Board's 1992 report. The Board noted that the payment of proposed dividends in 2002 was contrary to Hydro's own dividend policy and inconsistent with Hydro's long-term financial objectives.

Reference: Order No. P. U. 7 (2002-2003), pp.38 and 43

In 2002, Hydro paid $65.7 million in dividends, or 675% of regulated net operating income, well beyond the dividend policy of 75%. In 2003, Hydro paid a further $5.6 million in dividends, again contrary to Hydro's dividend policy. These dividend payments came as a result of a request from Hydro's shareholder, Government.

Reference: Transcript - Wells, October 9, 2003, p. 4, line 7 to p. 7, line 22
Transcript - Roberts, October 15, 2003, p. 97, line 13 to p. 99, line 17

As a result of the payment of these dividends totaling $71.3 million, the percentage of debt in Hydro's capital structure deteriorated to 86.4% in 2003 and 85.8% for forecast 2004.

Reference: Transcript - Wells, October 9, 2003, p. 3, line 18 to p. 4, line 6
Transcript - Brushett, December 11, 2003, p. 82, line 17 to p. 83, line 24

Mr. Roberts testified that:

> "If there is little equity in the capital structure, [Hydro's] financial flexibility is reduced."

Reference: Finance and Corporate Services Evidence, Roberts, p. 9, lines 21-22
Transcript - Roberts, October 15, 2003, p. 100, line 16 to p. 101, line 14

Hydro's cost of capital expert, Ms. McShane, considered Hydro as a Crown owned utility and compared it to other Crown owned utilities. Most other Crown owned utilities in Canada have legal or de facto maximum debt to equity ratios, with a maximum debt component of 80%.

Reference: Transcript - McShane, December 3, 2003, p. 87, line 25 to p. 90, line 21

Ms. McShane testified that 80% debt provides the minimal equity cushion compatible with being a self-supporting enterprise. A debt ratio in excess of 80% was not, in her view, compatible with being a self-supporting entity.

Reference: Cost of Capital Evidence, McShane, p. 14, lines 20-22
Transcript - McShane, December 3, 2003, p. 86, line 24 to p. 87, line 24

Ms. McShane has stated that Hydro's ability

> "to attain its target capital structure is dependent on maintaining a supportive dividend policy in conjunction with a fair and reasonable return on equity. A supportive dividend policy is one which is predictable to both the shareholders and management and thus permits reasonable planning on the part of both".

Reference: Cost of Capital Evidence, McShane, p. 17, lines 7-10

The evidence indicates that there has been some interaction between Hydro and its shareholder on matters relating to financial planning, including dividends. The consequences of a failure to establish a sound financial plan appears to have been specifically recognized by Hydro in its discussion paper where it is indicated that

> "failure to adhere to such a policy could result in similar disallowances by the Board, thereby adversely impacting on shareholder return."

Reference: Corporate Overview Evidence, Wells, Schedule II
Transcript - Wells, October 7, 2003, p. 163, line 6 to p. 167, line 2

Ms. McShane testified that if Hydro's debt ratio stays at the current level or deteriorates, rating agencies will have a tendency to view the corporation as not being fully self-supporting. A failure to progress towards the 80/20 target will be perceived as an inability to operate as a self supporting commercial enterprise.

Reference: Transcript - McShane, December 3, 2003, p. 91, line 11 to p. 92, line 23

Hydro will not achieve a debt/equity ratio of 80/20 in the next five years with either a 75% dividend payment policy or a 50% dividend payment policy. A 75% dividend policy would produce an 85% debt ratio in 2008, while a 50% dividend policy would produce an 83% debt ratio in 2008. It would require a 25% dividend payment policy to achieve an 81% debt ratio, close to the 80/20 target ratio, by 2008.

Reference: Corporate Overview Evidence, Wells, Schedule II, Discussion Paper on Hydro Dividends, p. 6 of 7
Finance and Corporate Services Evidence, Roberts, p. 10
Transcript - McShane, December 3, 2003, p. 90, line 6 to p. 91, line 24

Hydro's financial projections for 2003-2007 continue to be based on a 75% dividend policy.

Reference: CA-3 NLH, Financial Projection 2003 to 2007, p. 10

Mr. Roberts confirmed that a 75% dividend policy is still the policy of Hydro and that the capital structure target remains an 80/20 debt equity ratio. Yet, the evidence is clear that a 75% dividend policy will only result in an 85% debt ratio by 2008, not materially different than the 86% ratio for 2003.

Reference: Transcript - Roberts, October 15, 2003, p. 102, line 10 to p. 106, line 1

Hydro does not have the minimum equity in its capital structure which its own financial expert considers appropriate for a Crown owned utility. Its capital structure has actually weakened since 2002, with a debt component that has increased from 83% to 86%. Hydro does not have a supportive dividend policy to permit material improvement in its capital structure. Hydro has not yet been able to formulate and implement a sound financial plan to achieve the capital structure appropriate for a Crown owned utility.

Newfoundland Power accepts that the payment of dividends is a matter primarily for Hydro, its Board of Directors and its shareholder. However, for Hydro to meet the requirements of the *Electrical Power Control Act, 1994*, Hydro has an obligation to establish a capital structure that ensures that it maintains long-term financial strength and creditworthiness. The consequences of the absence of a sound financial plan should not be borne by consumers of electricity.

The evidence indicates, and the Board has previously accepted, that Hydro should have a capital structure with a debt/equity ratio of 80/20. The Board will have to exercise its regulatory judgment in determining whether or not changing Hydro's ROE is warranted in view of the absence of a sound financial plan.

C.3.5 The Debt Guarantee

Hydro's debt continues to be guaranteed by the Government of Newfoundland and Labrador. Hydro continues to pay Government a 1% guarantee fee for providing the guarantee. The guarantee fee is forecast to be $14.7 million in 2004.

Reference: Finance and Corporate Services Evidence, Roberts, Schedule VII, 2nd Revision

Newfoundland Power does not contend that the payment of the guarantee fee is inappropriate or that it is not of benefit to consumers. It enables Hydro to borrow at reasonable rates that could not otherwise be achieved with Hydro's capital structure.

Government's investment in Hydro consists of Hydro's retained earnings and Government's debt guarantee. Ms. McShane testified that Hydro is currently self-supporting. Hydro has been able to meet its operating and maintenance expenses and financial obligations without looking to its shareholder or debt guarantor.

Reference: Transcript - McShane, December 3, 2003, p. 112, line 3, p. 114, line 1
Transcript - McShane, December 3, 2003, p. 166, line 23 to p. 167, line 23

Consequently, the Government is not paying any of Hydro's costs. The guarantee fee is, in substance, a return to Government in respect of its ownership of Hydro.

Newfoundland Power submits that the Board should consider the payment of the guarantee fee in determining the just and reasonable return that Government should receive on its investment in Hydro.

C.3.6 Social Policy Benefits

Hydro continues to operate in a manner which reflects social and public policy objectives. As such, it does not operate fully in accordance with regulatory principles that would be applicable to an investor owned utility.

The rural deficit, for example, will be in excess of $41 million in 2004. In the summer of 2003, Government directed the Board to continue the cross-subsidization practice and ordered the continuation of certain preferential rates that Hydro had proposed to eliminate.

Reference: Cost of Service Evidence, Greneman, Exhibit RDG-1, 2nd Revision, p. 3 of 107, line 11, column 5

Newfoundland Power accepts that Government has the right to require such cross-subsidization and give such policy directions with respect to rates.

However, Newfoundland Power submits that the Board should consider the cross-subsidization and other social policy benefits to Government from Hydro's operations as a Crown owned utility. Sound regulatory principles prohibit an investor owned utility from conferring benefits on its shareholders, other than the return permitted within the allowed range of rate of return on rate base. The Board should consider the value of such social policy benefits to Government from the operations of Hydro in setting the just and reasonable return. Otherwise, Government as shareholder of a Crown owned utility would potentially receive a total return which exceeds that available from an investor owned utility.

C.3.7 Submission with Respect to Hydro's ROE

Table C-1 sets forth Hydro's existing ROE and the alternative positions advanced in this proceeding.

Table C-1 Return on Equity	
Existing	3%
Hydro Proposal	9.75%
McShane	11.0 – 11.25%
Kalymon	8.5 – 9.0%
Waverman	5.83% with consideration of an additional 1% equivalent to the guarantee fee

Reference: Transcript - McShane, December 3, 2003, p. 45, lines 2-3
Transcript - Kalymon, December 4, 2003, p. 3, lines 8-9
Transcript - Waverman, December 4, 2003, p. 58, lines 14-21

Hydro has proposed that it should receive a 9.75% return on equity, consistent with that of Newfoundland Power, an investor owned utility. Hydro has the burden of proving that it is entitled to be treated as an investor owned utility and entitled to an investor owned utility rate of return on equity. Hydro has not proven that it is entitled to be treated as a investor owned utility. Hydro has effectively abandoned that objective.

Hydro must demonstrate that it has a sound plan to achieve the financial and operating characteristics appropriate for Hydro as a Crown owned utility. Hydro has made little or no progress on most of the factors and objectives that would be required for such a plan since an 80/20 target capital structure was approved for Hydro in 1992. Hydro has actually moved backwards on the key issue of capital structure, with a debt ratio now of 86%.

The Board must consider whether or not awarding an increased ROE for Hydro in these circumstances advances any regulatory objective.

The Board should consider the degree to which it is appropriate to reduce Hydro's ROE below normal market returns in order to incent Hydro to develop and implement a sound financial plan in the long term interests of the consumers of the Province.

Hydro has been and remains able to borrow and maintain a sound credit rating at the previously approved rate of return on equity. Hydro continues to have appropriate interest coverage on its debt. Hydro has no major capital projects requiring substantial borrowing in the next few years. This gives Hydro time to develop a sound financial plan before its next general rate application.

The Board will also have to exercise its judgment in setting an appropriate ROE taking into consideration the financial return to Government from the guarantee fee and the social policy benefits directed by Government through Hydro's operations.

These matters require the Board to make decisions based upon policy and regulatory judgment. The determination of an appropriate ROE for Hydro in the circumstances is not a matter that can be determined simply on a mathematical basis from the evidence.

The Board must decide whether to increase Hydro's ROE from its existing level and, if so, the appropriate ROE compared with normal market returns, taking into account competing regulatory objectives and principles.

C.3.8 Range of Rate of Return, Excess Earnings Account and Automatic Adjustment Formula

Hydro has not brought forward any proposals in relation to three related issues: i) a range of rate of return on rate base, ii) an excess earnings account, or iii) an automatic adjustment formula.

Reference: Transcript - Roberts, October 15, 2003, p. 106, lines 17-22
Transcript - McShane, December 3, 2003, p. 94, line 24 to p. 95, line 4
Transcript - Brushett, December 11, 2003, p. 83, line 25 to p. 84, line 8

Hydro's stated position in response to Requests for Information, supported by its President and Chief Executive Officer, is that it is premature to establish a range of rate of return on rate base.

