Q. Provide the reports on the annual reviews of Hydro conducted by the Board's financial consultants for each year for the period 1998 to 2002.

A. Attached are the reports on the annual reviews of Hydro conducted by the Board's financial consultants for each year for the period 1998 to 2000. The 2001 and 2002 reports have not been received by Hydro.

NP-23 NLH

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Board of Commissioners of Public Utilities 1998 Annual Financial Review of Newfoundland and Labrador Hydro

Contents

Introduction

This report to the Board of Commissioners of Public Utilities ("the Board") presents our observations, findings and recommendations with respect to our 1998 Annual Review of Newfoundland and Labrador Hydro ("the Company")("Hydro").

Scope and Limitations

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

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

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

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

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

4. Verify Hydro's reconciliation of Net income to Revenue Requirement for 1998. Review and assess the reasonableness of adjustments in the calculation of revenue requirement.

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

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

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

8. Review Minutes of Board of Director's and Management Committee meetings.

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

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

11. Review as ordered in Board Order P.U.4 (1997-98), the implementation of the undertakings of Hydro in respect to the revised CICA policy.

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

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

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

The financial statements of the Company for the year ended December 31, 1998 have been audited by Ernst and Young LLP, Chartered Accountants, who have expressed their opinion on the fairness of the statements in their report dated February 16, 1999. In the course of completing our procedures we have, in certain circumstances, referred to the audited financial statements and the historical financial information contained therein.

Accounting System and Code of Accounts

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

During 1998 Hydro implemented its new accounting system, J.D. Edwards. This new system resulted in a new chart of accounts, and several changes in a number of the account groupings.

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

We have reviewed the new chart of accounts and advise that the changes have no impact on the quality of Hydro's financial reporting.

We suggest that Hydro submit its new system of accounts to the Board for their review in accordance with Section 58 of the *Public Utilities Act.*

Return on Rate Base

We have calculated the return on rate base for 1998 at 9.90% as compared to 10.94% for 1997 and 10.55% for 1996. Details with respect to the calculation of average rate base and return on rate base are as follows:

(000)'s	1998	1997	1996
Plant investment	$ 1,637,600	$ 1,616,700	$ 1,597,700
Less: Accumulated depreciation	(328,400)	(299,300)	(271,600)
CIAC's	(90,500)	(89,400)	(90,400)
	1,218,700	1,228,000	1,235,700
Balance previous year	1,228,000	1,235,700	1,232,600
Average	1,223,350	1,231,850	1,234,150
Cash working capital allowance	2,100	2,100	2,100
Materials and supplies	25,330	30,100	32,200
Average rate base	$ 1,250,780	$ 1,264,050	$ 1,268,450
Net income (as adjusted per Schedule 3)	$ 25,004	$ 31,351	$ 20,693
Hydro net interest expense	98,800	106,900	113,100
Adjusted net income	$ 123,804	$ 138,251	$ 133,793
Return on rate base	**9.90%**	**10.94%**	**10.55%**

The above calculation excludes the profit contribution of approximately $26 million from the Hydro Quebec recall. The return on rate base would be 11.98% if this profit contribution was included in the 1998 net income.

We have calculated the average rate base for Hydro using the methodology and criteria employed by Newfoundland Power Inc. As noted in our previous reports, it is obvious that at the first rate hearing under the new regulatory process the rate base of Hydro will have to be formally defined and approved by the Board. However, until the rate base is fixed and approved, utilization of the above methodology and criteria provides a reasonable indication of the return on rate base achieved by Hydro.

The calculation of the rate base is covered in Section 17(2) of the Hydro Corporation Act (as amended by Bill 35) and in Section 78 of the Public Utilities Act. The amended Section 17(2) of the Hydro Corporation Act states as follows:

> *"For all purposes of the Public Utilities Act, the rate base of the corporation shall include the property and assets of the corporation at their net book value but excludes investments in subsidiaries of the corporation."*

Section 78 of the Public Utilities Act is more detailed and specific in terms of determining what may be included in the rate base of the utility.

In our 1995 report we indicated that there may be an issue with respect to the interpretation and application of Section 17(2) of the Hydro Corporation Act and Section 78 of the Public Utilities Act for purposes of establishing the rate base of Hydro. We understand that legal counsel for the Board is reviewing this matter. This matter will be addressed in the course of reviewing and fixing Hydro's rate base at a formal hearing.

Return on Equity

The return on equity for 1998 has been calculated at 8.74% as follows:

(000)'s	1998	1997	1996
Shareholder's equity			
1998	$ 292,650		
1997	279,500	$ 279,500	
1996		261,000	$ 261,000
1995			250,600
Average equity	$ 286,075	$ 270,250	$ 255,800
Net income (as adjusted per Schedule 3)	$ 25,004	$ 31,351	$ 20,693
Return on equity	**8.74%**	**11.60%**	**8.09%**

The above calculation excludes the profit contribution of approximately $26 million from the Hydro Quebec recall. The return on equity would be 17.08% if this profit contribution was included in the 1998 net income.

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

	1998	1997	1996
Equity per non-consolidated financial statements	$ 591,650	$ 538,800	$ 516,300
Less:			
Contributed capital			
- Lower Churchill Development	(15,400)	(15,400)	(15,400)
- Muskrat Falls Project	(2,200)	(2,200)	(2,200)
Share capital issued to finance investment in CF(L)Co.	(22,500)	(22,500)	(22,500)
Net retained earnings attributable to CF(L)Co. (income recorded minus dividends flowed through to government)	(232,800)	(219,200)	(215,200)
Net retained earnings attributable to the sale of recall power to Hydro Quebec	(26,100)		
"Regulated Equity"	$ 292,650	$ 279,500	$ 261,000

Interest Coverage

Interest coverage for 1998 has been calculated at 1.42 times as follows:

(000's)	1998	1997	1996
Total interest	$ 100,682	$ 109,636	$ 117,557
Less: CF(L)Co	(1,896)	(2,760)	(4,494)
Hydro net interest	98,786	106,876	113,063
Less: Guarantee fee	(11,153)	(10,745)	(10,389)
Add: Interest earned and IDC			
Power bills	250	268	340
RSP	4,150	3,342	2,014
Sinking funds	28,269	32,172	27,762
IDC	428	391	771
Gross interest	$ 120,730	$ 132,304	$ 133,561
Net income (per Schedule 3)	51,257	$ 30,910	$ 20,127
Gross interest	120,730	132,304	133,561
Adjusted income	$ 171,987	$ 163,214	$ 153,688
Interest Coverage	**1.42**	**1.23**	**1.15**

The gross interest costs declined in 1998 as compared to 1997 as a result of lower average interest rates and net debt retirement, while net income increased substantially as a result of the contribution relating to Hydro Quebec Recall.

Interest coverage has been calculated at 1.21 times when the profit contribution from the Hydro Quebec recall is excluded from net income.

Capital Structure

The capital structure of Hydro, excluding its subsidiary companies, can be determined from Schedule 1. For the years 1996 to 1998, the capital structure was as follows:

(000)'s	1998	%	1997	%	1996	%
Debt	$ 1,165,400	78.5%	$ 1,184,100	80.9%	$ 1,200,900	82.1%
Equity	318,800	21.5%	279,500	19.1%	261,000	17.9%
	$ 1,484,200		$ 1,463,600		$ 1,461,900	

In comparison to 1997, Hydro's debt:equity ratio has improved considerably. This improvement can be attributed to the higher equity level at the end of 1998 which results primarily from the increase in earnings relating to the Hydro Quebec Recall.

For the 1998 fiscal year Hydro declared and paid dividends totaling $16.8 million to the provincial government which included a $4.8 million dividend based on a partial flow through of CF(L)Co revenue. The dividend policy approved by the Board of Directors of Hydro in November, 1995 provides for the payment of dividends annually up to 75% of net operating income provided such payment will not cause the debt: equity ratio to fall below 80:20 that was established in 1995. In addition, the policy provides for the payment annually of all dividends received from CF(L)Co after payment of debt servicing (including $1 million principal) associated with the CF(L)Co loan. The actual dividends paid were well within the policy approved by the Board of Directors of Hydro.

Also in 1998, Hydro retired four bond issues totalling $205 million with interest rates ranging between 10% to 10.25%, and replaced this debt with a new 10 year bond issue of $200 million with an interest rate of 5.5%. This lower cost debt produced interest savings for Hydro in 1998 which will continue in future years.

Other Costs

Schedule 3 of our report provides a breakdown of other costs for the years 1996 to 1998. This schedule shows that the total other costs (before transfers to capital and cost recoveries) have increased in 1998 relative to 1997 by $8.3 million ($91,753,000 - $83,421,000). This 9.9% increase in 1998 is a reversal of the downward trend, which began in 1995.

On a net basis, other costs show a similar trend with an increase in 1998 relative to 1997 of $6.7 million ($80,826,000 - $74,152,000). The lower increase on a net basis is largely attributable to the higher transfers to capital in 1998 as compared to 1997.

The most significant expense variances in 1998 relate to a increase in salaries of $3.1 million and miscellaneous of $2.2 million. The salary increase is partially attributed to an additional $1.8 million cost to support the capital work by internal staff for the P2000 project and Lower Churchill River project. The remaining $1.3 million salary hike is a result of two main factors: 1) a general scale increase of 2% for non-union employees and a 2.5% increase for union employees; and 2) extra maintenance required in the Transmission and Rural Operations division. The increase in miscellaneous is largely attributed to settlement costs paid to two non-utility generators (NUG's) to terminate power purchase agreements with Hydro regarding the development of new small hydro projects.

Schedule 4 of our report provides an analysis of the other costs on a kWh's sold basis for the years 1996 to 1998. This schedule indicates that the total other costs per kWh has resumed an upward trend after declining in 1996 and 1997.

On an individual basis, the various expense categories in other costs showed inconsistent trends in 1998; several categories showed increases, while others showed decreases. Schedule 3 provides the details on expenses for the period 1996 to 1998. We have reviewed the various expense categories on an individual basis and our observations and comments are noted below for your consideration.

Salaries and benefits

Gross payroll costs for 1998 were $54,960,000, which was 5.9%, or $3.1 million higher than 1997 levels. The salary groupings for 1997 and 1996 have been restated to reflect Hydro's code of accounts under the operation of its new computer system. The salaries and benefits costs are summarized below by category:

(000)'s	1998	1997	1996
Salaries	$ 39,386	$ 38,483	$ 39,548
Termination pay		2	2,289
Directors fees	108	102	81
Hourly wages	4,681	4,178	5,530
Overtime	4,074	2,837	2,742
Fringe benefits	5,437	4,849	5,221
Group insurance	1,200	1,382	1,300
Labrador travel benefit	74	72	81
	$ 54,960	$ 51,905	$ 56,792

While salaries and benefits costs increased 5.9% overall, the increase in the regular salaries category was only 2.3% for 1998. The breakdown of salaries only by division is as follows:

(000)'s	1998	1997	1996
Finance	$ 5,261	$ 4,953	$ 5,512
Human resources and legal	2,990	2,880	3,084
Transmission and rural operations (TRO)	17,360	17,389	17,849
Production	12,720	12,256	12,015
Internal audit	194	208	202
Management	861	797	886
	$ 39,386	$ 38,483	$ 39,548

In order to facilitate the review of variances in payroll costs, it is important to look at the breakdown of these costs between operating and capital. In terms of this breakdown it should be noted that with the introduction of a new computer system and code of accounts in 1998, the capitalized expense for non-departmental overhead is now grouped with capitalized salaries. For comparative purposes, 1997 and 1996 figures have been restated to reflect this change. The gross payroll costs for 1996 to 1998 are allocated to operations and capital as follows:

(000)'s	1998	1997	1996
Payroll charged to operating	$ 46,765	$ 45,494	$ 51,266
Payroll charged to capital	8,195	6,411	5,526
	$ 54,960	$ 51,905	$ 56,792

Payroll costs charged to operating in 1998 increased by $1.3 million or 2.8%. This increase is primarily attributable to the following major items:

- During 1996, a new collective agreement was signed with IBEW 1615. This agreement includes a 2.5% increase in each of the three years under the contract, effective April 1996. The majority of the employees represented by IBEW 1615 are within the TRO and Production divisions. They include line workers, system operators, diesel plant operators, mechanics, electricians, etc.

- A general scale increase of 2% was provided to all non-unionized workers and Management Committee in 1998.

- During 1998, extra maintenance requirements in the Transmission and Rural Operations division resulted in increases to hourly wages and overtime.

The payroll costs charged to capital increased by approximately $1.8 million (28%) in 1998 as compared to 1997. The Company has indicated that this increase in payroll charged to capital can be largely attributed to the Project 2000 and the Lower Churchill River Project. Project 2000 included the purchase of an integrated suite of software products (J.D. Edwards). Similar to 1997, this new software package required a significant amount of time in implementation and training, which was charged to the capital project. The Lower Churchill River Project refers to the negotiations with Hydro Quebec relating to hydro electric development on the Lower Churchill River in Labrador. All costs associated with these negotiations are capitalized and reimbursed by the Provincial Government .

Executive salaries for the years 1995 to 1998 are as follows:

	1998	1997	1996	1995
Total executive salaries and benefits	$ 770,999	$ 722,474	$ 814,747	$ 780,333
Number of executives	5	5	6	6
Average salary	$ 154,200	$ 144,495	$ 135,791	$ 130,056

The total executive salaries and benefits and the average salary per executive increased by 6.7% in 1998 in comparison to 1997.

The Compensation Committee recommended salary increases for the President and Vice-Presidents consistent with the increase provided for non-union staff. They also approved progression adjustments within the salary ranges to a maximum of 4%. Salary adjustments were effective January 1, 1998 following an evaluation of their performance.

During 1998, a new Vice-President for the Lower Churchill River Project was hired. This Vice-President is paid by Hydro but his salary is charged 100% to the project and therefore recovered through capitalized expenses. The salary for this Vice-President is not included in the total executive salaries and benefits as he does not participate in the regular duties of the Hydro Management Committee.

The staff complement for 1996 to 1998 is as follows:

	1998	1997	1996
Production	278	277	280
TRO	406	420	424
Finance	121	123	124
Internal audit	4	4	4
Management	9	8	9
Human resources and legal	71	72	77
	889	904	918

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

	1998	1997	1996
Production	271	275	265
TRO	395	407	415
Finance	118	121	122
Internal audit	4	4	4
Management	9	8	9
Human resources and legal	71	72	75
	868	887	890

The above tables reflect staffing numbers as at the end of the fiscal year. Hydro does not calculate and report full time equivalent (FTE) positions on an annual basis. Using FTE's is a more accurate and meaningful measure for analyzing staff levels. As noted in our 1997 report, we suggest that Hydro investigate using this statistic in the future.

The following is a schedule of the average number of temporary employees on staff for 1996 to 1998. The monthly numbers were taken at the end of each particular month.