Reference: NP-234 NLH
Transcript - Wells, October 9, 2003, p. 19, line 2 to p. 24, line 13
Transcript - Brushett, December 11, 2003, p. 64, line 23 to p. 65, line 10

Mr. Brushett recommended that the Board establish an allowed range of rate of return on rate base with an excess earnings account. While Hydro had not made any proposal or presented any evidence with respect to a range of rate of return on rate base, Mr. Brushett testified that "…Hydro would have its opinion and would probably address this in argument…". (December 11, 2003, p. 85, lines 2-4) Mr. Brushett acknowledged that the issue of a range is affected by the allowed rate of return and that different parameters and conclusions may result depending on the rate of return on equity and capital structure. (December 11, 2003, p. 88, line 17 to p. 89, line 9) Mr. Brushett acknowledged the need for the Board to "…go through due process". (December 11, 2003, p. 90, line 9)

Reference: Transcript - Brushett, December 11, 2003, p. 83, line 25 to p. 91, line 8

There has been little discussion or analysis of an appropriate range of rate of return on rate base in this hearing because Hydro has not brought forward any proposal for such a range. Differences in financial and operating characteristics between utilities may require a different range of rate of return on rate base. Newfoundland Power submits that the Board does not have sufficient evidence to determine an appropriate range of rate of return on rate base for Hydro.

However, if the Board increases Hydro's ROE beyond the existing 3% rate, the Board may need to establish a range of rate of return on rate base and an excess earnings account.

With respect to an automatic adjustment mechanism, Mr. Brushett recommended that Hydro be required to bring forward a proposal for an automatic adjustment mechanism because there may be specific issues relative to Hydro that could result in a different formula than that in place for Newfoundland Power. Mr. Brushett testified that there are issues as to what Hydro believes are appropriate mechanisms and trigger points.

Reference: Transcript - Brushett, December 11, 2003, p. 71, line 2 to p. 72, line 5
Transcript - Brushett, December 11, 2003, p. 83, line 25 to p. 91 line 8

Newfoundland Power submits that integrated proposals for dividend policy, capital structure, rate of return on equity, rate of return on rate base, range, excess earnings account, and automatic adjustment mechanism are required to fully address the financial position of Hydro. All of these items are important components in the regulation of Hydro as a Crown owned utility.

The preferable approach with respect to a range of rate of return on rate base, an excess earnings account and an automatic adjustment formula would be to deal with these issues together when Hydro brings forward an integrated proposal.

C.4 Summary

Newfoundland Power submits that the Board should rely upon the revised forecast Average Rate Base of $1,483,381,000 in determining Hydro's revenue requirement for the test year.

If the Board orders Hydro to reduce its forecast capital expenditures, as suggested in section B of this brief, Hydro must also be required to make the appropriate adjustments to its forecast average rate base.

It is premature to fix and determine Hydro's 2004 Rate Base at this time.

Newfoundland Power submits that the Board should order a $278,000 reduction in Hydro's 2004 interest expense based on Hydro's unjustified and unexplained decrease in forecast accounts payable for 2003 and 2004, and related impacts on short term promissory notes and test year interest expense.

Newfoundland Power submits that Hydro should be regulated as a Crown owned utility, not as an investor owned utility.

Newfoundland Power submits that the Board will have to exercise its regulatory judgment in setting Hydro's ROE in view of:

1) the lack of a sound financial plan for Hydro in this proceeding to achieve an appropriate capital structure;

2) the guarantee fee, and

3) the social policy benefits to Government.

If the Board increases Hydro's ROE beyond the existing 3% rate, the Board may need to establish a range of rate of return on rate base and an excess earnings account.

The preferable approach with respect to a range of rate of return on rate base, an excess earnings account and an automatic adjustment formula would be to deal with these issues together when Hydro brings forward an integrated proposal.

D. COST OF SERVICE

D.1 Plant Assignments on the Island Interconnected System

D.1.1 General

A cost of service methodology requires that the cost of each component of plant be assigned to customers in a fair and equitable manner. For the purpose of plant assignment in Hydro's cost of service study on the Island Interconnected System, the customers include Newfoundland Power, individual Industrial Customers and Hydro Rural.

Reference: Production Evidence, Haynes, Exhibit JRH-3, p. 23

In its 2001 GRA, Hydro proposed that the 138 kV transmission systems on the Great Northern Peninsula (GNP) and the Burin Peninsula, and the 138/66 kV transmission system serving the Doyles-Port aux Basques area, be assigned as common plant based on the presence of generation on each of these radial transmission lines that was of benefit to the entire grid. Hydro also proposed that the GNP generation be assigned as common.

In Order No. P.U. 7 (2002 - 2003), the Board did not approve the proposed assignment of the generation and transmission assets on the GNP to common or the assignment of the Doyles-Port aux Basques system to common. Instead, the Board ordered Hydro to file, as part of its next GRA, a detailed study on the assignment of the GNP, the Doyles-Port aux Basques and the Burin Peninsula assets.

In compliance with the Board's Order, Hydro filed, as Exhibit JRH-3 in this proceeding, a document entitled "Review of COS Assignment for the GNP, Doyles-Port aux Basques and Burin Peninsula Assets" (the "Review").

Based on the Review, Hydro has proposed the following assignments for cost of service purposes:

Generation Assets:

1. GNP – Change assignment from Hydro Rural to Common.
2. Burin Peninsula – Assigned to Common (No change).

Transmission assets:

1. GNP – Specifically assigned to Hydro Rural (No change).
2. Doyles-Port aux Basques – Specifically assigned to Newfoundland Power (No change).
3. Burin Peninsula – Assigned to Common (No change).

Reference: Production Evidence, Haynes, p. 40, lines 14-28

For cost of service purposes, plant is either specifically assigned or assigned as common. Plant which is viewed as providing benefit to all customer classes is assigned as common. The costs related to specifically assigned plant are assigned to the appropriate customer class within the cost of service study. Cost of service plant assignments are not always clear-cut and require a balancing of various factors.

Reference: Transcript - Haynes, October 23, 2003, p. 135, lines 7-9

D.1.2 Assignment of Generation Assets

Hydro proposes to assign its generation assets on the GNP and Burin Peninsula as common on the basis that the physical location of generation assets is of little consequence. All generation assets connected to the Island Interconnected System provide benefits to all customers on the Island Interconnected System.

Reference: Transcript - Haynes, October 20, 2003, p. 183, line 19 to p. 186, line 1and p. 187, lines 6-18
Production Evidence, Haynes, Exhibit JRH-3, pp. 14-16

The Industrial Customers' cost of service experts, Mr. Osler and Mr. P. Bowman, take the position that Hydro's proposed assignment of generation assets to common reflect cost allocations that are not based on the relative benefits these assets provide to the various customer classes.

Reference: Prefiled Testimony, Osler and P. Bowman, p. 3, lines 27-29

The relative benefits to various customer classes of the generation assets on the three radial systems may differ due to their locations near certain customer classes' load centers. However, all generation assets on the Island Interconnected System, including the assets in question, benefit all customers by deferring capacity additions to the system, regardless of their location. If the generation on the three radial systems were removed, Hydro would be required to obtain additional generation for 2004 in order to meet its system reliability criterion for capacity of no more than 2.8 LOLH per year. With this generation in place, the system reliability criterion for capacity is not exceeded until 2011. Recent events on the Island Interconnected System have also demonstrated the benefits of the generation in meeting system peak requirements and assisting in system restoration efforts.

Reference: Production Evidence, Haynes, Exhibit JRH-3, pp. 10-13 and pp. 15-16
Transcript - Haynes, October 20, 2003, p. 55, line 10 to p. 57, line 10 and p. 182, line 4 to p. 193, line 2
Cost of Service Evidence, Greneman, p.10, lines 6-7
Transcript - Haynes, October 24, 2003, p. 49, line 6 to p. 53, line 21

Newfoundland Power submits that all generation assets connected to the Island Interconnected System provide substantial benefit to the Island Interconnected System. Accordingly, Newfoundland Power supports Hydro's proposal that the generation assets on each of the two systems be assigned to common.

D.1.3 Assignment of Transmission Assets

Hydro proposes that there be no change in the assignment of the transmission assets in question and that each remains assigned in the same manner as approved in the 2002 test year. The proposals are in accordance with the guidelines that have been developed for the assignment of transmission assets for cost of service purposes.

Based on the Review, Hydro also concludes that it is appropriate to assign generation assets and the connecting transmission and terminal station assets differently for cost of service purposes.

Reference: Production Evidence, Haynes, Exhibit JRH-3, pp. 19-20

D.1.3.1 Assignment of the GNP and Doyles-Port aux Basques Transmission Assets

The St. Anthony/Roddickton portion of the GNP transmission system was constructed for the benefit of the customers on the previously isolated distribution system on the GNP. According to the Review, the generation assets on the GNP are not of sufficient magnitude to justify assignment of the GNP transmission assets as common, given that the dominant purpose of the transmission system is to serve a single customer class.

Reference: Production Evidence, Haynes, Exhibit JRH-3, p. 21

The primary purpose of the Doyles-Port Aux Basques transmission assets is to provide service to Newfoundland Power customers on that radial system. According to the Review, the generation assets located on this radial system are not sufficient in magnitude to justify assignment of the transmission assets as common, given that the dominant purpose of the transmission system is to serve a single customer class.

Reference: Production Evidence, Haynes, Exhibit JRH-2, p. 21

Mr. Osler and Mr. P. Bowman take no issue with the proposed specific assignment of the transmission assets serving Doyles-Port aux Basques and the GNP.

The position of the Board Staff's cost of service experts, EES Consulting, Ms. Tabone and Mr. Chymko, is that the transmission facilities should be treated the same as the associated generation facilities, given that all customers on the grid benefit from the generation that is connected. This position derives from their view that the transmission system is essentially an extension of the production system and their preference for a "postage stamp" policy for the assignment of generation and transmission facilities.

Reference: Evidence, EES Consulting: Cost of Service and Rates, pp. 18-19
Transcript - Chymko and Tabone, November 19, 2003, p. 17, line 14 to p. 19, line 23 and p. 109, line 8 to p. 113, line 18

D.1.3.2 Assignment of the Burin Transmission Assets

Hydro has proposed that the Burin Peninsula transmission assets continue to be assigned as common. Hydro's guideline for the assignment of transmission assets provides for assignment as common where the assets are associated with the connection of two or more customer classes to the grid and there is significant generation that is of benefit to the grid. The Burin Peninsula transmission assets (TL-212 and TL-219) serve both the Newfoundland Power and Hydro Rural customer groups and connect generation assets of Newfoundland Power (26.7 MW) and Hydro (8 MW) to the grid. In addition, there is a likelihood that a wind generation project will provide an additional 25 MW of generation in the near future.

Reference: Production Evidence, Haynes, Exhibit JRH-3
Transcript - Haynes, October 21, 2003, p. 19, lines 3-19 and p. 22, line 20 to p. 24, line 1

Mr. Osler and Mr. P. Bowman are of the opinion that assigning Burin transmission assets to common is inappropriate because the assets do not serve the Industrial Customers. They suggest that the assets should be assigned jointly to Newfoundland Power and Hydro Rural.

Reference: Prefiled Testimony, Osler and P. Bowman, p. 3, lines 27-29 and Attachment H, p. H-3, lines 13-15

There is currently no Newfoundland Power-Hydro Rural category of cost assignment. More importantly, assignment of the Burin transmission assets to Newfoundland Power and Hydro Rural would not reflect the benefits to the main grid of the significant generation on the Burin Peninsula.

Reference: Transcript - Haynes, October 23, 2003, p. 141 line 16 to p. 142, line 14

Mr. Osler and Mr. P. Bowman's evidence states that considering the generation on the Burin Peninsula for common assignment of the transmission lines only has merit in relation to transmission line TL-212, based on the location of the Paradise River plant.

Reference: Prefiled Testimony, Osler and P. Bowman, Attachment H, p. H-4, lines 12-13

However, this approach ignores the benefit of the alternative routes provided by the two transmission lines to:

(i) the Newfoundland Power and Hydro Rural customers on the Burin Peninsula with respect to supply from the main grid; and

(ii) other customers supplied from the main grid with respect to the available generation on the Burin Peninsula.

Neither Mr. D. Bowman nor EES Consulting disagreed with the cost assignment proposed for the Burin Peninsula transmission assets.

Reference: Prefiled Evidence, C. D. Bowman, p. 7, lines 11-17
Evidence, EES Consulting: Cost of Service and Rates, p. 19, lines 3-8

Newfoundland Power submits that Hydro's proposals with respect to the assignment of the GNP, Doyles-Port aux Basques and Burin Peninsula transmission assets for cost of service purposes are reasonable and reflect the balance of the information provided on this issue.

D.2 Generation Credit

D.2.1 General

Within Hydro's Cost of Service Study, costs are allocated based on Newfoundland Power's native peak demand less the amount of generation Newfoundland Power has available to Hydro on request. The amount of the demand reduction is referred to as the generation credit. The current generation credit of 125.4 MW is based on Newfoundland Power's thermal and hydraulic generation capacity less a 16% reserve.

Reference: Cost of Service Evidence, Greneman, Exhibit RDG-2, p.7
IC-306 NLH
NP-215 NLH

When necessary, Hydro can request Newfoundland Power to run its thermal generation and maximize hydraulic generation. Coordination between the two utilities results in Newfoundland Power not running its thermal generation when Hydro has other lower cost generation available. This promotes the least cost operation of the thermal generating facilities on the Island Interconnected System and ensures overall efficiency of operations in accordance with Section 3(b)(i) of the *Electrical Power Control Act, 1994*. The provision of the generation credit through the cost of service study provides fairness to Newfoundland Power and its customers and the achievement of this mandate.

Reference: Transcript - Perry and Henderson, December 9, 2003, p. 105, line 19 to p.106, line 20
Cost of Service Evidence, Greneman, Exhibit RDG-2, pp. 6-7
Transcript - Haynes, October 20, 2003, p. 51, lines 15-23
Prefiled Supplementary Evidence, Brockman, p.7, lines 19-22
NLH-228 NP

Mr. Osler and Mr. P. Bowman recognized that the consideration for Newfoundland Power's generation through the cost of service study should first recognize the clear power policy of Section 3(b) of the *Electrical Power Control Act, 1994.*

Reference: Prefiled Testimony, Osler and P. Bowman, p. 45, line 40 to p. 46, line 3

As a result of this arrangement between Newfoundland Power and Hydro on the operation of Newfoundland Power's generation, the peak demand assigned to Newfoundland Power through Hydro's cost of service study is net of Newfoundland Power's generation capacity less reserve. This is no different than the peak demands in the cost of service study for Corner Brook Pulp and Paper being based on its demand requirements net of its generation.

Reference: Prefiled Supplementary Evidence, Brockman, p. 7, line 19 to p. 8, line 8
NP-226 IC

The Board reviewed the treatment of Newfoundland Power's generation credit in Hydro's Cost of Service Study at both the 1992 Cost of Service Hearing and the 2001 Hydro General Rate Proceeding. On both occasions, the Board accepted the current Cost of Service methodology for dealing with the generation credit.

Reference: Prefiled Supplementary Evidence, Brockman, p. 5, lines 14-17

D 2.2 Position of Parties

Hydro's position is that all generation facilities on the Island Interconnected System, including those owned by Newfoundland Power, defer the need to add new generation to meet capacity requirements and assist in system restoration efforts. The generation credit is a recognition of the capacity value of the Newfoundland Power generation to the system. IC-306 NLH indicates the capacity value of the generation credit is 125.4 MW.

Reference: Production Evidence, Haynes, Exhibit JRH-3, Section 3
Prefiled Supplementary Evidence, Brockman, p. 8, lines 10-16
Cost of Service Evidence, Greneman, Exhibit RDG-2, p. 6

Based on his review of Hydro's evidence, Newfoundland Power's cost of service expert, Mr. Brockman, supports continuation of the generation credit consistent with the recommendations of Order No. P.U. 7 (2002-2003).

Reference: Prefiled Supplementary Evidence, Brockman, p. 8, lines 10-21

Mr. Osler and Mr. P. Bowman suggest that a generation credit for Newfoundland Power's thermal generation is not warranted because the Island Interconnected System is in a "situation of excess capacity until 2011". Mr. Osler and Mr. P. Bowman also expressed concern over the mathematical results of the treatment of the generation credit through the cost of service study. Mr. Osler and Mr. P. Bowman testified the Industrial Customers are paying too much for the thermal generation of Newfoundland Power.

Reference: Prefiled Testimony, Osler and P. Bowman, p. 24, lines 32 to p. 25, line 2
p. 28, lines 24-26
p. 29, line 1
p. 37, lines 25 to p. 38, line 14
Transcript - Osler and P. Bowman, November 13, 2003, p. 46, line 3 to p. 48, line 1

Mr. Haynes did not agree that the system is in a state of excess capacity. All generation connected to the Island Interconnected System, regardless of location, assists in meeting Hydro's capacity criteria and benefits the system. As recently as September 2003, Newfoundland Power has been required to start its gas turbines for system purposes.

Reference: Transcript - Haynes, October 21, p. 17, lines 23-25
Testimony, Haynes, October 20, 2003, p. 187, lines 9-18
Production Evidence, Haynes, Exhibit JRH-3, p. 15
Testimony, Haynes, October 23, 2003, p. 24, line 21 to p. 25, line 9

Generation and transmission additions provide blocks of increased capacity to the system. The size of the block depends on the resource being utilized. It is often the case that a system will have more or less than the exact amount of generation needed at any given point in time. All generation currently on the system (including that owned by Newfoundland Power) provides a benefit to all customers on the system.

Reference: Prefiled Supplementary Evidence, Brockman, p. 6, lines 5-13
Transcript - Haynes, October 20, p. 53, line 24 to p. 56, line 3

Mr. Osler and Mr. P. Bowman's mathematical results are a recalculation of the cost of service study based on removing the generation credit associated with Newfoundland Power's thermal generation. This is equivalent to assuming Newfoundland Power did not own its 43.9 MW of thermal generation.

The reality is Newfoundland Power does own 43.9 MW of thermal generation that reduces the load requirements that Hydro must supply for Newfoundland Power. Consequently, the generation credit reflects the fact that Hydro does not have to serve that load. Therefore, the basis for Mr. Osler's and Mr. P. Bowman's claims does not represent the reality of the Island Interconnected System. Newfoundland Power has thermal generation that reduces the peak requirements to be provided by Hydro. However, Newfoundland Power only operates these facilities for system requirements when required to do so by Hydro in compliance with the *Electrical Power Control Act, 1994*, Section 3(b)(i).

The claim that the Industrial Customers are paying for Newfoundland Power's generation is incorrect. Newfoundland Power's customers pay for Newfoundland Power's generation. If Newfoundland Power's peak demands in Hydro's cost of service study were not reduced by the generation capabilities of Newfoundland Power, the customers of Newfoundland Power would also be paying Hydro for Newfoundland Power's generation through higher purchased power expense.

Reference: Prefiled testimony - Osler and P. Bowman, p. 30, footnote 101
IC-187 NP

Mr. Chymko and Ms. Tabone agreed with the generation credit, but disagreed with reducing the peak demand for allocating transmission costs within the cost of service study. They appeared to recommend the credit be valued as a tariff outside the cost of service study.

Reference: Transcript - Chymko and Tabone, November 19, 2003, p. 156, lines 23-25 and p. 157, lines 23-25

The recommendation of Mr. Chymko and Ms. Tabone that Newfoundland Power should not receive a credit for allocating Hydro's transmission portion of Hydro's demand costs appears to be based on an assumption that Newfoundland Power's generating units are physically located in Hydro's service territory. That assumption is incorrect.

Reference: Evidence, EES Consulting: Cost of Service and Rates, p. 30, lines 7-13
Prefiled Supplementary Evidence, Brockman, p. 6, lines 17-18

Both the hydraulic and thermal generation of Newfoundland Power reduce the demand requirements that exist on Hydro's system.

Reference: Transcript - Perry and Henderson, December 9, 2003, p. 103, lines 15-19

Newfoundland Power submits that

(i) **Newfoundland Power's thermal and hydraulic generation play an important role in Hydro's generation planning and system operations;**

(ii) **The peak demands used in Hydro's cost of service should be net of the capacity Newfoundland Power provides to the Island Interconnected System; and**

(ii) **The Board should approve the continuation of the generation credit to Newfoundland Power, consistent with the Board's determination in Order No. P.U. 7 (2002-2003).**

D.3 Review of Test Year Load Forecasts

Mr. Osler and Mr. P. Bowman make the following recommendation:

> "NP load forecasts need to be reviewed further in the proceeding to assess the extent to which NP's peak demands as currently forecast result in a reasonable allocation of demand costs…."
>
> Reference: Prefiled Testimony, Osler and P. Bowman, p. 3, lines 30-34

Section 3(a)(ii) of the *Electrical Power Control Act, 1994* provides that rates to be charged for the supply of power within Newfoundland and Labrador should be established, where practicable, based on forecast costs.

Hydro's proposed test year cost of service study is provided on a forecast basis. Rates and cost allocations are based on "expected" or "normal" test year conditions. The idea of being over-charged due to forecast variances is inconsistent with the basing of rates on a forecast test year rather than an historic test year. However, all customer load forecasts should be reviewed in a rate case, since they are an important component of the cost of service and rate design.

Reference: Prefiled Supplementary Evidence, Brockman, pp. 9-10

Newfoundland Power is not the end user of the energy it purchases and the accuracy of its demand forecast is significantly affected by the actual weather conditions experienced during the winter season. It is not possible to accurately predict when a demand peak will occur.

Reference: Transcript - Henderson and Perry, December 9, 2003, p. 115, line 5 to p. 116, line 17
Transcript - Haynes, November 12, 2003, p. 189, lines 6-20

A comparison of historic forecast demands and actual demands shows that there is no pattern in the annual variances from Newfoundland Power's demand forecast.