	1998	1997	1996
January	84	40	67
February	131	61	93
March	107	88	142
April	140	104	132
May	141	125	144
June	236	205	205
July	248	236	254
August	199	189	190
September	195	178	208
October	155	168	196
November	162	129	127
December	99	67	83
Monthly average	158.1	132.5	153.4

System equipment maintenance

In 1998, system equipment maintenance costs decreased from 1997 levels by $183,000. This is in contrast to the significant increase from 1996 to 1997 of $1,212,000. While this overall decrease of 1.6% is only slight, there were some significant variances within the account groupings for this category. The changes in system equipment maintenance costs in 1998 as compared to 1997 are as follows:

• Higher maintenance costs for TRO	$ 1,010,000
• Higher maintenance costs for hydro generation	237,000
• Lower maintenance costs for thermal generation (Holyrood plant)	(1,294,000)
• Lower costs for lubricants, gases and chemicals	(107,000)
• Other miscellaneous variances – net	(29,000)
	$ (183,000)

The costs for 1996 to 1998 for the system equipment maintenance portion of this expense only (excluding tools and equipment, freight and lubricants, gases and chemicals) are broken down by department as follows:

	1998	1997	1996
Transmission and rural operations	$ 4,776	$ 3,766	$ 4,193
Production	5,577	6,572	4,555
Other	8	7	8
	$ 10,361	$ 10,345	$ 8,756

Extra maintenance requirements in the Central and Labrador regions of the province are a significant contributing factor to the increased costs within transmission and rural operations. The extra maintenance requirements in these regions included the following major projects:

• Radiator replacements at Massey Drive	$190,000
• Fall protection equipment	106,000
• Manifolds for two units in Nain, and an overhaul on an additional unit	102,000
• Asbestos removal at Corner Brook frequency convector	65,000
• Replacement of cylinder heads in Makkovik and an overhaul on an additional unit	54,000

In addition, with the introduction of the J.D. Edwards system in 1998 there was a cost coding change that impacted the amount of expenses recorded within system equipment maintenance. Items supplied from inventory for routine operations are now all coded to system equipment maintenance. Some of these items were previously coded to accounts outside the system equipment maintenance grouping such as safety supplies, tools and equipment, etc. This change in method of coding contributes to the increased costs in hydro generation and transmission and rural operations.

With respect to maintenance costs for hydro generation, this increase is related to repairs to governors, bushings, rings, etc. at the Upper Salmon, Bay D'Espoir and Cat Arm hydro plants.

The Holyrood thermal plant costs are as follows:

(000)'s	1998	1997	1996
Unit # 1 overhaul	$ 909	$ 2,669	$ 545
Unit # 2 overhaul	965	1,014	688
Unit # 3 overhaul	1,323	735	289
Annual routine maintenance	1,333	1,202	1,399
Asbestos removal		161	290
Retaining rings			218
Projects		42	276
	$ 4,530	$ 5,823	$ 3,705

Maintenance costs at Holyrood are subject to a high degree of variability due to the fact that required maintenance of the units cannot always be accurately predicted; during overhauls, different areas may be found to be in need of maintenance and the costs can vary greatly.

Based on information provided by the Company, Unit # 1 had a minor overhaul in 1998 verses a major overhaul in 1997. The cost differential between a minor and major overhaul on Unit #1 accounts for a majority of the variance between 1998 and 1997. Unit #'s 2 and 3 each had minor overhauls done in 1998, 1997 and 1996, however the overhaul for Unit #3 in 1998 and Unit #2 in 1997 also included costs relating to work performed on the valves of approximately $277,000.

Insurance (including director's liability)

Insurance costs decreased overall by $168,000 in 1998 as compared to 1997. This drop is largely attributed to a decrease in fees paid to the insurance broker, and a rebate received from Hydro's insurers.

Insurance expense relating to coverage on Boiler and Machinery decreased by $104,000 primarily due to a rebate received from the insurers after Hydro experienced a period with no losses.

During 1998, the total fees paid to Hydro's insurance broker, decreased by $71,000. This decrease is a direct result of a change in policy whereby Hydro is billed for broker fees only as incurred rather than fixed up-front payments. However, this decrease is slightly offset by a $28,000 increase in loss adjustment fees due to an increase in the number of claims filed by Hydro.

Miscellaneous changes to other premiums paid in the year net to a decrease of $21,000.

Transportation

Transportation expense is comprised of aircraft rentals, vehicle expenses (fuel, labour and repairs) and mobile equipment expenses (fuel, labour and repairs). This expense category increased overall by $465,000 (9.55%) in 1998 as compared to 1997. The majority of this increase is due to a higher aircraft rental costs of $267,000 plus an increase in vehicle repairs of $81,000 and mobile equipment repairs of $50,000. Higher vehicle rentals and allowances also increased transportation costs by $67,000.

The combined increase in aircraft rental costs and vehicle and mobile equipment repairs of $398,000 is consistent with the upward trend in maintenance costs incurred by Transmission and Rural Operations. Most of the maintenance work in TRO is completed by internal work forces and in most cases it involves Hydro's vehicles and equipment, as well as the rental of aircraft when working in remote locations. Therefore, an increase in maintenance costs should result in an increase in the transportation costs.

Based on information provided by Hydro, the total number of vehicles and mobile equipment (excluding vehicles/equipment held for auction) has only changed slightly from 1997 to 1998. In 1997 the fleet included 187 vehicles and 181 mobile equipment units in 1998 the Company had 180 vehicles and 189 mobile equipment units.

Office expenses, including membership fees

Office expenses in 1998 (including heat and light, telephone, supplies, postage, advertising, cleaning, office equipment maintenance, books and subscriptions and membership fees) are very comparable to 1997 with a slight decrease of less than $1,000. While the overall variance is small, there were significant variances within the account groupings in this category including a $50,000 decline in telephone and fax and $62,000 decline in heat and light, offset by an increase in office equipment and maintenance of $110,000. Various smaller variances amounted to an additional net increase of $2,000.

Telephone and fax costs continued to decline in 1998 by $62,000 primarily due to the implementation of a new telephone communications system in 1997 in many of its facilities throughout the province and reduced usage in the current year.

Heat and light declined again for the third year in a row mainly because of the warmer weather during the winter months. However, the increased cost of office equipment and maintenance offset these decreases as extra computer equipment was required to support the management information systems.

Building rental and maintenance

Costs in this category in 1998 were significantly higher than 1997 levels by approximately $1.02 million. The increase over 1997 can be attributed primarily to a small number of significant property maintenance projects. Such maintenance requirements included: the replacement of the roof for the Upper Salmon and Cat Arm Plants ($300,000) paving and renovations at Bishop Falls ($151,000) and powerhouse repairs and tank work at Holyrood ($300,000).

These large maintenance projects are not annually recurring items, yet each year this expense category continues to increase. This upward trend should be monitored and if it continues then a more indepth review may be appropriate.

Professional services

In 1998, professional services increased by approximately $770,000 or 29.3% over 1997.

This increase can be attributed primarily to the following major items:

• consulting work for the Reliability Centered Maintenance Pilot Project in transmission and rural operations	$ 250,000
• increased software acquisition and maintenance costs related primarily to the maintenance contract for the new J.D. Edwards software	181,000
• additional management consulting services by KPMG and Towers Perrin	157,000
• increase in Public Utilities Board assessments	90,000

With respect to the variance in this expense category, we have obtained explanations and performed additional analysis where appropriate. Based upon the results of our procedures, we have concluded that the professional services expense variances appear reasonable.

Professional services is another expense category which has exhibited a significant upward trend over the past two years (42% increase from 1996 to 1998). If this trend continues, then a more indepth review of this category may also be appropriate.

Travel and conferences

In 1998, the travel and conference expense category increased from 1997 levels by $255,000 or 13%, travel costs increased from $1.837 million to $2.113 million, and conference costs decreased from $120,000 to $99,000. The most significant increase in travel costs was noted in the transmission and rural operations department, the travel costs in this department increased by approximately $224,000. This increased operational travel is consistent with the increased system maintenance requirements in the transmission and rural operations area.

The decreased spending on conferences is mainly attributable to the destination point of the Canadian Electrical Association (CEA) annual meeting. This meeting was held in Toronto in 1998 as opposed to Vancouver in 1997. Also, aside from the annual CEA meeting, fewer conferences were attended during 1998 than 1997.

Similar to our 1997 findings, we noted during our review of the travel accounts that management travel includes several payments for spousal travel costs. While these items are considered appropriate and are accepted practice by Hydro, we believe that it is not prudent to include expenditures of this nature in the revenue requirement.

Equipment rentals

Equipment rental expense increased by $471,500 or 30.83% in 1998 as compared to 1997. This increase is attributable to a rise in equipment rentals of $238,000 and also in computer costs of $254,000. Other miscellaneous variances result in a net decrease of $20,500.

For equipment rentals, the following factors contributed to the increase:

- telecommunication requirements to increase the bandwidth from Newtel to support various Project 2000 activities created costs of $169,000, and;
- higher maintenance costs throughout the rural areas of transmission and rural operations resulted in extra rental costs of $77,000.

As well, Hydro experienced a general increase in computer costs with the new integrated suite of computer products.

Miscellaneous

In 1998, miscellaneous expense increased by $2,222,000 or 56.7% from 1997. The major variances in this expense category are as follows:

Increase in sundry costs	$1,500,000
Increase in inventory gain/loss	366,000
Increase in PCB costs in 1998	270,000
Increase in payroll taxes and municipal and provincial business taxes	94,500
Increase in employee expenses	42,500
Decrease in demand side management	(51,000)
	$2,222,000

The large increase in sundry costs for 1998 is related to $1,350,000 in settlement costs paid to two Non-Utility Generators (NUGS). In 1998 Government decided to undertake a complete energy policy review and all new small Hydro projects were suspended pending this review. To release Hydro from agreements with two Non-Utility Generators, settlements of $850,000 and $500,000 respectively were negotiated at the Provincial Government's request.

With respect to the other variances noted above, we have obtained explanations and performed additional analysis where appropriate. Based upon the results of these procedures, the miscellaneous expense variances appear reasonable.

Capitalized expenses

Capitalized expenses for 1998 were $8.667 million as compared to $6.897 million for 1997 and $6.074 million in 1996.

With the introduction of a new computer system in 1998 the groupings for capitalized expenses has been changed. The comparative figures for 1997 and 1996 have been restated to reflect this change. The breakdown of capitalized expenses for the three years is as follows:

	1998	1997	1996
Salaries	$ 8,194,967	$ 6,410,656	$ 5,526,111
Fleet expense	381,387	381,542	427,056
Travel direct work orders	90,700	104,357	121,277
	$ 8,667,054	$ 6,896,555	$ 6,074,444

The increase in capitalized salaries for 1998 is largely attributed to time spent on the P2000 project and the Lower Churchill River Project.

The methodology employed by Hydro with respect to capitalizing expenses is outlined below. This methodology has not changed during 1998.

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

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

All categories of capitalized expenditures other than capitalized direct salaries are allocated to work orders using percentages or standard rates developed by the Company. These allocations are intended to ensure that capital projects are adequately charged with the cost of support functions such as accounting and finance, engineering, and other such expenses which cannot be directly charged to specific capital projects.

For 1998, the percentages used to capitalize fringe benefits and overhead costs were as follows:

Benefits (% of direct salaries)	35.9%
Departmental overhead	
Non-field (% of direct salaries and benefits of engineers and office staff)	37.6%
Field (% of salaries and benefits of crews)	19.8%
Non-departmental overhead (% of work order total costs)	6.0%

Intercompany charges

Intercompany charges to CF(L)Co. for 1998 have remained relatively consistent on an overall basis in comparison to prior years. However, as a result of the new coding system implemented during the year, amounts in several categories in 1996 and 1997 have been reclassified to provide a better comparison with 1998. The breakdown of intercompany charges by department is as follows:

	1998	1997	1996
Operations	$ 168,895	$ 234,086	$ 152,319
Finance	1,042,353	1,070,202	1,710,643
Transmission and Rural Operations	20,000	20,000	31,750
Corporate Planning			72,985
Internal Audit	87,055	70,591	78,072
Management	135,379	155,754	174,931
Human Resources and Legal	806,389	820,889	226,285
	$2,260,071	$2,371,522	$2,446,985

These charges are for the provision of services in accordance with a Services Agreement between Hydro and CF(L)Co. Hydro staff prepared an internal review to study the appropriateness of the manner in which these costs were allocated in February, 1992.

As part of our analysis for 1995, we examined the method of allocation of all cost categories and on a test basis, reviewed the support for these allocations. We were able to conclude, based upon our tests, that the costs had been appropriately allocated based upon the February 1992 study. In reviewing the manner in which costs are allocated we observed that many of the methods of allocation are subjective and rely upon the judgment of Hydro management, consequently these allocated costs are not susceptible to proper verification. Considering this limitation however, nothing has come to our attention to indicate that the methods of allocation are unreasonable.

Fuels

In 1998 fuel expense decreased overall by $17,020,000 or 38.8% over 1997. The cost of Bunker "C" fuel (net of RSP recoveries) decreased by approximately $4,950,000 (16.3%) in 1998 as compared to 1997. This reduction is attributable to a decrease in consumption of approximately 390,000 barrels which is consistent with the decline in overall thermal production of 273 GWh or 17.9%.

In addition to the variance in Bunker "C", the changes in the hydraulic production and load variation components of the Rate Stabilization Plan account for a further decrease of $11,572,000 in costs in 1998 in comparison to 1997. The adjustment for hydraulic production (or water variation) is consistent with the decrease in actual hydraulic production in 1998 of approximately 8%. The adjustment for load variation is consistent with the overall decline in energy sales. Energy sales (excluding Hydro Quebec Recall) were down 530 GWh (7.8%) in 1998 in comparison to 1997. All variations relating to the Rate Stabilization Plan are calculated using actual results for the year in comparison to the 1992 cost of service data.

Another significant decrease in this expense category is related to diesel fuel for rural operations. This category decreased by $646,000 due to the interconnection of more customers to the island grid.

Power purchased

During 1998, the Company's purchased power expense increased due to purchasing additional power from a number of suppliers to allow Hydro to fill its excess sales demand over that generated. This increase is consistent with the decrease in thermal and hydraulic production during 1998. Approximately 1,950 GWh's was purchased in 1998 of which 1,249 GWh's was related to the Hydro Quebec Recall. This purchase is a direct result of a three year agreement between Hydro and Hydro Quebec that came into effect on March 9, 1998. This Agreement allows Hydro to recall the remaining power available to it from CF(L)Co and sell it to Hydro Quebec. Both the energy sales to Hydro Quebec and the related power purchased have been eliminated from the revenue requirement.

The Company also purchased power from two non-utility generators at a cost of approximately $2.2 million. This power was purchased at an average cost of $69 per MWH from the Algonquin Project and an average cost of $66 per MWH from Star Lake.

We note that power purchased expense includes an amount of $1.3 million paid to Abitibi Price in Stephenville for the right to interrupt a portion of their power supply should Hydro need the power to meet its own demand. A ten year contract has been signed between Hydro and Abitibi to this effect. This contract was signed in 1994 and has a cancellation clause, which requires a three year notice. Also, included in the purchased power expense is an accrual of approximately $1.7 million relating to the conditional purchase of secondary energy from Abitibi-Price in Stephenville. This conditional

purchase was contingent on Hydro's reservoir storage later in 1999. According to our discussions with Hydro management, this accrual was reversed in 1999, as Hydro's reservoir storage levels were at capacity.

Interest

Interest expense for 1998 dropped considerably compared to 1997, showing a decrease of $8.1 million. This decrease is primarily attributable to the lower interest rate on the new bond issue as compared to the four series which were redeemed during the year.

The following is a summary of interest expense for 1998 and 1997:

(millions)	1998	1997
Gross interest	$119.8	$140.0
Debt guarantee fee	11.5	11.2
Amortization of debt discount and financing costs	1.6	2.1
Foreign exchange losses	1.0	1.0
	133.9	154.3
Less:		
Interest earned	(32.8)	(44.2)
Interest attributable to CF(L)Co share purchase	(1.9)	(2.8)
Interest capitalized during construction	(0.4)	(0.4)
	$98.8	$106.9

In 1998, Hydro again took advantage of the favourable interest rate environment and exercised its call options and redeemed three series of bonds. Together with a fourth series which matured during 1998, the total face value of bonds redeemed was $205 million. These bonds had interest rates varying between 10% and 10.25%. During 1998 Hydro also issued a new series of bonds at an interest rate of 5.5%, face value of $200 million, maturing in 2008.