Reference: IC-155 NLH

Following the large forecast variance from the 2002 test year forecast, Newfoundland Power and Hydro agreed on a revised forecast methodology to reflect a longer historic period to provide a reasonable estimate of an expected peak. Basing the demand forecast on a 15-year average of load factor is a reasonable basis for demand forecasting.

Reference: Transcript - Henderson, December 9, 2003, p. 118, line 25 to p. 119, line 16
Transcript - Haynes, November 12, 2003, p. 195, lines 3-10

Newfoundland Power submits that its demand forecast for the 2004 Test Year is reasonable.

E. WHOLESALE RATE STRUCTURE

E.1 General

Newfoundland Power has been billed on an energy-only wholesale rate structure since the 1960's. In the late 1980's, Newfoundland Power raised a concern about the wholesale rate structure in the face of a forecast capacity constraint. At the time, Newfoundland Power believed that a change to a demand/energy wholesale rate could provide benefits to help avoid the significant demand growth that was forecast for the Island Interconnected System. In the early 1990's, demand growth on the system slowed significantly.

Newfoundland Power and Hydro have not been able to reach agreement on a change to a demand/energy wholesale rate.

At the 2001 Hydro GRA, Newfoundland Power and Hydro agreed that the energy-only wholesale rate was an acceptable rate structure and proposed that it be maintained. In Order No. P.U. 7 (2002-2003), the Board ordered that additional evidence be filed on the wholesale rate structure at Hydro's next rate hearing.

Hydro has presented the current application on the basis of an energy-only rate to Newfoundland Power. However, Hydro is recommending that the Board approve the implementation of a demand/energy wholesale rate structure for Newfoundland Power once a number of implementation issues are resolved. Hydro's consultant, Mr.

Greneman acknowledges that the energy-only rate remains a viable option, but believes that there are benefits to changing to a demand/energy rate structure.

Reference: Rates and Customer Services Evidence, Banfield, p. 3, lines 3-27
Cost of Service Evidence, Greneman, p. 14, lines 3-11

Hydro has proposed that the Sample Rate, originally developed by Mr. Greneman for illustrative purposes, be adopted as the wholesale rate ("Sample Rate").

The following section is a review of the characteristics of the Island Interconnected System that are relevant to an understanding of the strengths and weaknesses of the wholesale rate options presented to the Board in this proceeding.

E.2 Characteristics of the Island Interconnected System

The Island Interconnected System is predominantly a hydroelectric system with the remaining generation for the system being substantially provided by the thermal steam system at Holyrood. The Holyrood thermal system and the hydroelectric production facilities on the Island are used for supplying base and peak loads. Since 1998 Hydro has supplemented its supply with non-utility generation (predominantly hydroelectric). The gas turbines and diesel units on the system are used primarily for emergency situations and supplying peaking capacity.

Hydro operates its production facilities to minimize costs and to ensure appropriate security of supply. Hydro varies the production levels at Holyrood according to the hydrological conditions on the Island to ensure adequate supply is available.

Reference: Production Evidence, Haynes, p. 5, line 10 to p. 7, line 10

E.2.1 System Planning and System Expansion

Decisions as to when generation additions are required are based on two criteria: forecast energy shortage and forecast capacity shortfall.

Forecast energy shortages are determined based on Hydro's firm energy criterion. Hydro bases its firm energy capability on the estimated amount of energy that could be produced during the lowest three-year sequence of water flows on record (i.e., mid to late 1950's). If the forecast energy requirements for a future year are greater than the firm energy capability, then Hydro's firm energy criterion is violated. Hydro must then evaluate options to deal with the forecast energy shortage.

Hydro uses a probabilistic approach to determine if enough capacity exists on the system. Hydro analyzes the forced outage rates on the generating equipment in conjunction with the load forecast to ensure that there will be enough capacity to serve total customer loads with the exception of 2.8 hours per year. If the forecast for a future year indicates the loss of load hours (LOLH) will exceed 2.8 hours per year, Hydro must determine how to deal with the forecast capacity shortfall. The LOLH estimate is affected by a number of factors, including changes in load factor, load shape and the forced outage rate of the generators.

Hydro's energy forecast exceeds the firm energy capability of the Island Interconnected System in 2009. Hydro's capacity planning criterion does not show a deficit until 2011.

Reference: Transcript - Haynes, October 20, 2003, p. 138, line 23 to p. 142, line 18 and p. 144, line 19 to p. 145, line 18
Production Evidence, Haynes, p. 37, Table 8 and Schedule II
Transcript - Haynes, October 20, 2003, p. 145, line 19 to p. 147, line 11
IC-392 NLH
Transcript - Haynes, November 12, 2003, p. 199, line 14 to p. 200, line 8

Because the next plant addition is required to meet both demand and energy requirements, implementing a substantial demand reduction program with no associated energy reduction (similar to interruptible load or hot water tank control programs) would not defer the next plant addition.

Reference: NP-154 NLH
Production Evidence, Haynes, p. 37, Table 8
Transcript - Chymko, November 19, 2003, p. 93, line 23 to p. 94, line 12

Hydro did not renew the Interruptible B contract with Abitibi Stephenville priced at $28.20 per kW, when it expired in the spring of 2003. It is Hydro's assessment that the capacity deficit forecast for 2011 would not be impacted if the Interruptible B contract were continued, and the LOLH would only improve marginally for the prior years.

The minimal impact of 46 MW of interruptible load on the system expansion plan appears to be related to the frequency and number of hours the demand reduction could be utilized. As a result, the LOLH calculation used in determining when a capacity shortfall is experienced will not be significantly impacted by demand reduction programs that only impact system peak and have a minimal impact on energy usage.

Consequently, DSM programs that reduce both demand and energy requirements would appear to provide the most benefit in deferring plant additions.

Reference: NP-136 NLH
IC-194 NLH
NP-140 NLH
Production Evidence, Haynes, p. 37, Table 8
Transcript - Haynes, October 21, 2003, p. 50, lines 15-23
Transcript - Banfield, December 2, 2003, p. 84, lines 6-11

E.2.2 System Marginal Costs

Short-run marginal costs are the variable costs of production, namely fuel and variable operating and maintenance expenses. Determining long-run marginal costs requires a calculation of changes in system costs that result from changes in the system expansion plan.

Reference: Prefiled Evidence, Brockman, p. 7, line 8 to p. 8, line 3 and p. 9, line 10 to p. 10, line 11

E.2.2.1 Short-run Marginal Costs

Any reduction in energy usage at a given time of the year, either winter or summer, saves reservoir water, resulting in less use of oil at Holyrood. Therefore, the short-run marginal cost on the Island Interconnected System all year-round is the variable cost of production at Holyrood. The 2004 forecast of the short-run marginal production cost on the Island Interconnected System is 5.13¢ per kWh (i.e., the Holyrood test year fuel cost plus variable operating and maintenance expense).

In the short-term, an increase or a decrease in the peak demand of Newfoundland Power or Industrial Customers does not result in an increase or decrease in Hydro's annual costs.

Reference: IC-127 NLH, p. 29, paragraph 5
Transcript - Haynes, October 20, 2003, p. 167, line 8 to p. 168, line 5 and p. 165, lines 2-5
NP-130 NLH
Prefiled Evidence, Brockman, Exhibit LBB-2, p. 9

E.2.2.2 Long-run Marginal Costs

Hydro has not conducted a long-run marginal cost study since 1984. Because Hydro did not participate in the marginal cost study conducted by Newfoundland Power in 1997, an equivalent peaker approach was used by Newfoundland Power to calculate the long-run marginal generation demand costs on the system. The NARUC Manual states that on a predominantly hydraulic system, the long-run marginal generation cost of demand may be very low. Consequently, the equivalent peaker methodology may not appropriately reflect the marginal generation demand costs on the Island Interconnected System. At the time of filing its marginal cost study with the Board, Newfoundland Power informed the Board it was not comfortable with its estimate of the marginal generation demand costs.

Reference: Transcript - Brockman, November 18, 2003, p. 139, lines 9-19
CA-235 NLH, transmittal letter
Prefiled Evidence, Brockman, p. 10, lines 1-4 and p. 14, lines 7-9
CA-235 NP, Appendix B of Report, NARUC Cost of Service Manual, p. 115, footnote 7

The most recent generation plant constructed by Hydro was Granite Canal. The energy generated by Granite Canal is reducing the energy that is required to be generated at Holyrood. Holyrood fuel is strictly an energy cost. Since the annual cost of Granite Canal and the cost of Holyrood fuel are approximately the same on a cents per kilowatt hour basis, the long-run marginal cost of demand related to Granite Canal is approximately zero.

Determining long-run incremental costs on the Island Interconnected System requires sophisticated computer studies that vary the future demand and energy on the system to determine changes in system costs. For the Island Interconnected System, only Hydro has the information and tools required to accurately perform this type of study.

The following system characteristics are relevant in reviewing the wholesale rate issue:

(i) the next unit of generation on the system is required to serve both energy and demand;

(ii) there is no capacity shortfall projected until 2011;

(iii) the long-run marginal demand cost of Granite Canal was approximately zero; and

(iv) Hydro is currently not willing to pay $28.20 per kW for interruptible load.

Taken together, these support Mr. Brockman's claim that the current long-run marginal generation demand cost is probably between $0.00 and $28.20 per kW per year.

Reference: Transcript - Brockman, November 18, 2003, p. 139, lines 9-19
Production Evidence, Haynes, p. 37, Table 8

The following section is a review of the evidence regarding the performance of the existing energy-only wholesale rate.

E.3 The Energy-Only Wholesale Rate

E.3.1 Impact on System Expansion

Newfoundland Power has been subject to an energy-only wholesale rate structure since it began purchasing power from Hydro in the 1960's. No evidence was presented during the hearing to suggest that demand growth has been higher as a result of the existence of the energy-only wholesale rate.

Since 1980, all of Hydro's new plant additions on the Island Interconnected System have been hydraulic, and Hydro has not built any thermal generation solely to supply peak demand growth. Therefore, since 1980, all generation constructed by Hydro has been to serve the energy requirements and the demand requirements of its customers.

Reference: Transcript - Haynes, October 20, 2003, p. 142, line 19 to p. 144, line 9

The system load factor has increased since 1990 and is forecast to remain stable. No evidence was presented to indicate that the energy-only wholesale rate is negatively impacting the efficient use of electricity on the Island Interconnected System.

Reference: Production Evidence Haynes, p. 37, Table 8
Prefiled Evidence, Brockman, Exhibit LBB-3

E.3.2 Collection of Revenue Requirement

Hydro faces no risk in collecting its revenue requirement from Newfoundland Power under the energy-only rate structure. Any earnings shortfall or earnings gain by Hydro resulting from variances from test year forecast revenue from Newfoundland Power is either recovered or credited to the Rate Stabilization Plan (RSP) through the load variations component.

Reference: Prefiled Evidence, Brockman, p. 4, line 21 to p. 5, line 3
PUB-154 NLH
Transcript - Banfield, December 2, 2003, p. 67, lines 18-21

E.3.3 Fairness

> *"Fairness is generally judged by a cost of service standard. That is, if customers are charged what it costs to serve them, they are being treated fairly."*

Reference: Prefiled Evidence, Brockman, p. 5, lines 16-17

The Industrial Customer class is comprised of several customers, each an end-user with a certain degree of control over its own operating characteristics, and its demand and energy requirements. To ensure intra-class fairness and efficiency, it is necessary to charge these customers on a rate structure that reflects demand, energy and customer components.

Newfoundland Power is not an end-user. Newfoundland Power is the only utility in its customer class. Its usage characteristics are well known by Hydro. The total revenue requirement apportioned to Newfoundland Power through the cost of service study is effectively recovered by Hydro through the energy-only wholesale rate.

The revenue requirement from the Industrial Customers is also determined from the cost of service study. It is not affected by the structure of the wholesale rate to Newfoundland Power. Since total revenue requirements are apportioned to the Industrial Customers and Newfoundland Power directly from the cost of service study, Newfoundland Power's wholesale rate structure is not a factor in the fairness of cost recovery between the two customer classes.

Reference: Prefiled Evidence, Brockman, p. 6, lines 15-18;
Cost of Service Evidence Greneman, Exhibit RDG-2, p. 4

Mr. Chymko testified that one reason supporting a change to a demand/energy wholesale rate is an issue of fairness in relation to the Hydro Rural Interconnected customers. Mr. Chymko testified that the Hydro Rural customers are not being treated fairly because Newfoundland Power is being billed on the energy-only wholesale rate.

The Hydro Rural Interconnected customers are billed on the retail rates of Newfoundland Power. The Hydro Rural Interconnected customers pay approximately 64% of the annual cost to serve them. Given that the customers of Newfoundland Power pay most of the revenue shortfall, it is difficult to accept or understand the argument that the Hydro Rural customers are not being treated fairly in relation to Newfoundland Power.

References: Transcript - Chymko, November 19, 2003, p. 56, line 19 to p. 57, line 5
Cost of Service Evidence, Greneman, Exhibit RDG-1, 2nd Revision, p. 3 of 107, line 6, column 7
Rates and Customer Service Evidence, Banfield, 2nd Revision, p. 6, lines 24-26

E.3.4 Efficiency in System Operations

Newfoundland Power's generation plants are dispatched for overall system requirements through the coordinated efforts of Newfoundland Power's control centre and Hydro's control centre. This coordinated approach to managing the generation resources on the Island Interconnected System promotes least cost operation of the generating facilities on the Island Interconnected System and ensures overall efficiency of operations.

The use of the energy-only wholesale rate is not incompatible with the efficient operation of the Newfoundland Power generation facilities for the benefit of the Island Interconnected System. Newfoundland Power and Hydro operate similar to an integrated utility from a system operations perspective.

Reference: Transcript - Perry and Henderson, December 9, 2003, p. 105, line 19 to p. 106, line 20
Prefiled Supplementary Evidence, Brockman, p. 7, lines 19-22
Cost of Service Evidence, Greneman, Exhibit RDG-2
Transcript - Haynes, October 20, 2003, p. 51, lines 15-23
Transcript - Henderson, December 9, 2003, p. 51, lines 15-23

E.3.5 Proper Price Signals to Customers

E.3.5.1 The Price Signal to Retail Customers

The price signal to all retail customers on the Island Interconnected System, other than the Industrial Customers, is provided by the rates approved for Newfoundland Power. Newfoundland Power's rate designs reflect Island Interconnected System costs and are not influenced by the form of the wholesale rate.

The two main inputs in designing Newfoundland Power's rates are the system's embedded costs and the system's short-run marginal costs. Newfoundland Power uses Hydro's split of demand and energy costs in its cost of service study to ensure fairness in recovering its purchased power expense from its customers. However, the wholesale rate itself is not a factor that is considered in designing retail rates.

Demand charges are applied to customers where it is practical to do so. Newfoundland Power prices the tail-block energy rates to reflect the short-run marginal costs of producing that energy. This approach provides an efficient price signal to retail customers.

Reference: Prefiled Evidence, Perry and Henderson, p. 6, line 13 to p. 8, line 16
Prefiled Evidence, Brockman, p. 1, lines 19-21 and p. 17, lines 10-22

Mr. D. Bowman believes Newfoundland Power should offer rate options to its customers. Mr. D. Bowman and Mr. Brockman agree that a marginal cost study and retail rate design study are required. These studies would assist Newfoundland Power and the Board in evaluating the efficiency of the current retail rate designs and in determining whether any cost effective rate options should be offered to retail customers on the Island Interconnected System.

Mr. Brockman and EES Consulting agreed that the marginal cost study and retail rate design study should be a joint effort of Hydro and Newfoundland Power. Newfoundland Power's marginal costs also impact retail rates.

The current price signal being provided by Newfoundland Power's rates to customers on the Island Interconnected System is not based on the wholesale rate but on the best available system cost information.

Reference: Prefiled Evidence, C. D. Bowman, p. 3 and p. 11, line 16 to p. 12, line 4
Prefiled Supplementary Evidence, Brockman, pp. 2-3
Transcript - Chymko, November 19, 2003, p. 47, line 13 to p. 48, line 14

E.3.5.2 The Price Signal to Newfoundland Power

Economists generally agree that for efficiency the incremental price for a commodity should not be less than the cost of producing it. The energy-only wholesale rate proposed in this proceeding is 5.46 ¢/kWh. This is slightly above the short-run marginal cost of 5.13 ¢/kWh. Therefore, the proposed energy-only rate promotes efficiency. The energy-only rate also prices incremental energy usage the same for all months of the year. This makes economic sense since the short-run marginal cost of energy on the Island Interconnected System is the same for all months of the year.

Reference: Prefiled Evidence, Brockman, p. 15, lines 6-16
Transcript - Haynes, October 20, 2003, p. 167, line 8 to p. 168, line 5

The report of Hydro's cost of service expert, Mr. Greneman, provided as Exhibit RDG-2 entitled "Review of Rate Design for Newfoundland Power" (the "Greneman Report") which recommends a demand/energy wholesale rate, acknowledges that the energy-only rate provides both an energy price signal and a demand price signal to Newfoundland Power. The demand price signal is provided because Newfoundland Power is aware that its peak load is a key driver of the cost that is allocated to it.

Reference: Cost of Service Evidence, Greneman, Exhibit RDG-2, p. 4

E.3.6 Cost Effective Demand Side Management

DSM programs that result in higher rates over the long-term should not be implemented. This criterion is referred to as the Rate Impact Measure test. Proving that cost-effective DSM programs exist is a complicated undertaking. Mr. Brockman's Exhibit LBB-4 discusses the methods for evaluation of DSM programs.

Reference: NP-167 NLH

In Order No. P.U. 19 (2003) following Newfoundland Power's GRA, the Board made the following observations on DSM:

> *"The Board finds it difficult, however, to provide specific and meaningful policy direction to the utilities on DSM and conservation issues in the absence of supporting evidence and related impacts on the system overall. This matter would be most appropriately addressed in the context of a generic hearing involving both utilities and interested parties."*

Newfoundland Power agrees that determining a policy direction on DSM is complex and is best dealt with in a generic hearing once the necessary studies are completed.

Reference: Order No. P.U. 19 (2003), p. 111
Transcript - Perry, December 9, 2003, p. 6, lines 13-17

It is clear from the Board's decision in the Newfoundland Power GRA, and the evidence of experts at this hearing, that DSM programs need to be evaluated against system cost impacts (i.e., marginal costs). There is no evidence to suggest that DSM programs for Newfoundland Power should be justified against its wholesale rate. The structure of the wholesale rate is not a factor in determining cost effective DSM programs.

E.3.7 Rate and Revenue Stability

Rate stability for the utility and its customers is an accepted principle of rate design. The Board has established mechanisms to provide rate stability and revenue stability, such as Newfoundland Power's Weather Normalization Reserve and Hydro's Rate Stabilization Plan. These mechanisms also benefit customers through the avoidance of costly regulatory proceedings due to events beyond the control of Hydro and Newfoundland Power.

Reference: Order No. P.U. 7 (2002-2003), p. 29
Prefiled Evidence, Brockman, p. 3, lines 13 to p. 4, line 2
Prefiled Evidence, Perry and Henderson, p. 8, line 19 to p. 9, line 5

Because the customer base of Newfoundland Power is predominantly residential, Newfoundland Power recovers over 75% of its costs through energy charges. The high proportion of revenue recovered through energy charges combined with the purchased power cost being calculated on energy usage results in a strong relationship between monthly purchased power expense and monthly sales revenue. This strong relationship limits the impact on Newfoundland Power's earnings of energy sales variances from forecast.

Reference: Prefiled Evidence, Perry and Henderson, p. 6, lines 6-8 and p. 13, line 8 to p. 14, line 2

Newfoundland Power is regulated based on an allowed range of rate of return on rate base. Newfoundland Power's 2004 rates are currently based on a rate of return on rate base of 8.91%, within an allowed range of ±18 basis points (i.e., ±0.18%).

For Newfoundland Power, energy sales forecast variances under the existing energy-only rate structure can result in volatility of approximately ±9 basis points in the rate of return on rate base. There is no earnings volatility or uncertainty under the existing energy-only rate structure related to Newfoundland Power's peak demand forecast. Therefore, forecast variance alone will not result in Newfoundland Power going outside the allowed range of rate of return on rate base. The energy-only rate is effective in achieving revenue and rate stability.

Reference: Prefiled Evidence, Perry and Henderson, p. 26, lines 6-14

E.3.8 Summary on the Evaluation of the Energy-Only Wholesale Rate

There is no evidence that the energy-only wholesale rate has negatively impacted system expansion through higher demand growth. In fact, system load factor has increased since 1990.

The energy-only wholesale rate combined with the RSP ensures Hydro will recover its cost of serving Newfoundland Power.

The energy-only wholesale rate does not affect the fairness of the costs allocated between Newfoundland Power, the Industrial Customers and the Hydro Rural customers.

The energy-only wholesale rate is compatible with the efficient operation of Newfoundland Power's generation facilities for the benefit of the Island Interconnected System.

The energy-only wholesale rate allows retail pricing to reflect Island Interconnected System costs, thus providing an efficient pricing signal to customers.

The proposed energy-only wholesale rate is slightly above the short-run marginal cost of producing energy at Holyrood, thus promoting efficiency.

The energy-only wholesale rate is not a factor in determining cost effective DSM programs.

The energy-only wholesale rate is effective in achieving revenue stability to Newfoundland Power and Hydro and, in turn, rate stability to retail customers on the Island Interconnected System.

E.4 Proposal to Move from the Energy-Only Rate Structure

E.4.1 Basis for the Proposed Sample Rate

Hydro's evidence regarding the implementation of a demand/energy wholesale rate is found in the evidence of Mr. Greneman, and in particular the Greneman Report.