Overall, long term debt (net of sinking funds) increased by $85.6 million in 1998 but this was more than offset by a reduction in short term promissory notes of $126.6 million, leaving a net reduction in short and long term debt combined of $40.6 million.

Revenue Requirement

Reconciliations of Net Income to Revenue Requirement for the years 1996 to 1998 have been provided in Schedule 3 of our report. Our review of the revenue requirement reconciliation for 1998 included examining support for the adjustments and assessing the reasonableness in comparison to prior years.

In 1998, donations and management contributions of approximately $117,000 have been eliminated from revenue requirement as per the Board's direction.

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

A third adjustment to margin was to eliminate $305,000 in sundry revenue received from Newfoundland Industrial Development Corporation (NIDC) as reimbursement of professional fees and travel costs incurred in 1997 related to the negotiations with Hydro Quebec regarding the Lower Churchill Project.

The final adjustments to the margin were to eliminate $29.864 million in energy sales to Hydro Quebec and $3.786 million in power purchased from Upper Churchill. These adjustments relate to a three-year contract with Hydro Quebec regarding the Hydro Quebec Recall.

These four adjustments combine to decrease the margin (earnings) per Schedule 3 by $26.253 million.

Based on the results of our review procedures, we report that the net income has been appropriately adjusted and that the resulting revenue requirement is consistent with Board directives and prior years.

Depreciation

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

During 1998 Hydro reported depreciation expense of $32.1 million as follows:

Location	Asset Class	Net Cost	Method	1998 Expense
Hydro	Hydraulic stations Terminal stations Transmission lines	$993.8 million	Sinking Fund	$8.2 million
Hydro	All other classes	227.1 million	Straight Line	23.9 million
		$1,220.9 million		$32.1 million

The majority of Hydro's high dollar value capital assets are depreciated using the sinking fund method. As noted above this method is applied to hydraulic stations, terminal stations and transmission lines which account for approximately 81% of the net cost of all capital assets. Depreciation on the remaining classes of assets is calculated using the straight line method.

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

In completing our procedures, we recalculated depreciation for both depreciation methods on a test basis and compared the estimated service lives used in the calculations to the 1986 Peat Marwick Depreciation Policy Study. We also reviewed the interest rates used in calculating sinking fund depreciation for reasonableness. As a result of completing these procedures no significant discrepancies were noted and therefore, we conclude that depreciation expense appears reasonable.

In our 1997 report we provided the Board with the alternatives, observations and recommendations included in a depreciation study conducted by KPMG LLP. The final report relating to this study is dated October 7, 1998. Any recommendations relating to changes in accounting policies or service lives will be included for review and approval of the Board at Hydro's next rate application hearing.

Rate Stabilization Plan

Our examination of the Rate Stabilization Plan (RSP) for 1998 included reviewing the adjustments and components of the Plan in 1998 and assessing their reasonableness and compliance with Board directives. We also assessed the reasonableness of the interest charged and credited to the Plan during the year.

Schedule 5 of our report summarizes the changes in the RSP for the three years from 1996 to 1998. The fuel variation adjustment of approximately $12.1 million represents the most significant change in the plan in 1998. This item is primarily attributable to the difference in the actual fuel cost per barrel in 1998, as compared to the 1992 cost of service price per barrel. Another significant change in 1998 is the amount recovered from consumers of approximately $11.2 million. This increase is attributable to the increase in the mil rate used to recover a portion of the balance in the Rate Stabilization Plan from consumers. The increase in the mil rate is primarily due to the increasing balance in the Rate Stabilization Plan.

Based upon our review, we can conclude that the adjustments made to the RSP in 1998 are reasonable and that it has been operating in accordance with Board directives.

Deferred Charges

The following table shows the transactions in the deferred charges account from 1995 to 1998:

(000)'s	Balance Dec./95	Net Add.	Amort.	Balance Dec./96	Net Add.	Amort.	Balance Dec./97	Net Add.	Amort.	Balance Dec./98
Studies and software	$1,492	$88	($662)	$918	$327	($806)	$439	$429	($271)	$597
CF(L) Co.	227		(77)	150		(142)	$8	335	(50)	$293
Realized foreign exchange losses	17,855	21,574		39,429	56,849		$96,278			$96,278
Unrealized foreign exchange losses		61,499		61,499	(61,499)					
Discounts and issue costs on long term debt	5,984	8,599	(1,161)	13,422	1,395	(2,022)	$12,795	2,738	(1,574)	$13,959
Professional services	370	(370)								
Call option premiums	461	1,989	(2,450)		162	(162)				
	$26,389	$93,379	($4,350)	$115,418	($2,766)	($3,132)	$109,520	$3,502	($1,895)	$111,127

Significant additions to deferred charges during 1998 are as described below: (000's)

Studies and software	
Granite Canal development - environmental studies	$ 287
Software upgrades to electronic mail system	142
	$ 429
CF(L) Co.	
Implementation of J.D. Edwards computer system	$ 335
Discounts on long term debt	
Discount on new series of bonds issued	$ 2,738

Studies and Software

The Granite Lake environmental study was a continuation of the feasibility studies from 1997. The study was required to determine if the construction of a powerhouse on Granite Lake, that would produce 43 megawatts of power should proceed. This study was necessary to protect the project in-service date of June 2000. The estimated cost of completing this study was $660,000, however it was completed at a cost of $286,481.

Based on studies completed by the Company, it was recommended that the Company should use Lotus Notes as an upgrade to their current system which was mainframe based and obsolete. The estimated cost for the software and purchase systems to administer Lotus Notes was $120,000 compared to the actual cost of $109,982.

New Bond Issue

In 1998, Hydro issued a new series of bonds, with a total face value of $200 million, at a market price of $.98642. The resulting discount on the issue of the new bonds (plus small miscellaneous fees) accounts for $2.72 million of the deferred charge addition for bond discounts. The remaining $19,000 relates to the cost associated with the publication of the notice of redemption for previous bond issues, these costs were fully amortized in 1998.

Foreign Exchange Losses

Total deferred foreign exchange losses remained unchanged between 1998 and 1997 at $96.278 million.

As noted in our previous reports, section 17(4) of the Hydro Corporation Act (as amended by Bill 35) states that for purposes of the Public Utilities Act (including Subsection 80(2)), the foreign exchange losses as at December 31, 1994 were considered to be reasonable and prudent expenses of Hydro and therefore properly chargeable to operating account. Section 17(3)(e) establishes the period of amortization for these losses to be 40 years commencing in the year when Hydro's rates are first altered under the Public Utilities Act. If Hydro was to commence amortizing the foreign exchange losses based on the 1998 balance noted above, the annual amortization to be included in the revenue requirement would be $2.4 million.

In 1998 Hydro accrued $1 million towards its foreign exchange losses consistent with prior years and in compliance with the Board's recommendation from the 1992 hearing.

Cost Control/Productivity Initiatives

During 1998, Hydro's management continued their efforts in controlling costs and improving productivity to increase efficiency in Hydro's business operations. The Company has undertaken a number of initiatives to explore the possibility of future savings and increased productivity. Some of the more significant initiatives began in 1997 and were ongoing during 1998. An update on the progress of these initiatives as provided to us by Hydro senior management is outlined below.

Joint Steering Committee (Coordination of Utility Activities)

This is a joint committee consisting of union representatives from Hydro and Newfoundland Power. The Committee was established in early 1997 to review potential opportunities for co-ordination that could result in lowering the overall cost of providing electrical service. The overall mandate of the Steering Committee is to advise and make recommendations to the utilities based on reviews that are carried out on their behalf.

The Committee met on a regular basis during 1998 and during the first part of 1999, however due to difficulties in scheduling meetings there were no meetings held during the latter part of 1999. According to Hydro officials this process has led to the realization of minor savings, however a report has yet to be finalized.

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

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

In our 1997 report, we indicated that Hydro had completed a RCM pilot in each of the following areas: transmission; distribution; and diesel generation.

Based on correspondence from Hydro officials, the results of the three pilots and the recommendations were presented to Management Committee in November 1999 and approval was given to start the implementation in January 2000. They indicated that an implementation team will be trained in the RCM process, templates will be drafted and the analysis of Hydro's systems will be scheduled to start in September 2000.

Proposed New Customer Service Approach

In our 1997 report we indicated that this initiative included the centralization of the co-ordination of all customer services in St. John's. Hydro officials indicated that the Customer Service System was implemented in May 1999. This new system included the following changes:

- Implementation of a toll free number for customer service calls, as well as calls relating to power outages and emergencies.
- Centralization and standardization of collection activity.
- Co-ordination of meter readers duties.
- Implementation of a new integrated utilities customer information system (UCIS) for Hydro rural customers.

Materials Management Department – New Strategies

In 1997, the Director of Materials Management presented a number of strategies to the Management Committee that were expected to result in reduced costs relating to inventory and administration overhead. The strategies include the implementation of blanket contracts where appropriate and multi year agreements with appropriate suppliers.

Based on information from Hydro officials, as of January 2000, Materials Management has awarded nine long-term blanket contracts and there are four additional tenders under evaluation. It was indicated that tenders are being prepared for the remaining material supply and service requirements.

The consolidation of requirements has allowed Hydro to identify where duplication has occurred in the past and to standardize materials and procedures throughout the Hydro Group. Hydro officials hope to achieve significant reductions in procurement and inventory costs when these long-term agreements are fully implemented later in 2000.

Energy Policy Review

As noted in our 1997 report, KPMG LLP began their review of Hydro's corporate structure, staffing, as well as internal and external relationships in the Fall of 1997. The consultants were also planning to assist Hydro in defining an objective set of indicators of corporate performance.

As you are aware, in August 1998, the Provincial Government announced an Energy Policy Review, and as a result it was thought that the role and mandate of Hydro could not be definitively dealt with until the Energy Policy Review was completed, therefore a report was not filed by KPMG LLP.

The Provincial Government has not released any information on this Energy Policy Review to date.

New Initiatives in 1998

The significant initiatives undertaken by Hydro during 1998 are described below:

Diesel Plant Operation Review

A review of the isolated diesel operation systems resulted in a initiative to move to a new classification called Diesel System Representative (DSR). This change should help enhance efficiencies and reduce costs in the rural operations. This initiative started in 1998 and should be fully implemented by 2001. According to Hydro officials the training program started in September 1999 and will continue throughout 2000 and into 2001.

Operator Shift Restructuring at Holyrood

In late 1998, the Operator Shift Restructuring at Holyrood was approved. It is hoped that the restructuring will result in a better trained and qualified work force, as well as being more productive and accountable.

The restructuring was implemented in January 1999 and training has been in progress since that time and will continue for several years. According to Hydro officials, the operators are now preparing permits that were previously prepared by the Shift Supervisor. This allows the Supervisor to have more time to attend to the daily operating issues and be involved in the training process. Hydro officials also indicated that another notable change resulting from this restructuring process is the renewed interest of Operators in plant performance and career advancement.

As part of the annual review process, we will monitor the results of the above initiatives and obtain an update from the Company during the 1999 review.

Contributions in Aid of Construction (CIAC's)

Our procedures in this area included the following:

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

As part of our review, we have held discussions with Mr. Barry Brophy of Hydro regarding the Company's CIAC policies and procedures and we have selected and reviewed documentation supporting a sample of five (5) CIAC calculations prepared during 1998.

Based on the results of our inquiry and review of documentation, we noted that the Board's requirements for the approval, review and calculation processes as specified in P.U.4 (1997-98), are being complied with. However, certain observations were noted during our review which are noted below for your information:

- Hydro essentially uses a manual system to monitor all CIAC quotes. The Company did implement a spreadsheet system in 1997 that is updated on a regular basis for new CIAC quotes. Mr. Brophy indicated that any CIAC quotes prior to 1997 are more difficult to accumulate due to the previous filing system. The most significant deficiency resulting from the manual system is the manual calculation of the individual quotes. However, to compensate, Hydro requires the manual calculations be checked and approved by the appropriate supervisor.

- We also noted that there is no formal two year review process in place as ordered by P.U. 4 (1997-98). The purpose of the review is to ensure all CIAC quotes are reviewed after 24 months for any adjustments for rate changes, etc. However, Hydro staff have implemented an informal annual review process which essentially fulfills this requirement. The CIAC database (spreadsheet) is sorted by region and a listing of all CIAC quotes are sent to each region to be reviewed. Any required adjustments are forwarded to staff at Head Office for updating.

- Hydro does not include sketches with the customer letters.

Based on our discussions, we believe that the shortfalls in Hydro's procedures are mainly due to the manual process. The onus is on the regional technicians who perform the fieldwork to ensure that they have their sketches precise and their line measurements exact. Also, it is the responsibility of the regional offices to ensure all CIAC quotes are documented, filed and reported to Head Office.

As a result of completing our review procedures on the sample of 1998 CIAC calculations, we report the following observations:

- No calculation errors were found in the sample quotes.
- There were several instances where there was no evidence that the specific regional offices reviewed the annual listing of CIAC quotes and provided a response to the Head Office. According to Mr. Brophy, personnel at the regional office may call the Head Office, use email or mail a response.

We recommend that Hydro develop a standardized form that is required to be completed by the appropriate personnel at the regional office indicating their review of the annual CIAC quote listing provided to them by the Head Office. This will ensure that the CIAC's are being reviewed on an annual basis.

During the 1999 annual financial review we will continue to review a sample of the CIAC quotations prepared in 1999, including the administrative processes to ensure the Company is in compliance with the Board Order.

Appendix A

Review Findings Requiring Follow-up

The following is a list of items related to our observations/findings during our review which require follow-up or action on behalf of the parties indicated.

Newfoundland and Labrador Hydro

- Submit its new System of Accounts to the Board for formal review and approval. (Ref. Pg. 3).
- Investigate using calculation of full time equivalent (FTE) positions for purposes of analyzing staffing levels. (Ref. Pg. 13).

Grant Thornton LLP

- Follow-up on 1998 cost control/productivity initiatives during our 1999 annual review. (Ref. Pgs. 29-31).
- During the annual financial review for 1999, review expense categories for increasing trends (eg. building rentals and maintenance, professional services). (Ref. Pgs. 17-18).
- During the annual financial review for 1999, review a sample of the CIAC quotations prepared in 1999, including the administrative processes to ensure the Company is in compliance with Board Order P.U. 4 (1997-98).