The Greneman Report does not recommend a specific demand/energy rate to Newfoundland Power, but rather a demand/energy rate structure based on the rate design principles set out in the Greneman Report. The Greneman Report also recommends:

- i) that Hydro run cases to carefully determine an appropriate demand/ energy balance and impacts on revenue streams;
- ii) that the results of the various cases be shared with Newfoundland Power; and
- iii) that the proposed demand rate be based on discussions between both utilities.

The Greneman Report provides an example of the type of rate structure that is illustrative in form and in operation. The demand charge is set at the full embedded demand cost determined from the 2004 cost of service study and the minimum billing demand is set at 98% of the 2004 forecast peak native load of Newfoundland Power less the generation credit.

Reference: Cost of Service Evidence, Greneman, Exhibit RDG-2, Section 6.3

The Greneman Report recommends that the appropriate demand/energy balance should be further analyzed. The Greneman Report states that there are circumstances where it is desirable to reflect less than the full embedded demand cost in the demand rate. It also states that the demand rate should be set at levels that reasonably reflect the cost of deferring new generating capacity on Hydro's system and that the energy rate should reflect short-run marginal cost.

Reference: Cost of Service Evidence, Greneman, Exhibit RDG-2, p. 11

Hydro has not followed many of the Greneman Report's recommendations in proposing a wholesale demand/energy rate. Rather, Hydro has simply adopted the Sample Rate as the appropriate wholesale demand/energy rate for billing Newfoundland Power.

Reference: NP-126 NLH
NP-127 NLH
NP-129 NLH
NP-130 NLH

NP-154 NLH
CA-203 NLH
CA-131 NLH

The Greneman Report identified four key issues to be addressed in considering the wholesale rate structure:

1) Send a correct price signal to all parties (i.e., encourage DSM programs);
2) Ensure that Hydro and Newfoundland Power remain revenue neutral and avoid earnings (revenue) volatility;
3) Provide Newfoundland Power an incentive to minimize the island peak through use of its generation, rates, and other cost effective means; and
4) Rationalize the rate approach with the treatment of Newfoundland Power's generation in the cost of service study.

Reference: Cost of Service Evidence, Greneman, Exhibit RDG-2, p. 3

The following sections review the evidence regarding Hydro's Sample Rate in relation to these key issues.

E.4.2 Evaluation of the Sample Rate

E.4.2.1 Send a Correct Price Signal to all Parties

Mr. Greneman believes a demand/energy rate can be designed that will provide a proper price signal to Newfoundland Power and its customers. Hydro's Sample Rate is summarized below:

Energy Charge first 420,000,000 kWh - $0.0344/kWh

Energy Charge all over 420,000,000 kWh - $0.0470/kWh

Demand Charge - $7.00/kW of billing demand per month or $84/kW per year

The proposed billing demand is based on the weather normalized single native peak of Newfoundland Power less its generation credit.

Reference: Cost of Service Evidence, Greneman, Exhibit RDG-2, pp. 15-16
Cost of Service Evidence, Greneman, p. 18, lines 5-13

The Price Signal to the End-User

The important price signal is the one sent to the end-user. As explained in Section E.3.5.1, Newfoundland Power's rate designs reflect Island Interconnected System costs and are not influenced by the form of the wholesale rate. Newfoundland Power charges demand rates where reasonable to do so and attempts to reflect system short-run marginal costs in its rate designs. Therefore, the rate design methodology of Newfoundland Power focuses on providing proper price signals to the end-users. Neither Hydro nor Mr. Greneman has reviewed the retail rates of Newfoundland Power.

Because the wholesale rate is not an input in the rate design methodology of Newfoundland Power, a revision to the wholesale rate structure will not affect Newfoundland Power's rate designs. Therefore, there is no reason for moving to a demand/energy wholesale rate to influence the price signal to end-users.

Reference: Cost of Service Evidence, Greneman, p. 18, lines 5-13
Transcript - Wells, October 9, 2003, p. 46, lines 1-4
Transcript - Brockman, November 18, p. 144, line 15 to p. 145, line 4
Prefiled Evidence, Brockman, p. 19, lines 2-20
Transcript - Greneman, November 14, 2003, p. 81, lines 12-19

The Price Signal to Newfoundland Power – Promoting DSM

The Greneman Report emphasizes DSM as an important objective of the price signal to be sent to all parties. The Greneman Report states:

"The demand portion of Hydro's rate will provide Newfoundland Power a quantitative measure against which to develop a viable load management plan."

Reference: Cost of Service Evidence, Greneman, p. 16, lines 15-16

However, as noted in Section E.3.6, for DSM to be cost effective, projects should be evaluated against system cost impacts (i.e., marginal costs). DSM should not be evaluated based on the demand portion of the wholesale rate. The demand charge in Hydro's Sample Rate is based on the embedded, or historical, average system costs. Historical system demand costs may be significantly different than future system demand costs. Using a wholesale rate demand charge to quantitatively evaluate DSM programs is inconsistent with other experts' evidence, Hydro's evidence, and with the report on DSM evaluation methods provided by Mr. Brockman as Exhibit LBB-4.

Reference: NP-167 NLH

Hydro's approach to signalling its customers the requirement for DSM programs appears to be inconsistent. Normally the largest load management opportunities are with commercial and industrial customers rather than residential customers. On the one hand, Hydro has no plans to implement any DSM programs with its major industrial customers and has not renewed the Interruptible B contract. On the other hand, Hydro's Sample Rate would send Newfoundland Power a strong signal to add interruptible load.

Reference: Cost of Service Evidence, Greneman, Exhibit RDG-2, p. 10
Transcript - Banfield, December 2, 2003, p. 81, line 21 to p. 82, line 2, and p. 101, lines 6-22
Transcript - Osler, November 13, 2003, p. 247, lines 13-22
Prefiled Evidence, Brockman, p. 14, lines 7-13

The Price Signal to Newfoundland Power – Demand Price Signal

Mr. Banfield testified that the $84 per kW demand charge reasonably reflects the cost of a peaker. However, Mr. Banfield did not consider the net present value of the peaker to reflect that the capacity criterion is not violated until 2011. Therefore, the peaker proxy of $84 per kW overstates the long-run marginal cost of demand. As explained in Section E.2.2.2, the peaker method may not be appropriate for determining the value of marginal generation demand cost on the Island Interconnected System. Further, Hydro has no plans to install a peaker in 2011.

Under the Sample Rate, Newfoundland Power would save $84 per kW by implementing demand reduction programs such as interruptible load or hot water tank controls that reduce demand only during system peak hours, and are not accompanied by any material reduction in energy consumption. The evidence on the system characteristics (Section E.2.1) shows that such demand reduction programs would have a minimal effect on Hydro's LOLH calculation and, consequently, on the timing of a capacity shortfall.

In light of Hydro's position regarding the Interruptible B contract, the strong emphasis on a demand charge based on the single annual peak is puzzling. The potential $84 per kW savings to Newfoundland Power that would result from expanding its interruptible load program is inconsistent with Hydro not renewing the Interruptible B contract at a cost of $28.20 per kW.

Reference: Prefiled Evidence, Brockman, p. 16, line 22 to p. 17, line 9
Transcript - Perry, December 9, 2003, p. 11, lines 6-24
Transcript - Banfield, December 2, 2003, p. 79, lines 16-21
Transcript - Haynes, November 14, 2003, p. 144, line 20 to p. 145, line 5
Prefiled Supplementary Evidence, Brockman, p. 4, footnote 2
IC-289 NLH

The evidence on system characteristics (Section E.2) indicates that Newfoundland Power cannot impact the current system expansion plan without reducing both energy consumption and demand.

Reference: Transcript - Banfield, December 2, 2003, p. 85, line 16 to p. 87, line 10
Production Evidence, Haynes, p. 37, Table 8

CA-235 NP, Appendix B of Report, NARUC Cost of Service Manual, p. 115, footnote 7
NP-154 NLH

The Price Signal to Newfoundland Power – Energy Price Signal

Because of the large size of the first energy block in the Sample Rate, the price Newfoundland Power would pay for energy for 8 months of the year is 3.44 ¢/kWh. This charge is significantly below the short-run cost of production for all months of the year (i.e., 5.13 ¢/kWh). Pricing energy during the non-winter months at an amount significantly below the cost of producing that energy is not efficient. The 4.70 ¢/kWh energy price that would apply to incremental purchases during the non-winter months is also below the short-run marginal cost.

Reference: Prefiled Evidence, Brockman, p. 15, lines 6-19 to p. 16, lines 1-20

Hydro's Sample Rate does not meet the goal of sending a correct price signal to all parties.

E.4.2.2 The Maintenance of Revenue Stability

As noted in Section E.3.2, Hydro's annual revenue is guaranteed under the energy-only rate and the RSP. The implementation of Hydro's Sample Rate will introduce additional volatility in Hydro's earnings.

Hydro has limited its downside risk by proposing a 98% demand ratchet in its Sample Rate. Conversely, Hydro has proposed no limit on the upside revenue potential from the Sample Rate. Hydro's downside risk is limited to approximately $1.8 million while the upside potential for Hydro is approximately $5 million.

Reference: PUB-152 NLH

Mr. Banfield testified that revenue volatility for Newfoundland Power is a concern only for Newfoundland Power to deal with. However, the revenue volatility associated with the Sample Rate would also increase rate instability for Newfoundland Power's customers. Hydro's retail customers will also be affected by any rate instability that results from implementing a demand/energy wholesale rate.

Reference: Transcript - Banfield, December 2, 2003, p. 93, lines 8-17 and
p. 115, lines 8-24
NP-127 NLH

As explained in Section E.3.7, Newfoundland Power is regulated based on an allowed range of rate of return on rate base and its 2004 rates are set within an allowed range of ±18 basis points. Hydro's Sample Rate would increase earnings volatility for Newfoundland Power. The increased potential earnings volatility has two sources:

1. increased potential for earnings volatility related to Newfoundland Power's energy sales forecast variances; and

2. the added potential for earnings volatility associated with the introduction of a demand charge.

The combined effect of the change in potential earnings volatility related to Hydro's Sample Rate is shown in the following table.

Newfoundland Power Summary of Potential Change in Rate of Return on Rate Base (Basis Points)			
	Energy-Only Rate	**Sample Rate**	
	Increase/Decrease	**Increase**	**Decrease**
Energy Forecast Variance	±9	+30	-30
Peak Demand Forecast Variance	±0	+17	-47
Total	**±9**	**+47**	**-77**

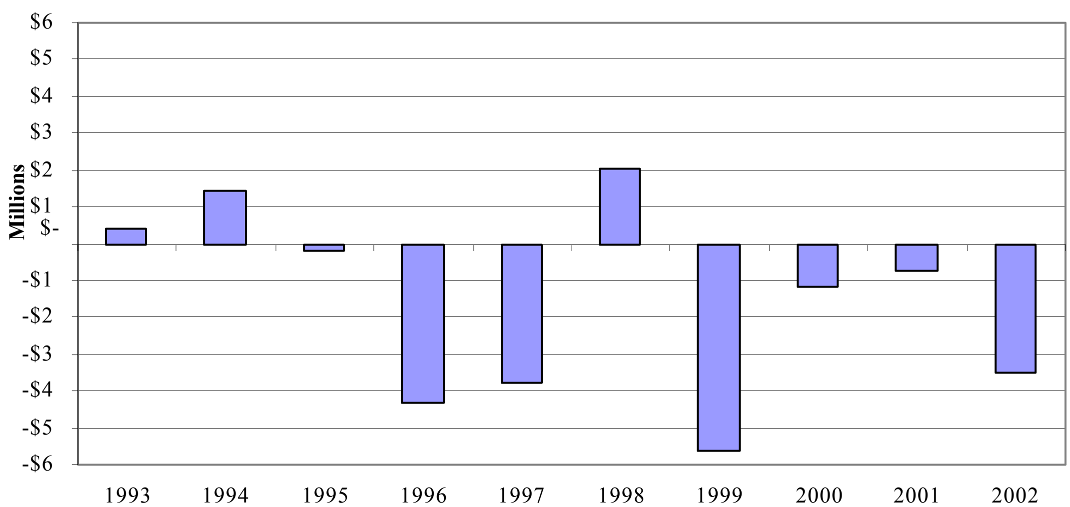
The increased downside potential for earnings volatility from -9 basis points to -77 basis points represents a potential change in pre-tax earnings loss from \$0.9 million to \$8.3 million. This potential earnings volatility would have a negative effect on the rate stability that customers have experienced under the energy-only wholesale rate and the ability of Newfoundland Power to earn a just and reasonable rate of return on rate base.

Reference: Prefiled Evidence, Perry and Henderson, p. 1, lines 18-24 and p. 25, line 9 to p. 26, line 4

Chart 3 of U NP#2 (provided below) shows the pro-forma difference in Newfoundland Power's pre-tax earnings in moving from the energy-only rate to Hydro's Sample Rate based on the actual variances from forecast experienced during the period 1993 to 2002.

Chart 3 shows that, for 7 of the 10 years, the earnings of Newfoundland Power would have been negatively affected. Furthermore, the negative earnings impacts are larger than the positive earnings impacts primarily because of the floor proposed by Hydro in conjunction with the Sample Rate to minimize Hydro's earnings risk.

Chart 3
Difference in Pre-tax Earnings of Newfoundland Power in Changing from Energy-Only Rate to Sample Rate



Note: Positive numbers indicate increased pre-tax earnings and vice versa .

The implementation of Hydro's Sample Rate will result in additional rate instability to retail customers of Newfoundland Power and Hydro Rural retail customers.

Reference: Prefiled Evidence, Perry and Henderson, p. 27, lines 9-20

Mr. Greneman testified that increased volatility goes hand in hand with a demand/energy rate structure. Mr. Greneman did not view the potential earnings volatility as extreme. Mr. Greneman testified:

> *"…it's only plus or minus $5 million over their total earnings, and that's not a humongous number".*

However, Mr. Perry pointed out that $5 million would have a very significant impact on Newfoundland Power and its customers. One option to solve the earnings volatility issue would be the implementation of a reserve mechanism to ensure Newfoundland Power recovers it purchased power costs from its customers. However, the creation of the reserve mechanism would not avoid the issue of rate instability for customers.

In conclusion, implementing Hydro's Sample Rate would not resolve the key issue of earnings volatility and would likely create rate instability.

Reference: Transcript - Greneman, November 14, 2003, p. 13, line 11 to p. 14, line 12 and p. 18, lines 2-9
Transcript - Perry and Henderson, December 9, 2003, p. 25, lines 3-12; p. 37, lines 6-8 and p. 89, lines 10-14

E.4.2.3 Provide Newfoundland Power an Incentive to Minimize the Island Peak Through Use of Generation, Rates or Other Cost Effective Means

Hydro, Mr. Greneman and most other experts agreed that it was not appropriate to change the existing coordinated dispatch of Newfoundland Power's generation at system peak.

The evidence reviewed in Section E.4.2.1 indicates that the Sample Rate:

1) would not affect retail rate designs that already reflect system costs;
2) should not be used to evaluate DSM projects and may actually send the wrong signal for implementing cost effective DSM projects; and
3) would not send an efficient pricing signal to Newfoundland Power.

The provision of a proper signal to Newfoundland Power with respect to the operation of its generation is dealt with in the following section.

E.4.2.4 *Rationalize the Rate Approach with the Treatment of Newfoundland Power's Generation in the Cost of Service Study*

Newfoundland Power operates its generating facilities in the best interests of the overall system in accordance with Section 3(b)(i) of the *Electrical Power Control Act, 1994* which states that all sources and facilities for the production, transmission and distribution of power in the Province should be managed and operated in a manner that would result in the most efficient production, transmission and distribution of power.

Mr. Perry testified that Newfoundland Power will continue to operate its generation facilities in the most efficient manner in accordance with the *Electrical Power Control Act, 1994*, irrespective of the wholesale rate structure.

Mr. Greneman's evidence indicates that the wholesale rate should continue to be "generation independent" as is currently the case. Mr. Greneman, Mr. Haynes and Mr. Banfield all testified that no change is desired in the current approach to managing the generation resources of Newfoundland Power.

The Greneman Report recommends that Newfoundland Power's billing demand be calculated as the native peak of Newfoundland Power less the generation credit (referred to as Option A). This is the appropriate approach as it does not signal the need for Newfoundland Power to operate its hydraulic generation at peak any differently than under the energy-only rate structure.

Reference: Cost of Service Evidence, Greneman, Exhibit RDG-2, pp. 3, 4, 6, 7, 9 and 17
Transcript - Perry and Henderson, December 9, 2003, p. 90, line 8 to p. 94, line 17
Transcript - Banfield, December 2, 2003, p. 98, line 14 to p. 99, line 2
Transcript - Greneman, November 14, 2003, p. 96, line 21 to p. 97, line 12
Transcript - Haynes, October 21, 2003, p. 17, line 5 to p. 18, line 10

However, the Sample Rate would provide an incentive for Newfoundland Power to shift water storage from non-winter months to winter months to reduce purchased power expense. This shift in storage would increase the likelihood of spillage, thus increasing costs to customers over the longer term. Therefore, Hydro's Sample Rate is not consistent with the objective of generation independence for the operation of Newfoundland Power's hydro plants.

The Board should not approve a wholesale rate that inappropriately sends a signal regarding the operation of Newfoundland Power's hydro plants. Mr. Osler testified that a rate should not be designed that invites inappropriate system operations.

Reference: Transcript - Henderson and Perry, December 9, 2003, p. 90, line 8 to p. 94, line 17
Prefiled Evidence, Perry and Henderson, p. 29, lines 3-10
Transcript - Osler, November 13, 2003, p. 266, line 13 to p. 267, line 24

E.4.2.5 Summary of the Evaluation of the Sample Rate

The most important price signal is the one sent to the end-user. Newfoundland Power's retail rate designs are not influenced by the wholesale rate structure.

The proposed demand charge in the Sample Rate is too high, based on the information available on long-run marginal costs. The proposed energy charges in the Sample Rate are below short-run marginal cost, and thus would promote inefficient use of resources.

Hydro's Sample Rate would give Newfoundland Power a signal to pay $84 per kW to reduce its annual peak through the addition of interruptible load. However, Hydro is not willing to pay $28.20 per kW for interruptible load. This approach is inconsistent.

The implementation of Hydro's Sample Rate will introduce significant volatility in the earnings of Newfoundland Power and will create rate instability for retail customers on the Island Interconnected System. It would also increase earnings volatility for Hydro.

If Hydro's Sample Rate were implemented, Newfoundland Power would need to implement a recovery mechanism to ensure recovery of its purchased power costs from its customers.

The Sample Rate would provide an incentive to reduce the system peak. However, the emphasis on demand charges based on a single peak may not be a correct price signal, and could lead to inappropriate decisions in the implementation of DSM programs. The wholesale rate is not a factor in determining cost effective DSM programs.

Hydro's Sample Rate does meet the objective of generation independence for the thermal generation of Newfoundland Power. However, it sends an inappropriate signal regarding the operation of Newfoundland Power's hydro plants.

In conclusion, Newfoundland Power submits that Hydro's Sample Rate does not promote efficiency, creates unnecessary revenue volatility and rate instability, and should not be implemented.

E.5 EES Wholesale Demand/Energy Rate Design

EES Consultants suggested a demand/energy wholesale rate option during cross-examination, testifying that Hydro's proposal for an $84 per kW demand charge based on peak demand was too high. They proposed a demand charge of $51 per kW per year. The energy charge proposed was 4.34¢ per kWh for all kWh.

Reference: Transcript - Chymko, November 19, 2003, p. 39, line 12 to p. 42, line 8
p. 85, line 16 to p. 86, line 22
p. 93, line 9 to p. 97, line 16
p. 89, line 22 to p. 90, line 3

Mr. Perry testified that the rate proposed by Mr. Chymko would result in substantial earnings volatility. The proposed energy charge of 4.34 ¢/kWh is approximately 15% below the current estimate of system short-run marginal cost (5.13 ¢/kWh). Ms. Tabone agreed that energy should not ordinarily be sold below the short-run marginal cost of production. If the energy charge was set to equal the short-run marginal cost of energy at 5.13 ¢/kWh, the demand price would be approximately $1 per kW per month ($12 per KW per year).

Reference: Transcript - Chymko, November 19, 2003, p. 99, lines 2-10 and p. 100, lines 23 to p. 102, line 15
Transcript - Perry, December 9, 2003, p. 143, line 18 to p. 144, line 1
Transcript - Tabone, November 19, p. 98, lines 19-25

The demand/energy wholesale rate suggested by EES Consultants does not address the key rate design issues of sending a proper price signal and minimizing revenue volatility.

E.6 Implementation Issues with a Demand/Energy Wholesale Rate

The introduction of a demand/energy wholesale rate structure for Newfoundland Power would require resolution of the following implementation issues:

1) Design of a reasonable demand/energy rate based upon the characteristics of the Island Interconnected System;
2) Development of a weather normalization methodology for demand;
3) Month of implementation to ensure calendar year revenue neutrality while moving from the energy-only rate to a demand/energy rate;
4) Creation of a reserve to ensure Newfoundland Power is permitted to recover its annual purchased power expense and earn a just and reasonable rate of return on rate base; and
5) Resolution of some minor metering issues.

E.6.1 Demand/Energy Rate Design

Any attempt to implement a demand/energy rate without a marginal cost study would require the Board to guess at the appropriate demand/energy balance. A marginal cost study is required to ensure that any demand/energy wholesale rate will promote efficiency.

Reference: Transcript - Brockman, November 18, 2003, p. 10, line 25 to p. 14, line 22

At Hydro's 2001 Rate Hearing, Mr. D. Bowman, the Consumer Advocate's expert testified he would need to see marginal costs before recommending a demand rate to the Board. In this proceeding, Mr. D. Bowman testified he would still like to see what the marginal costs are when designing a rate.