Newfoundland and Labrador Hydro

Schedule 1

Balance Sheet

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

(000)'s

	1998	1997	1996
ASSETS			
Fixed assets	$1,234,963	$1,237,986	$ 1,239,375
Current assets	113,363	93,924	89,403
Rate stabilization plan	31,744	28,259	22,442
Long-term receivable	-	-	229
Deferred charges	111,128	109,520	115,419
Total assets	$1,491,198	$1,469,689	$1,466,868
LIABILITIES AND SHAREHOLDER'S EQUITY			
Long-term debt	$ 918,927	$ 793,901	$914,726
Current liabilities			
Accounts payable	71,628	62,809	57,926
Due to affiliates	4,041	3,071	6,562
Promissory notes	83,665	209,896	74,085
Long-term debt within one year	87,127	114,459	147,569
	246,461	390,235	286,142
Unrealized foreign exchange loss provision	7,000	6,000	5,000
Shareholder's equity			
Retained earnings	318,810	279,553	261,000
Total liabilities and equity	$1,491,198	$1,469,689	$1,466,868

Newfoundland and Labrador Hydro

Schedule 2

Statements of Earnings and Retained Earnings
(Excluding CF(L)Co., LCDC and Contributed Capital - Muskrat Falls)

(000)'s

	1998	1997	1996
Revenue	$ 304,196	$ 292,658	$ 287,761
Expenses			
Fuels	26,880	43,900	41,683
Power purchased	13,472	5,692	5,225
Other costs	81,729	75,400	79,027
Depreciation	32,072	29,880	28,639
Interest	98,786	106,876	113,062
	252,939	261,748	267,636
Net earnings	$ 51,257	$ 30,910	$ 20,125
Retained earnings, beginning of year	$ 279,553	$ 261,000	$ 250,563
Net earnings	51,257	30,910	20,125
Dividends	(12,000)	(12,357)	(9,688)
Retained earnings, end of year	$ 318,810	$ 279,553	$ 261,000

Newfoundland and Labrador Hydro

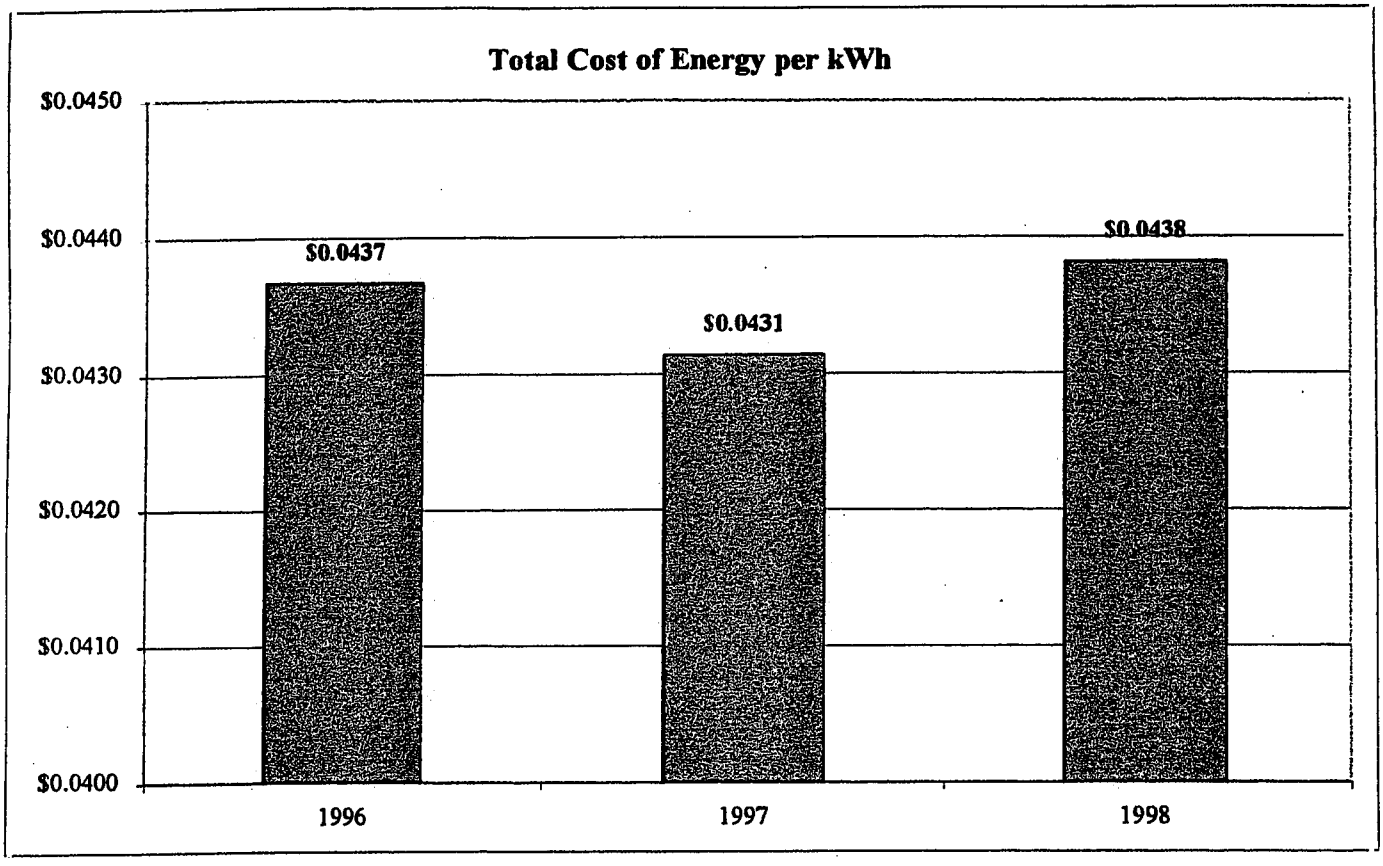
Schedule 3

Reconciliation of Net Income to Revenue Requirement
1996 to 1998

(000)'s	1998			1997			1996		
	Financial Statement	Adjust.	Revenue Require.	Financial Statement	Adjust.	Revenue Require.	Financial Statement	Adjust.	Revenue Require.
Depreciation	$ 32,072	$ 771	$ 32,843	$ 29,880	$ 806	$ 30,686	$ 28,639	$ 662	$ 29,301
Fuel	26,880		26,880	43,900		43,900	41,683		41,683
Power purchased	13,472	(3,786)	9,686	5,692		5,692	5,225		5,225
Other costs									
Salaries	54,960	(56)	54,904	51,905	(42)	51,863	56,792	(68)	56,724
System equip. maint.	11,325	(2)	11,323	11,511	(5)	11,506	10,303	(9)	10,294
Insurance	1,056		1,056	1,224		1,224	1,169		1,169
Transportation	3,642	(1)	3,641	3,177		3,177	3,513		3,513
Office supplies	2,715		2,715	2,716		2,716	2,842		2,842
Bldg. rentals and maint.	3,226		3,226	2,210		2,210	1,931	(1)	1,930
Professional services	3,398		3,398	2,883	(256)	2,627	2,391	(61)	2,330
Travel	2,211		2,211	2,006	(49)	1,957	1,874		1,874
Equipment rentals	2,000		2,000	1,531	(1)	1,530	1,742	(2)	1,740
Miscellaneous	5,927	215	6,142	3,752	168	3,920	4,279	(265)	4,014
Loss on disposal	1,137		1,137	691		691	(110)		(110)
Amortization of studies and software	771	(771)		806	(806)		662	(662)	
Customer costs	332	(332)		298	(298)		225	(225)	
Sub-total	92,700	(947)	91,753	84,710	(1,289)	83,421	87,613	(1,293)	86,320
Allocations									
Other	(44)	44		(42)	42		(65)	65	
Hydro capitalized	(8,667)		(8,667)	(6,897)		(6,897)	(6,074)		(6,074)
C.F.(L) Co.	(2,260)		(2,260)	(2,372)		(2,372)	(2,447)		(2,447)
Sub-total	(10,971)	44	(10,927)	(9,311)	42	(9,269)	(8,586)	65	(8,521)
Total	81,729	(903)	80,826	75,399	(1,247)	74,152	79,027	(1,228)	77,799
Interest	98,786		98,786	106,876		106,876	113,062		113,062
Margin	51,257	(26,253)	25,004	30,910	441	31,351	20,127	566	20,693
Revenue requirement	$304,196	($30,171)	$274,025	$292,657		$292,657	$287,763		$287,763

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

Year	kWh sold and used	Depreciation	Fuel	Purchased Power	Other Costs	Interest	Margin	Total Cost of Energy	Cost per kWh
1996	6,589,000	$ 29,301	$ 41,683	$ 5,225	$ 77,799	$ 113,062	$ 20,693	$ 287,763	$ 0.0437
1997	6,784,000	$ 30,686	$ 43,900	$ 5,692	$ 74,152	$ 106,876	$ 31,351	$ 292,657	$ 0.0431
1998	6,254,000	$ 32,843	$ 26,880	$ 9,686	$ 80,826	$ 98,786	$ 25,004	$ 274,025	$ 0.0438

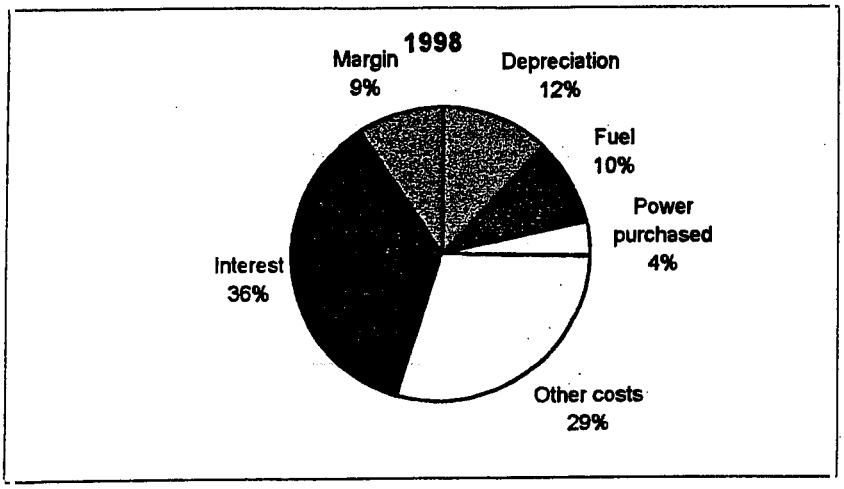


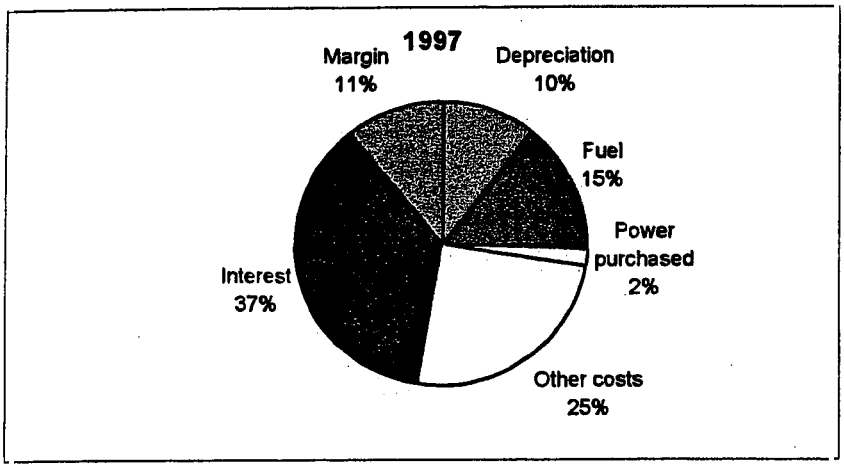
Schedule 4B

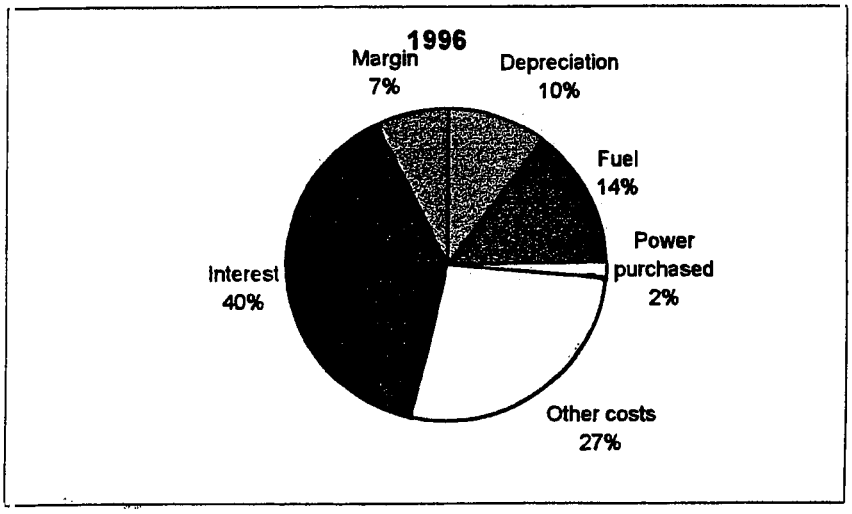
Newfoundland and Labrador Hydro
Comparison of Costs as a Percentage of kWh Sold and Used

kWh sold and used	6,589,000			6,784,000			6,254,000		
	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total
Depreciation	$ 29,301	0.004	10.18%	$ 30,686	0.005	10.49%	$ 32,843	0.005	11.99%
Fuel	41,683	0.006	14.49%	43,900	0.006	15.00%	26,880	0.004	9.81%
Power purchased	5,225	0.001	1.82%	5,692	0.001	1.94%	9,686	0.002	3.53%
Other costs	77,799	0.012	27.04%	74,152	0.011	25.34%	80,826	0.013	29.50%
Interest	113,062	0.017	39.29%	106,876	0.016	36.52%	98,786	0.016	36.05%
Margin	20,693	0.003	7.19%	31,351	0.005	10.71%	25,004	0.004	9.12%
Total	$ 287,763	$ 0.044	100.00%	$ 292,657	$ 0.043	100.00%	$ 274,025	$ 0.044	100.00%

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







Schedule 4C

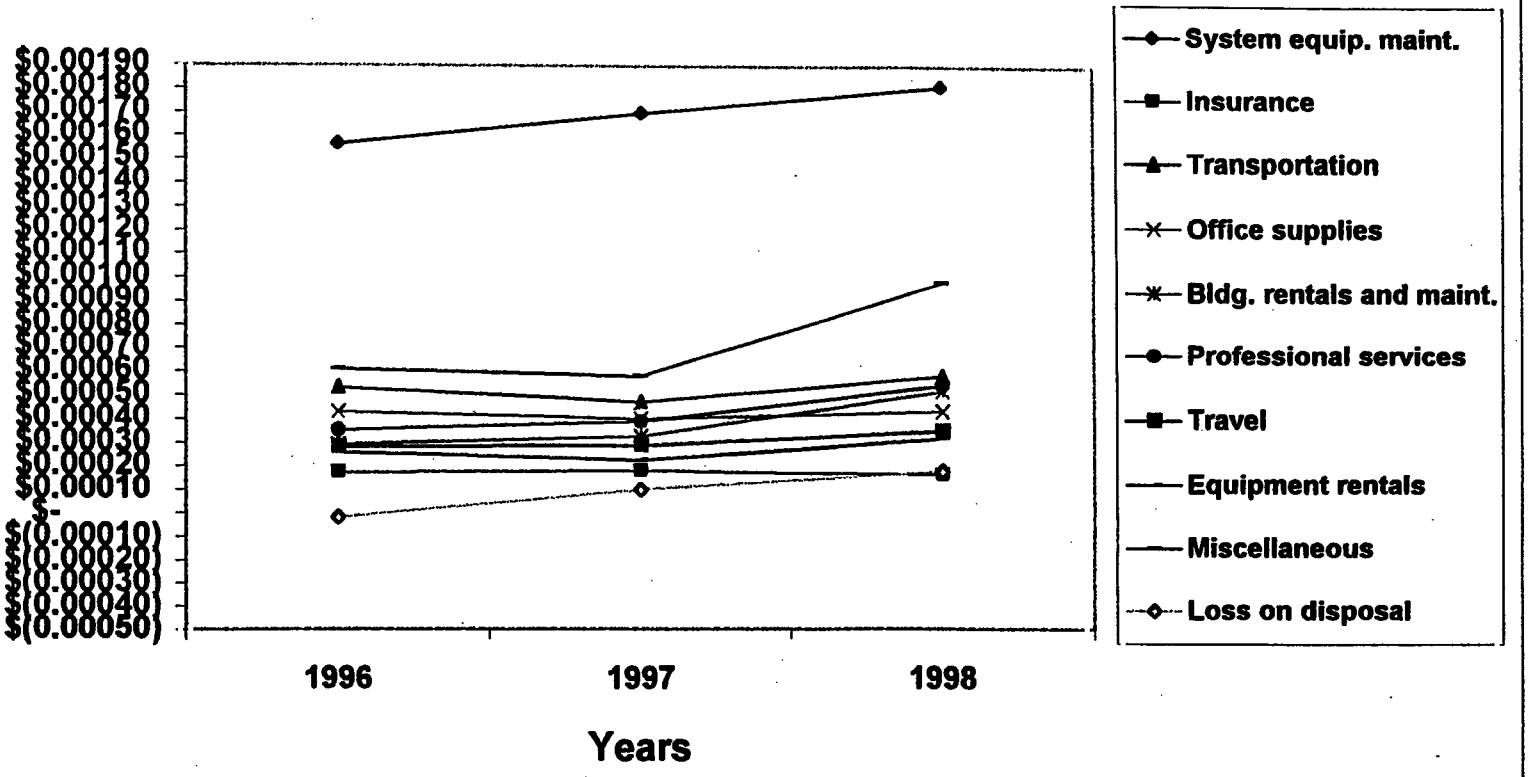
Newfoundland and Labrador Hydro
Comparison of Other Costs by Breakdown
1996 to 1998

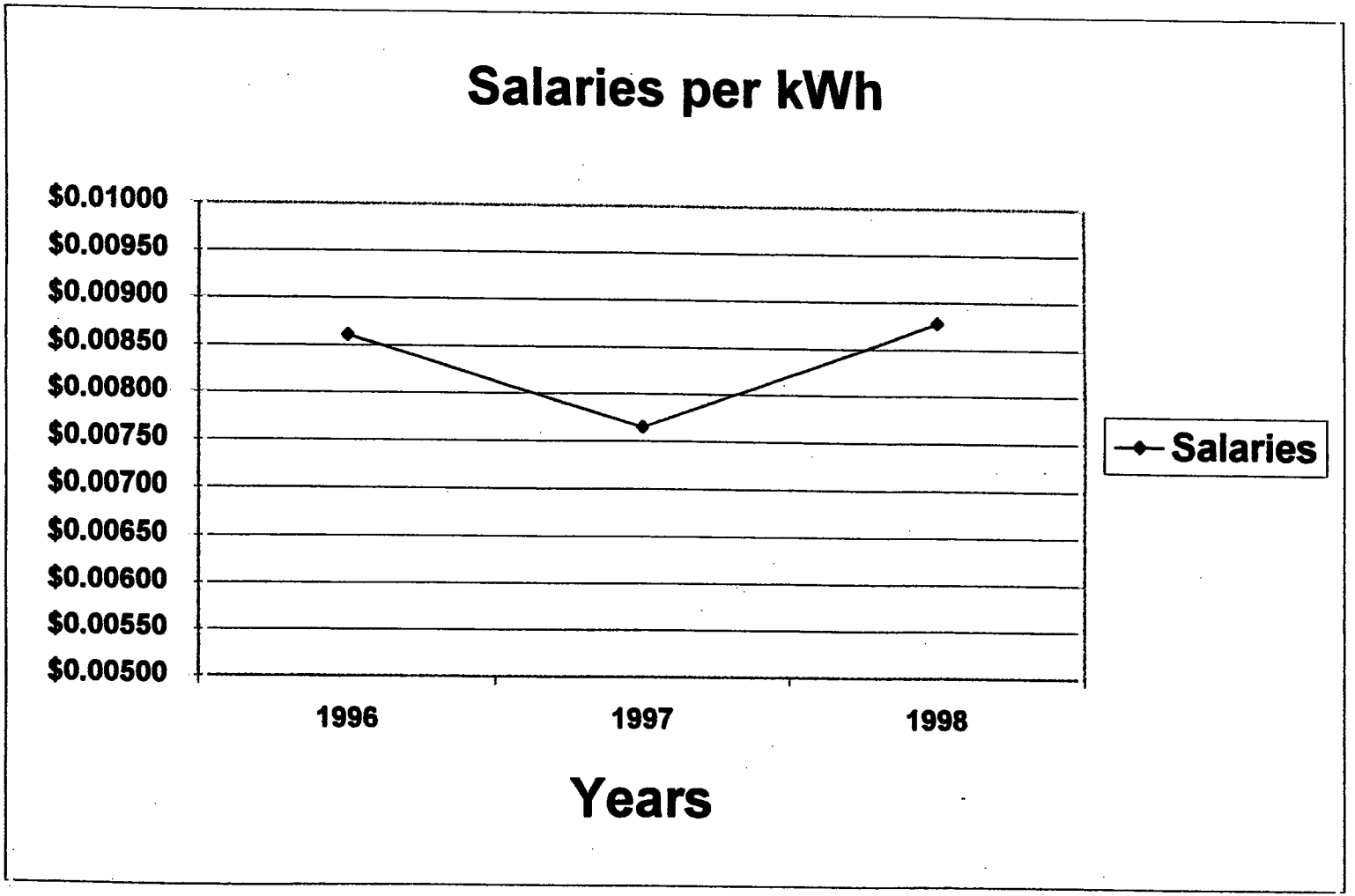
kWh sold and used	[redacted]			[redacted]			[redacted]		
	6,589,000			6,784,000			6,254,000		
	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total
Salaries	$ 56,724	0.00861	100.00%	$ 51,863	0.00764	100.00%	$ 54,904	0.00878	100.00%

kWh sold and used	[redacted]			[redacted]			[redacted]		
	6,589,000			6,784,000			6,254,000		
	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total
System equip. maint.	$ 10,294	0.00156	34.78%	$ 11,506	0.00170	36.46%	$ 11,323	0.00181	30.73%
Insurance	1,169	0.00018	3.95%	1,224	0.00018	3.88%	1,056	0.00017	2.87%
Transportation	3,513	0.00053	11.87%	3,177	0.00047	10.07%	3,641	0.00058	9.88%
Office supplies	2,842	0.00043	9.60%	2,716	0.00040	8.61%	2,715	0.00043	7.37%
Bldg. rentals and maint.	1,930	0.00029	6.52%	2,210	0.00033	7.00%	3,226	0.00052	8.75%
Professional services	2,330	0.00035	7.87%	2,627	0.00039	8.32%	3,398	0.00054	9.22%
Travel	1,874	0.00028	6.33%	1,957	0.00029	6.20%	2,211	0.00035	6.00%
Equipment rentals	1,740	0.00026	5.88%	1,530	0.00023	4.85%	2,000	0.00032	5.43%
Miscellaneous	4,014	0.00061	13.56%	3,920	0.00058	12.42%	6,142	0.00098	16.67%
Loss on disposal	(110)	(0.00002)	-0.37%	691	0.00010	2.19%	1,137	0.00018	3.09%
Total	$ 29,596	$ 0.00449	100.00%	$ 31,558	$ 0.00465	100.00%	$ 36,849	$ 0.00589	100.00%

Grand Total	$ 86,320	$ 0.01310	100.00%	$ 83,421	$ 0.01230	100.00%	$ 91,753	0.01467	100.00%

Breakdown of Other Costs (salaries excluded) per kWh




Salaries per kWh
$0.01000
$0.00950
$0.00900
$0.00850
$0.00800
$0.00750
$0.00700
$0.00650
$0.00600
$0.00550
$0.00500
1996
1997
1998
Years
Salaries

Newfoundland and Labrador Hydro
Rate Stabilization Plan Summary
1996 to 1998

Schedule 5

(000)'s	1998 Current Variation	1998 Current Interest	1998 Prior Interest	1998 Total	1997	1996
Balance, beginning of year				$41,378	$30,162	$12,916
Water variation	$ (967)	$ 59	$ 17,889	16,981	9,331	9,807
Load variation	3,435	142	(549)	3,028	(1,129)	1,843
Fuel variation	12,068	732	(19,009)	(6,209)	4,887	1,581
Recovery	(11,228)		4,965	(6,263)	(1,400)	4,115
Rural rate alteration	122	(11)	(92)	19	(546)	(173)
Labrador interconnected	(169)	(5)	26	(148)	73	73
Net change	$ 3,261	$ 917	$ 3,230	7,408	11,216	17,246
Balance, end of year				$48,786	$41,378	$30,162

Comprised of:

Water variation	$216,922
Load variation	(3,094)
Fuel variation	(218,695)
Recovery	54,518
Rural rate alteration	(1,013)
Labrador interconnected	148
Balance, end of year	$48,786
Current receivable	$17,042
Long-term receivable	31,744
	$48,786

Newfoundland and Labrador Hydro
Amortization of Studies and Software
1996 to 1998

Schedule 6

	1998	1997	1996
Review of Granite Lake and Island Pond	$25,687	$29,980	
Miscellaneous	20,993	21,599	$28,608
Granite Canal Environmental Assessment	38,616	23,275	24,767
Paradise River Regulation Structure - Pre-engineering	17,479	17,479	17,479
Stack Testing - Holyrood	35,034	35,920	35,920
Biological Monitoring - Holyrood	8,674	10,589	10,589
Design Review - T/L # 202 & 206	20,310	20,366	20,366
Island Pond Development Study			67,026
Hydro Rural:			
Miscellaneous	7,974	12,258	21,396
Heating, Ventilation, Lighting and Noise Study	9,415	15,260	20,372
Nain Monitoring Studies	11,109	12,634	12,634
Roddickton Thermal Study		14,819	16,850
Computer Software:			
Upgrade Electronic Mail System	14,825		
Integrated Resource Planning Model	39,768	46,414	
LAN Mainframe Backup Software	16,150	16,195	16,195
Computerized Inventory System		55,001	66,037
Human Resources Management System		453,786	179,755
Development Tools and Software		7,577	22,251
Profs Electronic Mail Software		6,230	14,301
Rural Customer Service System			68,092
Replacement of CPU			10,174
Miscellaneous	4,880	6,989	9,452
	$270,914	$806,371	$662,264

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Board of Commissioners of Public Utilities
1999 Annual Financial Review of Newfoundland and Labrador Hydro

Contents

Introduction

This report to the Board of Commissioners of Public Utilities ("the Board") presents our observations, findings and recommendations with respect to our 1999 Annual Review of Newfoundland and Labrador Hydro ("the Company")("Hydro").

Scope and Limitations

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

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

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

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

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

4. Verify Hydro's reconciliation of Net income to Revenue Requirement for 1999. Review and assess the reasonableness of adjustments in the calculation of revenue requirement.

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

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

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

8. Review Minutes of Board of Director's and Management Committee meetings.

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

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

11. Review and provide commentary with respect to Hydro's process for forecasting capital expenditures.

12. Prepare a comparison of the budgeted figures to the actual results for operating expenses. We will prepare this comparison for the 1998 and 1999 fiscal years, and provide comments as to the accuracy of Hydro's Budgeting process.

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

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

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

The financial statements of the Company for the year ended December 31, 1999 have been audited by Ernst and Young LLP, Chartered Accountants, who have expressed their opinion on the fairness of the statements in their report dated February 18, 2000. In the course of completing our procedures we have, in certain circumstances, referred to the audited financial statements and the historical financial information contained therein.

Accounting System and Code of Accounts

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

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

During ~~1998 Hydro implemented its new accounting system, J.D. Edwards. This new system resulted in a new chart of accounts, and several changes in a number of the account groupings.~~

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

In regards to Section 58 of the *Public Utilities Act*, we have received correspondence from the Board dated July 31, 2000 indicating that Hydro has submitted their code of accounts that was in effect for 1999. Hydro's system of accounts provides adequate flexibility to allow the Company to meet its own and the Board's reporting requirements.

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

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

Return on Rate Base

We have calculated the return on rate base for 1999 at 7.32% as compared to 9.90% for 1998 and 10.94% for 1997. Details with respect to the calculation of average rate base and return on rate base are as follows:

(000)'s	1999	1998	1997
Plant investment	$ 1,640,900	$ 1,637,600	$ 1,616,700
Less: Accumulated depreciation	(351,700)	(328,400)	(299,300)
CIAC's	(89,800)	(90,500)	(89,400)
	1,199,400	1,218,700	1,228,000
Balance previous year	1,218,700	1,228,000	1,235,700
Average	1,209,050	1,223,350	1,231,850
Cash working capital allowance	2,400	2,100	2,100
Materials and supplies	35,950	25,330	30,100
Average rate base	$ 1,247,400	$ 1,250,780	$ 1,264,050
Net income (as adjusted per Schedule 3)	$ (1,886)	$ 25,004	$ 31,351
Hydro net interest expense	93,180	98,800	106,900
Adjusted net income	$ 91,294	$ 123,804	$ 138,251
Return on rate base	**7.32%**	**9.90%**	**10.94%**

In February 2000, the Board issued P.U.5 (2000 - 2001) authorizing Hydro to abandon the woodchip fired thermal generating station located in Roddickton. This resulted in a write-down of capital assets of $16.7 million, which Hydro has reflected in the 1999 financial statements. The return on rate base would be 8.66% excluding this write-down of capital assets.

The above calculation also excludes the profit contribution of approximately $33.7 million from the Hydro Quebec recall. The return on rate base would be 10.0% (1998 - 11.98%) if this profit contribution was included in the regulated net income. Adjusting 1999 for both the capital asset write-down and the profit from Hydro Quebec recall would result in a return of 11.4%.

We have calculated the average rate base for Hydro using the methodology and criteria employed by Newfoundland Power Inc. As noted in our previous reports, it is obvious that at the first rate hearing under the new regulatory process the rate base of Hydro will have to be formally defined and approved by the Board. However, until the rate base is fixed and approved, utilization of the above methodology and criteria provides a reasonable indication of the return on rate base achieved by Hydro.

Return on Equity

The return on equity for 1999 has been calculated at (.65%) as follows:

(000)'s	1999	1998	1997
Shareholder's equity			
1999	$ 290,680		
1998	$ 292,650	$ 292,650	
1997		279,500	$ 279,500
1996			261,000
Average equity	$ 291,665	$ 286,075	$ 270,250
Net income (as adjusted per Schedule 3)	$ (1,886)	$ 25,004	$ 31,351
Return on equity	-0.65%	8.74%	11.60%

As previously noted in the report, the net income indicated above includes a write-down of capital assets of $16.7 million. The return on equity would be 4.93% if this transaction was normalized in the net income calculation.

The above calculation also excludes the profit contribution from the Hydro Quebec recall of approximately $33.7 million in 1999 and $26.1 million for 1998. The return on equity would be 10.08% for 1999 and 17.08% for 1998 if these profit contributions were included in the 1999 and 1998 net income respectively. Adjusting 1999 for both the capital asset write-down and the profit from Hydro Quebec recall would result in a return on equity of 15.37%.

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

(000's)	1999	1998	1997
Equity per non-consolidated financial statements	$ 626,280	$ 591,650	$ 538,800
Less: Contibuted capital			
- Lower Churchill Development	(15,400)	(15,400)	(15,400)
- Muskrat Falls Project	(2,200)	(2,200)	(2,200)
Share capital issued to finance investment in CF(L)Co.	(22,500)	(22,500)	(22,500)
Net retained earnings attributable to CF(L)Co. (income recorded minus dividends flowed through to government)	(247,700)	(232,800)	(219,200)
Net retained earnings attributable to the sale of recall power to Hydro Quebec (income recorded minus allocation of dividends)	(47,800)	(26,100)	
"Regulated Equity"	$ 290,680	$ 292,650	$ 279,500

The adjustment to regulated equity relating to the net retained earnings attributable to the sale of recall power to Hydro Quebec is reduced by the dividends paid during the current year. We believe it is reasonable to apply the dividends in this manner due to the Company experiencing a "regulated" loss in 1999. Consequently, it is assumed the dividends would be paid from the non-regulated income earned during the year.