Mr. Chymko testified that an integrated resource plan and marginal cost study should be undertaken very quickly. Without that information, the Board does not know the appropriate price balance for demand and energy in evaluating DSM and rate design.

Newfoundland Power submits that, if a demand/energy wholesale rate is to be implemented, long-run marginal cost information is required to design an efficient demand/energy wholesale rate.

Reference: Transcript - C. D. Bowman, November 17, 2003, p. 94, line 1 to p. 95, line 4
Transcript – Chymko, November 19, p.96, line 7 to p.97, line 17

E.6.2 Weather Normalization of Demand

The Greneman Report recognizes that one of the concerns about implementing a demand/energy rate is the potential volatility in earnings due to weather variations. The Greneman Report recommends that the rate design should recognize only the relevant variables in determining the billing demand by normalizing for the effects of weather.

Hydro currently uses a weather adjustment model that estimates the weather-related portion of system peak. The Greneman Report has presented options for a weather normalization methodology for demand in Appendix 1.

Reference: Cost of Service Evidence, Greneman, Exhibit RDG-2, p. 5, 12 and pages 18-19

Based on the results of the weather normalization method currently available, the potential financial impact of demand forecast variances on Newfoundland Power and its customers is severe. Therefore, the current weather normalization methodology does not sufficiently address the potential for earnings volatility under the proposed Sample Rate.

Newfoundland Power submits that, if a demand/energy wholesale rate is to be implemented, the use of weather normalized billing demand is required. However, Newfoundland Power believes that an improved methodology is required.

Reference: Transcript - Perry, December 9, 2003, p. 35, line 17 to p. 37, line 8
PUB-151 NLH
PUB-152 NLH

E.6.3 Revenue Neutrality

If the implementation of a demand/energy rate were to occur other than on January 1st , the amount of revenue collected for the remainder of the year could differ significantly from the revenue that would be collected under the energy-only wholesale rate. For example, if the Sample Rate were implemented on April 1st 2004, Hydro would collect approximately $5 million more (solely as a result of timing) during the remainder of 2004 than if the energy-only wholesale rate remained in effect. The amount would vary significantly depending on the month of implementation.

Reference: Transcript - Perry, December 9, 2003, p. 13, lines 4-16

Newfoundland Power submits that, if a demand/energy wholesale rate is to be implemented, the Board should ensure that revenue neutrality is maintained during the calendar year of implementation. This can best be achieved by implementing the change on January 1st of that year.

E.6.4 Reserve Mechanism

Section 80(2) of the *Public Utilities Act* entitles Newfoundland Power to recover its purchased power expense from its customers.

The potential earnings losses illustrated in Section E.4.2.2 as a result of implementing Hydro's Sample Rate would not be recovered in Newfoundland Power's customer rates unless the customer rates are modified.

In Canada, there is a propensity to have rate adjustment mechanisms among investor-owned distribution utilities to deal with purchased power cost volatility. The response to

CA-238 NP provides a description of the mechanisms in place for Aquila Networks BC, EPCOR and ENMAX in Alberta, Ontario Utilities, and Maritime Electric.

Reference: Prefiled Evidence, Brockman, p. 21, lines 6-8

The earnings volatility of Newfoundland Power under the energy-only wholesale rate already has potential to consume approximately half of the range of rate of return on rate base. Mr. Perry explained that even if the wholesale rate were modified to include a demand charge of $1 per kW per month with an energy charge of 5.13¢ per kWh, the potential earnings volatility would consume the entire range of rate of return on rate base. The potential earnings volatility with Hydro's Sample Rate would consume more than four times the range or nine times the current level of potential earnings volatility under the energy-only wholesale rate.

Reference: Transcript - Perry, December 9, 2003, p. 6, line 19 to p. 8, line 11

Mr. Perry explained that a reserve mechanism would be required for Newfoundland Power to deal with the increased earnings volatility that would result if a demand/energy rate were implemented. The reserve mechanism could provide for a July 1st adjustment to customer rates.

Reference: Transcript - Perry, December 9, 2003, p. 35, line 17 to p. 37, line 8 and p. 154, line 7 to p. 155, line 2

Newfoundland Power submits that, if a demand/energy wholesale rate is to be implemented, a reserve should be established to deal with variances in purchased power expense. The reserve should be implemented in concert with the change in the wholesale rate structure.

E.7 Conclusion

A review of the evidence on the wholesale rate options presented to the Board leads to the following conclusions:

1) **Retail rate designs should not be based on the wholesale rate but on system costs;**
2) **DSM evaluations should not be based on the wholesale rate but on the impacts on future system costs;**
3) **The cost effectiveness of rate options to customers can only be determined based on their effects on future system costs;**
4) **The current energy-only wholesale rate is compatible with efficient operation of generation on the system;**
5) **The movement to a demand/energy wholesale rate would result in increased earnings volatility for the utilities;**
6) **The movement to a demand/energy wholesale rate would result in reduced rate stability for customers; and**
7) **The movement to a demand/energy wholesale rate would provide no benefits to customers.**

A long-run marginal cost and retail rate design study is required to permit implementation of cost effective DSM and to evaluate the efficiency of retail rate designs. Newfoundland Power would review the results of the study to determine what action, if any, is required in the areas of rate design and DSM.

Newfoundland Power is currently undertaking a load research program that will provide usage pattern information to be used in evaluating the fairness of its retail rate designs. Newfoundland Power currently uses the short-run marginal costs as an input in rate design. Information from a long-run marginal cost study and a retail rate design study will provide further information to evaluate the efficiency of retail rate designs.

Improvements in system efficiency can only be achieved if proper signals are sent to the end users. The structure of the wholesale rate to Newfoundland Power does not affect these signals and does not need to be changed.

The current energy-only wholesale rate structure to Newfoundland Power should be maintained.

F. RURAL DEFICIT

F.1 Managing the Rural Deficit

F.1.1 General

Hydro owns and operates 24 diesel generating plants serving 4,400 customers on isolated systems. Hydro also serves 21,800 rural customers on the Island Interconnected System. The rural deficit is the difference between the cost of providing service to those rural customers and the revenues collected from those customers. Until 1989, the rural deficit was funded by Government. The cost is currently borne by customers of Newfoundland Power and by the customers served by Hydro's Labrador Interconnected System. In 1999, the Industrial Customers of Hydro were relieved by legislation of the responsibility for sharing in the rural deficit.

The forecast rural deficit for the 2004 test year is $41.1 million. Approximately $36.4 million is proposed to be included in the 2004 revenue requirement from Newfoundland Power and $4.7 million is proposed to be included in the 2004 revenue requirement from Rural Labrador Interconnected. The rural deficit increases the revenue requirement from Newfoundland Power by 17% and increases the rates paid by the customers of Newfoundland Power by approximately 10%.

Reference: Corporate Overview Evidence, Wells, Schedule II, Rural Deficit Issue, pp. 1-2 of 14
Cost of Service Evidence, Greneman, Exhibit RDG-1 Rev. 2, p. 3 of 107
Transcript - Wells, October 7, 2003, p. 123, lines 1-7

In Order No. P.U. 7 (2002 – 2003), the Board acknowledged the burden that the rural deficit places on subsidizing ratepayers and expressed concern with the potential for increasing levels of subsidization.

Reference: Order No. P.U. 7 (2002 – 2003), p. 126

F.1.2 Minimizing the Rural Deficit

Hydro has implemented a number of cost reduction initiatives to reduce the rural deficit. The initiatives identified by Hydro include: interconnection of a number of diesel areas to the main grid; a reduction in the number of operating and support personnel; the implementation of reliability-centered maintenance practices; and savings achieved through conservation initiatives in high cost diesel areas.

While Government policy for rural rates and the cost of service assignment of assets are generally outside of Hydro's control, Hydro can influence the level of the rural deficit by being as efficient and innovative as possible in its operations.

Reference: Corporate Overview Evidence, Wells, 1st Revision, p. 25, line 30 to p. 26, line 17
Transcript - Martin, October 24, 2003, p. 96, line 23 to p. 98, line 7

In spite of Hydro's initiatives to date, the rural deficit is forecast to continue to increase. For example, the projected rural deficit for 2007 is $44 million.

Reference: NP-56 NLH

F.1.3 Contributors to Rural Deficit Growth

The rural deficit allocated to the L'Anse au Loup system has increased by approximately $200,000 from 1999 to 2004.

Reference: Transcript - Wells, October 7, 2003, p. 144, line 21 to p. 145, line 18

Hydro's generation reliability criterion for isolated systems requires Hydro to maintain firm generation capacity to meet the system peak load. Firm generation capacity is defined as the total installed capacity on the system minus the largest single unit.

Reference: NP-41 NLH

As a result of the demand growth on the L'Anse au Loup system that resulted from shifting from diesel rates to Newfoundland Power rates, Hydro is considering an increase in diesel capacity in L'Anse au Loup for reliability purposes in 2005. The cost of a 500 kW diesel generator is approximately $500,000.

Reference: CA-14 NLH, p. 4
Transcript - Martin, October 27, 2003, p. 54, lines 4-9

In Charlottetown and Little Bay Islands, Hydro recently installed additional generating equipment as a result of the addition of a major general service customer in each location.

Reference: NP-50 NLH
NP-209 NLH
Transcript - Martin, October 27, 2003, p. 64, line 10 to p. 65, line 6

Recovery of depreciation and finance costs associated with the capital addition in Charlottetown impacts the rural deficit by approximately $170,000 annually.

Reference: NP-51 NLH

Twice in the mid 1990's, Hydro reported that a new policy to recover the capital cost of installing generation equipment at the request of a major new general service customer would be implemented. This policy has not been implemented. If it had, the impact of the generation additions at Charlottetown and Little Bay Islands would have been lessened.

Reference: NP-52 NLH, p.5.14
NP-53 NLH, p.32
NP-209 NLH

F.1.4 Monitoring the Rural Deficit

The Board's Financial Consultant is of the view that provision to the Board of information on the impact of proposed capital projects on the rural deficit, when significant, would be useful. The Board's Financial Consultant is also of the view that an annual report to inform the Board of factors affecting changes in the level of the rural deficit would be useful.

Reference: Transcript - Brushett, December 11, 2003, p. 138, line 13 to p. 140, line 17

Newfoundland Power submits that Hydro should report annually to the Board on the components of the rural deficit. The report should provide an analysis of factors contributing to significant changes in the rural deficit and a 5-year forecast of the rural deficit.

G. CONCLUSION

Newfoundland Power submits that the Board should decide the various issues arising out of Hydro's General Rate Application in accordance with the submissions contained in this Brief of Argument.

Newfoundland Power also submits that the Board should make its determination on the issues upon which the parties have agreed in accordance with the proposed resolution in the Mediation Report on Cost of Service and Rate Design Issues dated October 3, 2003, filed as Consent #1.

RESPECTFULLY SUBMITTED

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