Overall, the above calculations provide a reasonable indication of the rate of return on equity achieved by Hydro during the year.

Interest Coverage

Interest coverage for 1999 has been calculated at 1.33 times as follows:

(000's)	1999	1998	1997
Total interest	$ 94,288	$ 100,682	$ 109,636
Less: CF(L)Co	(1,109)	(1,896)	(2,760)
Hydro net interest	93,179	98,786	106,876
Less: Guarantee fee	(10,849)	(11,153)	(10,745)
Add: Interest earned and IDC			
Power bills	85	250	268
RSP	3,217	4,150	3,342
Sinking funds	8,689	28,269	32,172
IDC	1,984	428	391
Gross interest	$ 96,305	$ 120,730	$ 132,304
Net income (per Schedule 3)	31,715	$ 51,257	$ 30,910
Gross interest	96,305	120,730	132,304
Adjusted income	$ 128,020	$ 171,987	$ 163,214
Interest Coverage	**1.33**	**1.42**	**1.23**

The gross interest costs declined in 1999 as compared to 1998 as a result of lower average interest rates and net debt retirement, while net income decreased despite the net increase of profit from Hydro Quebec recall of $7.6 million over 1998. The decrease in net income is largely attributed to the write-down of the woodchip-fired thermal generating station in Roddickton for $16.7 million.

Interest coverage has been calculated at 1.50 times when the write-down of the generating station is excluded from net income, and 1.15 times when the profit contribution from the Hydro Quebec recall is also excluded from net income.

The Company's interest coverage appears reasonable and comparable to prior years, considering that the write-down of the generating station at Roddicton is a non-recurring item.

Capital Structure

The capital structure of Hydro, excluding its subsidiary companies, can be determined from Schedule 1. For the years 1997 to 1999, the capital structure was as follows:

(000)'s	1999	%	1998	%	1997	%
Debt	$ 1,134,332	77.0%	$ 1,165,400	78.5%	$ 1,184,100	80.9%
Equity	338,525	23.0%	318,800	21.5%	279,500	19.1%
	$ 1,472,857		$ 1,484,200		$ 1,463,600	

Hydro Quebec Recall

For the 1999 fiscal year Hydro declared and paid dividends totaling $17 million to the provincial government which included a $5 million dividend based on a partial flow through of CF(L)Co revenue. The dividend policy approved by the Board of Directors of Hydro in November, 1995 provides for the payment of dividends annually up to 75% of net operating income provided such payment will not cause the debt: equity ratio to fall below 80:20. In addition, the policy provides for the payment annually of all dividends received from CF(L)Co after payment of debt servicing (including $1 million principal) associated with the CF(L)Co loan. The actual dividends paid were well within the policy approved by the Board of Directors of Hydro.

Also in 1999, Hydro retired two bond issues totalling $105 million with interest rates ranging between 10% to 13.375%.

In comparison to 1998 and 1997, Hydro's debt:equity ratio still continues to improve. This improvement can be attributed to the higher equity level at the end of 1999, which results primarily from the increase in earnings relating to the Hydro Quebec Recall and the net reduction in debt of approximately $31 million.

Other Costs

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

Schedule 3 of our report provides a breakdown of other costs for the years 1997 to 1999. This schedule shows that the total other costs (before transfers to capital and cost recoveries) have increased in 1999 relative to 1998 by $4.045 million ($95,798,000 - $91,753,000). This 4.4% increase in 1999 is a continuation of the upward trend, which began in 1998.

On a net basis, other costs show a similar trend with an increase in 1999 relative to 1998 of $4.3 million ($85,152000 - $80,826,000). The additional increase on a net basis is largely attributable to the lower transfers to capital in 1999 as compared to 1998.

The most significant expense variances in 1999 relate to an increase in salaries of $2.2 million and system equipment maintenance of $3.6 million. The salary increase is a result of three main factors: 1) a general scale increase of 2% for union and non-union employees; 2) back filling vacant positions in the Production and the Transmission and Rural Operations divisions; and 3) extra maintenance required at the Holyrood Thermal plant. This additional maintenance work at Thermal Holyrood is also a large contributor to the $3.6 million increase in system equipment maintenance. In 1999 major and minor overhauls on thermal units 1,2 and 3 increased maintenance costs by approximately $2.8 million. The remaining increase resulted from additional Hydro Generation work at Cat Arm.

Schedule 4 of our report provides an analysis of the other costs on a kWh's sold basis for the years 1995 to 1999. This schedule indicates that the total other costs per kWh has continued its upward trend, which began in 1998.

On an individual basis, the various expense categories in other costs showed inconsistent trends in 1999; several categories showed increases, while others showed decreases. Schedule 3 provides the details on expenses for the period 1997 to 1999. We have reviewed the various expense categories on an individual basis and our observations and comments are noted below for your consideration.

Salaries and benefits

Gross payroll costs for 1999 were $57,127,000, which was 3.9%, or $2.2 million higher than 1998 levels. The salary groupings for 1997 have been restated to reflect Hydro's code of accounts under the operation of its new computer system. The salaries and benefits costs are summarized below by category:

(000)'s	1999	1998	1997
Salaries	$ 40,503	$ 39,386	$ 38,483
Termination pay			2
Directors fees	77	108	102
Hourly wages	5,727	4,681	4,178
Overtime	3,946	4,074	2,837
Fringe benefits	5,514	5,437	4,849
Group insurance	1,289	1,200	1,382
Labrador travel benefit	71	74	72
	$ 57,127	$ 54,960	$ 51,905

While salaries and benefits costs increased 3.9% overall, the increase in the regular salaries category was somewhat less at 2.8% for 1999. The breakdown of salaries only by division is as follows:

(000)'s	1999	1998	1997
Finance	$ 3,894	$ 5,261	$ 4,953
Human resources and legal	2,857	2,990	2,880
Transmission and rural operations (TRO)	17,227	17,360	17,389
Production	15,057	12,720	12,256
Internal audit	207	194	208
Management	1,261	861	797
	$ 40,503	$ 39,386	$ 38,483

In order to facilitate the review of variances in payroll costs, it is important to look at the breakdown of these costs between operating and capital. In terms of this breakdown it should be noted that with the introduction of a new computer system and code of accounts in 1998, the capitalized expense for non-departmental overhead is now grouped with capitalized salaries. For comparative purposes, 1997 figures have been restated to reflect this change. The gross payroll costs for 1997 to 1999 are allocated to operations and capital as follows:

(000)'s	1999	1998	1997
Payroll charged to operating	$ 48,954	$ 46,765	$ 45,494
Payroll charged to capital	8,173	8,195	6,411
	$ 57,127	$ 54,960	$ 51,905

Payroll costs charged to operating in 1999 increased by $2.2 million or 4.7%. This increase is primarily attributable to the following major items:

- Backfilling vacant positions in the Production and the Transmission and Rural Operations divisions resulted in increases to permanent salaries and hourly wages.
- A general scale increase of 2% was provided to all union and non-union workers and Management Committee in 1999.
- During 1999, extra maintenance requirements in the Hydro Generation and Thermal General departments of the Production division resulted in increases to hourly wages.
- The increase in salary costs for the Management division is due to a full year salary for the Vice President of the Lower Churchill River Project and the creation of the new position , Director - Production Division. Also, during 1999, there was a reclassification relating to the Executive Assistants which resulted in an increase for this group.

The decrease in salary costs relating to the Finance division and the increase in the production division is mainly the result of the transfer of the MIS group from Finance to Production. This group consisted of 40 employees at the end of 1998 and the salary costs for this group in 1998 was approximately $1.48 million.

The payroll costs charged to capital decreased slightly in 1999 as compared to 1998. Capitalized salaries are made up of more than 20 separate projects, however 4 of these projects represent approximately 53% of total salary costs. These projects include Project 2000, the Lower Churchill River Project, Upgrading Work on TL217 and Service Extensions and Upgrading in the Central Region. Project 2000 includes the implementation and conversion to a new integrated suite of software products (J.D. Edwards). Similar to 1997 and 1998, this new software package required a significant amount of time in implementation and training, which was charged to the capital project.

The Lower Churchill River Project refers to the negotiations with Hydro Quebec relating to hydro electric development on the Lower Churchill River in Labrador. All costs ~~associated with these negotiations are capitalized and reimbursed by the Provincial~~ Government . Upgrading and service extensions includes the erection of new poles, upgrading existing transmission line and providing services to new customers.

Executive salaries for the years 1996 to 1999 are as follows:

	1999	1998	1997	1996
Total executive salaries and benefits	~~$ 818,139~~	~~$ 770,999~~	$ 722,474	$ 814,747
Number of executives	5	5	5	6
Average salary	~~$ 163,625~~	$ 154,200	~~$ 144,495~~	$ 135,791

The total executive salaries and benefits and the average salary per executive increased by 6.1% in 1999 in comparison to 1998.

The Compensation Committee recommended salary increases for the President and Vice-Presidents consistent with the increase provided for non-union staff. They also approved step progression for those who were not at their job rate. Salary adjustments were effective January 1, 1999 following an evaluation of their performance.

During 1998, a new Vice-President for the Lower Churchill River Project was hired. This Vice-President is paid by Hydro but his salary is charged 100% to the project and therefore recovered through capitalized expenses. The salary for this Vice-President is not included in the total executive salaries and benefits as he does not participate in the regular duties of the Hydro Management Committee.

The staff complement for 1997 to 1999 is as follows:

	1999	1998	1997
Production	320	278	277
TRO	412	406	420
Finance	85	121	123
Internal audit	4	4	4
Management	9	9	8
Human resources and legal	71	71	72
	901	889	904

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

	1999	1998	1997
Production	312	271	275
TRO	383	395	407
Finance	81	118	121
Internal audit	4	4	4
Management	9	9	8
Human resources and legal	70	71	72
	859	868	887

The above tables reflect staffing numbers as at the end of the fiscal year. Hydro did not calculate and report full time equivalent (FTE) positions on an annual basis in 1999. Using FTE's is a more accurate and meaningful measure for analyzing staff levels.

We were informed by the Board on July 31, 2000 that Hydro has developed a system to report FTE positions and this will be included in their reports to the Board in 2000 and future years.

The significant variances in the staff complement relate to the Finance and Production divisions. As previously indicated in the report, this is mainly due to the transfer of the MIS group.

The following is a schedule of the average number of temporary employees on staff for 1997 to 1999. The monthly numbers were taken at the end of each particular month.

	1999	1998	1997
January	94	84	40
February	93	131	61
March	115	107	88
April	134	140	104
May	168	141	125
June	240	236	205
July	231	248	236
August	235	199	189
September	207	195	178
October	183	155	168
November	150	162	129
December	100	99	67
Monthly average	162.5	158.1	132.5

Based on the results of our procedures, nothing has come to our attention to indicate that the salary and benefit costs are not prudent or unreasonable in relation to sales of power and energy.

System equipment maintenance

In 1999, system equipment maintenance costs increased from 1998 levels by $3,632,000 or 32.1%. This increase was mainly due to the higher costs of $2,881,000 at the Holyrood Thermal Plant and $1,017,000 in Hydro Generation. These increases were partially offset by decreased costs overall in rural operation of $279,000. Other miscellaneous variances amounted to a net increase of $13,000.

The costs for 1997 to 1999 for the system equipment maintenance portion of this expense only (excluding tools and equipment, freight and lubricants, gases and chemicals) are broken down by department as follows:

	1999	1998	1997
Transmission and rural operations	$ 4,497	$ 4,776	$ 3,766
Production	9,544	5,577	6,572
Other	9	8	7
	$ 14,050	$ 10,361	$ 10,345

The increase in maintenance costs for hydro generation is related to the tunnel and valve remediation work and replacement of rip rap at the Cat Arm and Upper Salmon hydro plants. The costs relating to these projects were approximately $785,000 and $290,000 respectively.

The Holyrood thermal plant costs are as follows:

(000)'s	1999	1998	1997
Unit # 1 overhaul	$ 1,428	$ 909	$ 2,669
Unit # 2 overhaul	3,268	965	1,014
Unit # 3 overhaul	1,193	1,323	735
Annual routine maintenance	1,522	1,333	1,202
Asbestos removal			161
Projects			42
	$ 7,411	$ 4,530	$ 5,823

Maintenance costs at Holyrood are subject to a high degree of variability. During overhauls, different areas may be found to be in need of maintenance and the costs can vary greatly.

Based on information provided by the Company, Unit # 1 had a minor overhaul in 1999 and 1998. The increase in costs for 1999 compared to 1998 was largely due to the scope of the overhaul. Since the last major overhaul performed on unit one was in 1997, increased maintenance materials and labour work was required to keep this thermal plant in good working order. Unit # 2 had a major overhaul in 1999 versus a minor overhaul in 1998. The cost differential between a minor and major overhaul on Unit # 2 accounts for a majority of the variance between 1999 and 1998. Unit # 3 had minor overhauls done in 1999, 1998 and 1997, however the overhaul for Unit #3 in 1998 also included costs relating to work performed on the valves of approximately $277,000.

In 1998, extra maintenance requirements in the Central and Labrador regions of the province contributed to the increased costs within transmission and rural operations. Since the extra maintenance requirements amounting to over $400,000 were not part of the regular routine maintenance in these regions, costs for 1999 decreased by approximately $470,000. These cost savings were slightly offset by increased expenditures in the Northern region of $190,000 due to major overhauls and other fuel system maintenance at various diesel plant locations.

While there have been significant variances in system equipment maintenance costs in comparison to prior years, based on the results of our procedures, nothing has come to our attention to indicate that these costs are not prudent or unreasonable in relation to sales of power and energy.

Insurance (including director's liability)

Insurance costs increased overall by $12,000 in 1999 as compared to 1998. This slight increase is largely attributed to a rebate Hydro received from their insurers in 1998.

This rebate in 1998 related to the Boiler and Maintenance policy, and as a result, the insurance expense relating to coverage on the Boiler and Machinery increased by $75,000 in 1999. Hydro received this rebate as a result of experiencing a period with no losses.

This increase was partially offset by a decrease in loss adjustment fees of $54,000. These fees decreased due to a reduction in the number of claims filed by Hydro in 1999 compared to 1998.

Miscellaneous changes to other premiums paid in the year net to a decrease of $9,000.

Based on the results of our procedures, nothing has come to our attention to indicate that the insurance costs are not prudent or unreasonable in relation to sales of power and energy.

Transportation

Transportation expense is comprised of aircraft rentals, vehicle expenses (fuel, labour and repairs) and mobile equipment expenses (fuel, labour and repairs). This expense category decreased overall by $160,000 (4.4%) in 1999 as compared to 1998. The majority of this decrease is due to lower aircraft rental costs of $252,000. However, this decrease was partially offset by an increase in mobile equipment repairs of $120,000. Other miscellaneous variances such as an increase in vehicle repairs of $25,000 and a decrease in vehicle rentals of $53,000 netted to a decrease of $28,000.

The combined decrease in aircraft and vehicle rental costs of $305,000 is consistent with the downward trend in maintenance costs incurred by Transmission and Rural Operations. Most of the maintenance work in TRO is completed by internal work forces and in most cases it involves Hydro's vehicles, as well as the rental of aircraft when working in remote locations. Therefore, a decrease in maintenance costs should result in a decrease in the transportation costs.

Despite, the overall decrease in transportation expenditures for 1999 as compared to 1998, the fuel costs for mobile equipment, which falls under the category for mobile equipment repairs has risen steadily due to increasing fuel prices.

Based on information provided by Hydro, the total number of vehicles and mobile equipment (excluding vehicles/equipment held for auction) has only changed slightly from 1998 to 1999. In 1998 the fleet included 362 vehicles and 353 mobile equipment units in 1999 the Company had 356 vehicles and 355 mobile equipment units.

Based on the results of our procedures, nothing has come to our attention to indicate that the transportation costs are not prudent or unreasonable in relation to sales of power and energy.

Office expenses, including membership fees

Office expenses in 1999 (including heat and light, telephone, supplies, postage, advertising, cleaning, office equipment maintenance, books and subscriptions and membership fees) increased by $143,000 or 5.25% over 1998. The increase can be attributed to three main areas including a $96,000 increase in telephone and fax, $67,000 rise in memberships and dues and a $59,000 increase in supplies. This increase was partially offset by a decrease in office equipment and maintenance of $75,000. Various smaller variances amounted to an additional net decrease of $4,000.

Telephone and fax costs increased in 1999 by $96,000 over 1998 mainly due to increased usage in the current year.

Membership dues increased in 1999 after two years of remaining fairly consistent. These increases were largely a result of additional initiatives undertaken by the Canadian Electrical Association. The costs associated with these initiatives are sometimes cost shared among the members and the CEA.

There is no identifiable cause for the increase in supplies in 1999. The costs associated with supplies are often cyclical depending on the activity in the current year and the timing of purchases.

The decreased cost in office equipment and maintenance partially offsets the increases noted above. The computer equipment purchases required to support the management information systems in prior years was not a re-occurring expense in 1999.

Based on the results of our procedures, nothing has come to our attention to indicate that the office costs, including membership fees, are not prudent or unreasonable in relation to sales of power and energy.

Building rental and maintenance

In 1999, building rental and maintenance costs dropped from 1998 levels by $329,000. This decrease in costs is in contrast to the increasing trend that has been occurring since 1996. The decrease can be attributed primarily to a small number of significant property maintenance projects that occurred in 1998 of approximately $651,000. However, these reductions were offset by unbudgeted costs in 1999 for soil sampling and the cleanup of contaminated soil, particularly in the community of Westport.

Based on the results of our procedures, nothing has come to our attention to indicate that the building rental and maintenance costs are not prudent or unreasonable in relation to sales of power and energy.

Professional services

Professional services costs for 1999 were $3,756,346, which was $358,000 or 10.5% higher than 1998 levels.

The increase in professional fees can be attributed to four main factors, the most significant component of this increase relates to the information security architecture and IT governance consulting work, as well as the various studies that were completed in the TRO division that were not originally included in the budget. Secondly, additional costs were incurred in software acquisition and maintenance when the Company implemented the Microsoft Suite of products, an initiative that cost more than was originally budgeted and also a decision was made to maintain the Amdahl Mainframe System throughout 1999 which was not included in the budget for this expense.

The final two components contributing to the rise in professional services related to consulting work for a year 2000 program review and environmental effects monitoring studies.

In our review we noted that the original budget for professional services in 1999 was approximately $3,175,000, which was $222,000 lower than the 1998 actual expense of $3,397,500. However, as previously indicated the 1999 actual expense for professional

services is $3,756,346, which is $581,000 greater than budget. We also noted that the original budget included approximately $545,000 for an anticipated rate hearing that did not occur in 1999. Taking this item into consideration, there was approximately $1,126,000 in non-budgeted or under budgeted projects included in this expense category for 1999.

The components of this increase relative to budget are as follows:

Professional services	$ 775,000
Software acquisition and maintenance	351,000
	$ 1,126,000

The reasons for this additional spending are as described above.

With respect to the variance in this expense category, we have obtained explanations and performed additional analysis where appropriate. Based upon the results of our procedures, nothing has come to our attention to indicate that the professional services costs are not prudent or unreasonable in relation to sales of power and energy. However, the professional services expense category has exhibited a significant upward trend over the past three years (51% increase from 1996 to 1999). Considering this trend, a more in-depth review of this category may be appropriate for 2000.

Travel and conferences

In 1999, the travel and conference expense category increased from 1998 levels by $248,000 or 11%. Travel costs increased from $2.1 million to $2.3 million and conference costs increased from $99,000 to $145,000.

The most significant increase in travel costs was noted in the human resources and legal department, the travel costs in this department increased by approximately $85,000. This increase is largely attributable to staff visiting the various area offices, and area office staff traveling to St. John's to provide or obtain training and assistance regarding the J.D. Edwards computer system. Another large increase of $64,000 occurred in the production department due to additional system equipment maintenance requirements in Holyrood.

The increased spending on conferences was primarily attributable in two of the six departments at Hydro. Increased spending in management of $11,000 is attributable to the destination point of the Canadian Electrical Association (CEA) annual meeting. This meeting was held in Vancouver in 1999 as opposed to Toronto in 1998. Conference costs for 1999 are very comparable to 1997, the last time the CEA annual meeting was held in Vancouver. Finance is the second department to exceed 1998 conference costs by approximately $35,000. These increased expenditures were readily apparent within the customer service section of this department. A number of the customer service employees attended conferences held during the year. Also, more than 30 employees attended a meter readers conference held in central Newfoundland.

Similar to our 1998 findings, we noted during our review of the travel accounts that management travel includes several payments for spousal travel costs. While these items are considered appropriate and are accepted practice by Hydro, we believe that it is not prudent to include expenditures of this nature in the revenue requirement.

Equipment rentals

Equipment rental expense decreased by $398,500 or (19.9%) in 1999 as compared to 1998. This decrease is attributable to a drop in equipment rentals of $175,000, a reduction in computer costs of $142,000 and a decrease in telecommunication computer processing of $81,500.

The decrease in equipment rentals and computer costs is largely attributable to non-recurring costs in 1998 of:

- telecommunication requirements to increase the bandwidth from Newtel to support various Project 2000 activities created costs of $169,000, and;
- the new integrated suite of computer products ie. J.D. Edwards System increased costs by $254,000

The reduction in telecommunication computer processing can be attributed to the new billing process for rural customers with the implementation of the UCIS module of the J.D. Edwards system. This process was implemented in the spring of 1999, and costs associated with this processing should be eliminated entirely in 2000.

Based on the results of our procedures, nothing has come to our attention to indicate that the equipmental rental costs are not prudent or unreasonable in relation to sales of power and energy.

Miscellaneous

In 1999, miscellaneous expense decreased by $1,413,000 or 23.0% from 1998. The major variances in this expense category are as follows:

Decrease in sundry costs	($1,319,000)
Decrease in inventory gain/loss	(172,500)
Decrease in PCB costs	(279,000)
Increase in staff training	272,000
Increase in bad debt expense	171,500
Decrease in employee expenses	(50,000)
Net decrease in other variances	(36,000)
	($1,413,000)

The large decrease in sundry costs is related to $1,350,000 in settlement costs paid to two Non-Utility Generators (NUGS) in 1998. In 1998 Government decided to undertake a

complete energy policy review and all new small Hydro projects were suspended pending this review. To release Hydro from the agreements with two Non-Utility Generators, settlements of $850,000 and $500,000 respectively were negotiated at the Provincial Government's request.

With respect to the variances noted above, we have obtained explanations and performed additional analysis where appropriate. Based upon the results of these procedures, nothing has come to our attention to indicate that the miscellaneous costs are not prudent or unreasonable in relation to sales of power and energy.

Capitalized expenses

Capitalized expenses for 1999 were $8.537 million as compared to $8.667 million for 1998 and $6.897 million in 1997.

With the introduction of a new computer system in 1998 the groupings for capitalized expenses has been changed. The comparative figures for 1997 have been restated to reflect this change. The breakdown of capitalized expenses for the three years is as follows:

	1999	1998	1997
Salaries	$ 8,173,343	$ 8,194,967	$ 6,410,656
Fleet expense	255,218	381,387	381,542
Travel direct work orders	108,145	90,700	104,357
	$ 8,536,706	$ 8,667,054	$ 6,896,555

The costs incurred in 1999 and allocated to capitalized salaries is made up of more than 20 projects. However, a large portion of these expenses can be attributed to four main projects: P2000 project, the Lower Churchill River Project, upgrading work on TL217 and service extension and upgrading in the central region. While capitalized salaries remains fairly consistent with 1998, fleet expense dropped by 33%. This decrease in costs or usage of fleet vehicles is a result of contracting outside forces to perform the fieldwork.

The methodology employed by Hydro with respect to capitalizing expenses is outlined below. This methodology has not changed during 1999.

Capitalized salaries include the salaries and benefits of Company employees whose time is charged directly to capital projects, as well as, departmental and non-departmental overhead. The benefits component is determined by applying a pre-determined percentage to the gross salaries, which are capitalized directly. The departmental overhead component is allocated to the capital projects as a percentage of direct salaries

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

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

All categories of capitalized expenditures other than capitalized direct salaries are allocated to work orders using percentages or standard rates developed by the Company. These allocations are intended to ensure that capital projects are adequately charged with the cost of support functions such as accounting and finance, engineering, and other such expenses which cannot be directly charged to specific capital projects.

For 1999, the percentages used to capitalize fringe benefits and overhead costs were as follows:

Benefits (% of direct salaries)	35.9%
Departmental overhead	
Non-field (% of direct salaries and benefits of engineers and office staff)	37.6%
Field (% of salaries and benefits of crews)	19.8%
Non-departmental overhead (% of work order total costs)	6.0%

Based on the results of our procedures, nothing has come to our attention to indicate that the capitalized expenses are not prudent or unreasonable in relation to the Company's ongoing capital projects.

Intercompany charges

Intercompany charges to CF(L)Co. for 1999 have decreased by $151,000 or 6.7% compared to 1998. As a result of the new coding system implemented during 1998, amounts in several categories in 1998 and 1997 have been reclassified to provide a better comparison with 1999. The breakdown of intercompany charges by department is as follows:

	1999	1998	1997
Operations	$ 792,042	$ 715,390	$ 234,086
Finance	345,557	495,858	1,070,202
Transmission and Rural Operations	20,000	20,000	20,000
Corporate Planning			
Internal Audit	87,055	87,055	70,591
Management	184,020	135,379	155,754
Human Resources and Legal	680,355	806,389	820,889
	$ 2,109,029	$ 2,260,071	$2,371,522

These charges are for the provision of services in accordance with a Services Agreement between Hydro and CF(L)Co. Hydro staff prepared an internal review to study the appropriateness of the manner in which these costs were allocated in February, 1992.

As part of our analysis for 1995, we examined the method of allocation of all cost categories and on a test basis, reviewed the support for these allocations. We were able to conclude, based upon our tests that the costs had been appropriately allocated based upon the February 1992 study. In reviewing the manner in which costs are allocated we observed that many of the methods of allocation are subjective and rely upon the judgment of Hydro management, consequently these allocated costs are not susceptible to proper verification. Considering this limitation however, nothing has come to our attention to indicate that the methods of allocation are unreasonable.

However, as a result of the introduction of the J.D. Edwards systems in 1999, some of the departments, such as finance and human resources and legal, have taken the responsibility to track actual costs for services rendered to CF(L)Co by using specific work orders. The method of allocating actual expenses to CF(L)Co has resulted in decreases in the intercompany charges from both the finance and human resources departments.

Based on our discussions with Hydro staff, it appears that there are now two methods used within Hydro to charge costs to CF(L)Co. Some of the departments are charging based on tracking actual costs and others are using a method of allocation based on a 1992 study. According to discussions with Hydro staff, it was noted that there were significant reductions in the charges to CF(L)Co when it was based on actual costs.

We recommend that the Company review the approach to determining intercompany charges to CF(L)Co and consider updating the 1992 study in preparation for the general rate hearing scheduled for 2001.

Fuels

In 1999 fuel expense increased overall by $8,230,000 or 30.62% over 1998. The cost of Bunker "C" (net of RSP recoveries) decreased by approximately $5,518,000 (21.8%) in 1999 as compared to 1998. This decrease is attributable to a decrease in consumption of approximately 448,000 barrels, which is consistent with the decline in overall thermal production of 341 GWh or 27.1%.

The decrease in Bunker "C" is completely offset by the increase costs in the hydraulic production and load variation components of the Rate Stabilization Plan. These components provide an increase of $13,277,000 in comparison to 1998. The adjustment for hydraulic production (or water variation) is consistent with the increase in actual hydraulic production in 1999 of approximately 12.7%. The adjustment for load variation

is consistent with the increase in energy sales. Energy sales (excluding Hydro Quebec Recall) were up 134 GWh (2.6%) in 1999 in comparison to 1998. One of the reasons for the increase in energy sales and hydraulic production in 1999 is due to the 1998 strike at two of the paper mills operated by Abitibi Price. Sales to both of the mills increased by 257 GWhs in 1999. All variations relating to the Rate Stabilization Plan are calculated using actual results for the year in comparison to the 1992 cost of service data.

Another significant increase in this expense category is related to diesel fuel for rural operations. This category increased by $414,000 due primarily to a rise in the average cost per litre of fuel.

Based on the results of our procedures, nothing has come to our attention to indicate that the fuel costs are not prudent or unreasonable in relation to sales of power and energy.

Power purchased

During 1999, the Company's purchased power expense increased due to purchasing additional power from a number of suppliers to allow Hydro to fill its excess sales demand over that generated. This increase is consistent with the decrease in thermal production during 1999. Despite the increased generation in hydraulic energy of 12.7% over 1998, this production was still insufficient to meet sales level. Approximately 2,232 GWh's was purchased in 1999 of which 1,731 GWh's was related to the Hydro Quebec Recall. This purchase is a direct result of a three-year agreement between Hydro and Hydro Quebec that came into effect on March 9, 1998. This Agreement allows Hydro to recall the remaining power available to it from CF(L)Co and sell it to Hydro Quebec. Both the energy sales to Hydro Quebec and the related power purchased have been eliminated from the revenue requirement.

The Company also purchased power from two non-utility generators at a cost of approximately $10.4 million as compared to $2.2 million in 1998. The purchased power from the non-utility generators in 1998 only represents two months, whereas in 1999 it was for the full year. This power was purchased at an average cost of $69 per MWH from the Algonquin Project and an average cost of $66 per MWH from Star Lake.

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

Based on the results of our procedures, nothing has come to our attention to indicate that the power purchased costs are not prudent or unreasonable in relation to sales of power and energy.

Interest

Interest expense for 1999 dropped considerably compared to 1998, showing a decrease of $5.6 million. This decrease is primarily attributable to a decline in the amount of debentures and short-term promissory notes in 1999.

The following is a summary of interest expense for 1999 and 1998:

(millions)	1999	1998
Gross interest	$95.0	$119.8
Debt guarantee fee	11.0	11.5
Amortization of debt discount and financing costs	1.3	1.6
Foreign exchange losses	1.0	1.0
	108.3	133.9
Less:		
Interest earned	(12.0)	(32.8)
Interest attributable to CF(L)Co share purchase	(1.1)	(1.9)
Interest capitalized during construction	(2.0)	(0.4)
	$93.2	$98.8

In 1999, Hydro again took advantage of the favourable interest rate environment and exercised its call options and redeemed two series of bonds. The total face value of bonds redeemed was $105 million. These bonds had interest rates varying between 10% and 13.375%.

Overall, long term debt (net of sinking funds) decreased by $91.5 million and short term promissory notes decreased $29.3 for a total reduction in short and long term debt combined of $120.8 million.

Based on the results of our procedures, nothing has come to our attention to indicate that the interest costs are not prudent or unreasonable in relation to sales of power and energy.

Revenue Requirement

Scope: ***Verify Hydro's reconciliation of net income to revenue requirement for 1999. Review and assess the reasonableness of adjustments in the calculation of revenue requirement.***

Reconciliations of Net Income to Revenue Requirement for the years 1997 to 1999 have been provided in Schedule 3 of our report. Our review of the revenue requirement reconciliation for 1999 included examining support for the adjustments and assessing the reasonableness in comparison to prior years.

In 1999, donations and management contributions of approximately $107,000 have been eliminated from revenue requirement as per the Board's direction.

In addition, costs of $11,000 related to Muskrat Falls have also been eliminated as they relate to the development of the Lower Churchill, a project which is non-regulated and therefore does not impact Hydro's revenue requirement.

The final adjustments to the margin were to eliminate $38.476 million in energy sales to Hydro Quebec and $4.756 million in power purchased from Upper Churchill. These adjustments relate to a three-year contract beginning in 1998 with Hydro Quebec regarding the Hydro Quebec Recall.

These three adjustments combine to decrease the margin (earnings) per Schedule 3 by $33.602 million.

Based on the results of our review procedures, we report that the net income has been appropriately adjusted and that the resulting revenue requirement is consistent with Board directives and prior years.

Depreciation

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

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

During 1999 Hydro reported depreciation expense of $36.1 million as follows:

Location	Asset Class	Net Cost	Method	1999 Expense
Hydro	Hydraulic stations Terminal stations Transmission lines	$988.6 million	Sinking Fund	$8.1 million
Hydro	All other classes	213.0 million	Straight Line	28.0 million
		$1,201.6 million		$36.1 million

The majority of Hydro's high dollar value capital assets are depreciated using the sinking fund method. As noted above this method is applied to hydraulic stations, terminal stations and transmission lines which account for approximately 82% of the net cost of all capital assets. Depreciation on the remaining classes of assets is calculated using the straight line method.

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

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

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

In our 1997 report we provided the Board with the alternatives, observations and recommendations included in a depreciation study conducted by KPMG LLP. The final report relating to this study is dated October 7, 1998. Any recommendations relating to changes in accounting policies or service lives will be included for review and approval of the Board at Hydro's rate application hearing in 2001.

However, considering the date this report was completed in relation to an assumed test year of 2002, we believe the Company should consider having this study updated for purposes of the rate hearing.

Rate Stabilization Plan

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

Our examination of the Rate Stabilization Plan (RSP) for 1999 included reviewing the adjustments and components of the Plan in 1999 and assessing their reasonableness and compliance with Board directives. We also assessed the reasonableness of the interest charged and credited to the Plan during the year.

Schedule 5 of our report summarizes the changes in the RSP for the three years from 1997 to 1999. The water variation adjustment of approximately $15.9 million represents the most significant change in the plan in 1999. Another significant change in 1999 is the amount recovered from consumers of approximately $15.4 million. This increase is attributable to the increase in the mil rate used to recover a portion of the balance in the Rate Stabilization Plan from consumers. The increase in the mil rate is primarily due to the increasing balance in the Rate Stabilization Plan.

Based upon our review, we report that the adjustments made to the RSP in 1999 are reasonable and it has been operating in accordance with Board directives.

Deferred Charges

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

The following table shows the transactions in the deferred charges account from 1996 to 1999:

(000)'s	Balance Dec./96	Net Add.	Amort.	Balance Dec./97	Net Add.	Amort.	Balance Dec./98	Net Add.	Amort.	Reclass	Balance Dec./99
Studies and software	$918	$327	($806)	$439	$429	($271)	$597			($597)	
CF(L) Co.	150		(142)	$8	335	(50)	$293	1,564	(379)		$1,478
Realized foreign exchange losses	39,429	56,849		$96,278			$96,278				$96,278
Unrealized foreign exchange losses	61,499	(61,499)									
Discounts and issue costs on long term debt	13,422	1,395	(2,022)	$12,795	2,738	(1,574)	$13,959	10	(1,274)		$12,695
Professional services											
Call option premiums		162	(162)								
	$115,418	($2,766)	($3,132)	$109,520	$3,502	($1,895)	$111,127	$1,574	($1,653)	($597)	$110,451

In 1999, it was decided that all costs associated with the completion of feasibility studies and the purchase of new software would be included in the capital asset section of the balance sheet. This reclassification resulted in a decrease to deferred charges of $597,000 as compared to December 31, 1998.

Significant additions to deferred charges during 1999 are as described below: (000's)

CF(L) Co.	
Implementation of J.D. Edwards computer system	$ 1,564

Foreign Exchange Losses

Total deferred foreign exchange losses remained unchanged between 1999 and 1998 at $96.278 million.

As noted in our previous reports, section 17(4) of the Hydro Corporation Act (as amended by Bill 35) states that for purposes of the Public Utilities Act (including Subsection 80(2)), the foreign exchange losses as at December 31, 1994 were considered to be reasonable and prudent expenses of Hydro and therefore properly chargeable to operating account. Section 17(3)(e) establishes the period of amortization for these losses to be 40 years commencing in the year when Hydro's rates are first altered under the Public Utilities Act. If Hydro was to commence amortizing the foreign exchange losses based on the 1999 balance noted above, the annual amortization to be included in the revenue requirement would be $2.4 million.

In 1998 Hydro accrued $1 million towards its foreign exchange losses consistent with prior years and in compliance with the Board's recommendation from the 1992 hearing.

Based on the results of our procedures, nothing has to come to our attention to indicate that the changes to deferred charges are not prudent and unreasonable in relation to sales of power and energy.

Cost Control/Productivity Initiatives

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

The Company has undertaken a number of initiatives to explore the possibility of future savings and increased productivity. In our 1998 report, we noted a number of initiatives that the Company was in the process of implementing. An update on the progress of these initiatives as provided to us by Hydro senior management is outlined below.

Joint Steering Committee (Coordination of Utility Activities)

This is a joint committee consisting of union representatives from Hydro and Newfoundland Power. The Committee was established in early 1997 to review potential opportunities for co-ordination that could result in lowering the overall cost of providing electrical service. The overall mandate of the Steering Committee is to advise and make recommendations to the utilities based on reviews that are carried out on their behalf.

According to management, most of the review of the Joint Steering Committee has been conducted, however, a report has not been finalized. The process has lead to the realization of some minor savings, and recently a Memorandum of Understanding to Share Services and Equipment during emergencies was finalized.

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

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

In our 1998 report, we indicated that Hydro had completed a RCM pilot in the transmission, distribution; and diesel generation areas, and that an implementation team would be trained in the RCM process, templates would be drafted and the analysis of Hydro's systems would be scheduled to start in September 2000.

Based on correspondence from Hydro officials, this initiative is on schedule.

Materials Management Department – New Strategies

In 1997, the Director of Materials Management presented a number of strategies to the Management Committee that were expected to result in reduced costs relating to inventory and administration overhead. The strategies include the implementation of

blanket contracts where appropriate and multi year agreements with appropriate suppliers.

Based on information from Hydro officials, as of January 2001, Materials Management has awarded nineteen long-term blanket contracts for goods and services. These orders account for the majority of their regular maintenance materials and service requirements. The majority of these orders have been in place for less than six months.

The consolidation of requirements has allowed Hydro to identify where duplication has occurred in the past and to standardize materials and procedures throughout the Hydro Group. Hydro officials are continuing to explore opportunities to further consolidate, standardize and reduce duplication.

Diesel Plant Operation Review

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

MIS and Telecontrol Reorganization

In late 1999 the MIS and Telecontrol Departments were combined to form a new Information System and Telecontrol Department (IS & T). The new department became fully operational June 30, 2000 and combines all computer and data processes under one department.

As part of the annual review process, we will monitor the results of the above initiatives and obtain an update from the Company during the 2000 review and inquire as to any future initiatives that are being evaluated.

Contributions in Aid of Construction (CIAC's)

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

Our procedures in this area included the following:

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

As part of our review, we have held discussions with Mr. Barry Brophy of Hydro regarding the Company's CIAC policies and procedures and we have selected and reviewed documentation supporting a sample of five (5) CIAC calculations prepared during 1999.

Based on the results of our inquiry and review of documentation, we noted that the Board's requirements for the approval, review and calculation processes as specified in P.U.4 (1997-98), are being complied with. However, certain observations were noted during our review which are noted below for your information:

- Hydro essentially uses a manual system to monitor all CIAC quotes. The Company did implement a spreadsheet system in 1997 that is updated on a regular basis for new CIAC quotes. Mr. Brophy indicated that any CIAC quotes prior to 1997 are more difficult to accumulate due to the previous filing system. The most significant deficiency resulting from the manual system is the manual calculation of the individual quotes. However, to compensate, Hydro requires the manual calculations be checked and approved by the appropriate supervisor. No calculation errors were found in the sample quotes.

- We also noted that there is no formal two year review process in place as ordered by P.U. 4 (1997-98). The purpose of the review is to ensure all CIAC quotes are reviewed after 24 months for any adjustments for rate changes, etc. However, Hydro staff have implemented an informal annual review process, whereby the CIAC database (spreadsheet) is sorted by region and a listing of all CIAC quotes are sent to each region to be reviewed. Any required adjustments are forwarded to staff at Head Office for updating.

- All customers are to be advised of the conditions relating to refunds of CIACs. However, none of the customers selected in our sample were advised of these conditions in writing.

- Hydro does not include sketches with the customer letters.

Based on our discussions, we believe that the shortfalls in Hydro's procedures are partially due to the manual process. The onus is on the regional technicians who perform the fieldwork to ensure that they have their sketches precise and their line measurements exact. Also, it is the responsibility of the regional offices to ensure all CIAC quotes are documented, filed and reported to Head Office. However, despite the several shortfalls highlighted above there were also several other concerns noted during the review that fall outside the general need of a computerized system. We report the following observations:

- In several instances, it was noted that CIAC quotes were provided to customers without any written request for service on file.
- Based on a letter dated October 24, 1997 sent from head office to all regional managers, Hydro outlined a format to be followed in the preparation of customer files for all new CIAC quotes. The purpose of this format was to ensure the completeness of each CIAC file. After reviewing our sample of CIAC quotes, it was noted that Hydro failed to follow its own policies. Most files were poorly organized and documented, containing only the bare essentials to provide a CIAC quote.
- Hydro's annual review process got off to a late start in 2000. The annual listing of CIAC quotes was not sent out to the regional areas from head office until mid-March 2000. Out of the three regional areas, only two regions have reported back to head office with completed reviews. As of late November 2000, the remaining region has reported to be still in the process of performing these reviews. Mr. Barry Brophy of Hydro has informed us that possible time limits on annual reviews may have to be put in place to speed up the process.

We recommend in the preparation of CIAC quotes, all employees should follow a standardized set of policies and procedures in order to maintain consistency. We also recommend all CIACs quotes should contain a written request for service and documentation regarding refunds should be provided to all customers. Finally, Hydro should develop a standardized form that is required to be completed by the appropriate personnel at the regional offices, in a timely manner, indicating their review of the annual CIAC quote listing provided to them by the Head Office. This will ensure that the CIAC's are being reviewed on an annual basis.

Based on the results of our inquiry and review of documentation, we noted that the Board's requirements for the approval, review and calculation processes as specified in P.U.4 (1997-98), are being complied with. However, we have noted a number of observations and provided several recommendations for the CIAC process.

During the 2000 annual financial review we will continue to review a sample of the CIAC quotations prepared in 2000, including the administrative processes to ensure the Company is in compliance with the Board Order.

Capital Budgeting Process

Scope: ***Review and provide commentary with respect to Hydro's process for forecasting capital expenditures.***

The Public Utilities Act requires a public utility to submit an annual capital budget of proposed improvements or additions to its property to the Board for approval. The preparation for Hydro's capital budget plan begins approximately one year before commencement of proposed projects. At the direction of the Management Committee, Hydro develops and maintains a five-year capital plan for the Hydro Group of Companies.

The first budget function in the preparation of the five-year capital plan involves the Vice President of Finance distributing annual capital budget instructions to the Hydro Group of Companies. These instructions include a budget timetable, highlighting specific action dates, the current five-year capital budget and the policies and procedures for the preparation of capital budget proposals.

The department directors and managers are responsible for reviewing the budget package with their supervisors and to provide any explanations they may feel is necessary to ensure the accuracy, consistency and the timeliness of the information included in the capital budget proposals.

A capital budget proposal must be prepared for each individual capital expenditure and may include the following:

- new, replacement, modified, or upgraded equipment or systems;
- feasibility studies and environmental assessments;
- units of property such as dams, dikes, penstocks, etc.
- components of a unit of property which provide an addition or betterment; and
- purchases with unit prices greater than $1,000 and a useful life in excess of two years.

Based on the above definition, supervisory personnel from each department will review their area requirements annually and identify projects for capital proposals. This includes capital projects that are not likely to take place until the second preceding year but will incur up-front costs in the budget year. Capital budget proposals currently listed in the five year capital plan which have not advanced to approved job cost status must also be reviewed. Any changes that have occurred during the past year will require the initiator of a project to resubmit the proposal. The system-planning department is responsible for identifying the energy-related capital projects contained in the current five-year plan that may need to be rescheduled or redefined. The majority of these projects fall within the transmission and rural operations (TRO) and production divisions.

The capital budget proposal is divided into two main components, originator and estimator. The originator component contains an administrative section for information such as the division, department, area, classification and title. There are also two other

sections in this component, which require a detailed description of the project and project justification with any attachments for further clarification.

The second component of the proposal requires the estimator to prepare a preliminary cost estimate. This estimate must be reasonably conservative, but still include all the time and purchases required to complete the proposed project including corporate overheads, interest if construction is involved and escalation or inflation rates. To assist in the preparation of the cost estimate, Hydro has devised a spreadsheet, which itemizes each expense to produce a final project cost. In addition to this information, the Board requires a separate explanation to be submitted for all projects greater than $50,000. This explanation should include a description of the following:

1. the nature of the project,
2. the customer impact,
3. a cost benefit study; and
4. future commitments created by the project.

Area supervisors, with the help of superintendents and engineering personnel, prepare both components of the capital budget proposal for non-energy-related projects. Cost estimates are usually set based on past job costs or through supplier contact if no history is available. Estimates for office automation equipment (i.e. computers), however, are usually coordinated through the information systems department. Upon completion of the proposals, regional managers and department directors review and approve each proposal and forward to the projects reporting division for input to a central database for summarization purposes.

For energy related projects, system planning will complete and approve the originator component and then forward the proposal to appropriate parties for the preparation of estimates, monthly cost and cash flows based on the official load forecast prepared by Economic Analysis. Once both sections of the proposal are complete, the system planning division will meet with the directors and managers of each affected department to gain approval on the information outlined in the proposal. Once a mutual understanding has been reached, the proposal is signed and forwarded to the projects reporting division for input.

After entering the data, the projects reporting division will distribute a summary of the proposals to the plant ledger supervisor. The plant ledger supervisor is responsible for reviewing each proposal to ensure the project is of a capital nature and not maintenance work. Summaries are also distributed to the directors and managers of each division to collectively analyze for possible changes. Revisions are made by the projects reporting division and updated summaries are then distributed to the department directors, managers and their vice-presidents.

Divisional vice-presidents will review and approve all capital proposals within their division. Their review will consist of examining each proposal on a capital versus

maintenance basis taking into consideration all the comments received from the plant ledger supervisor. The projects reporting division will be notified of any changes.

The third draft of summarized capital proposals and copies of the five-year capital plan are then distributed to the Management Committee in late May. The Committee will review the five-year plan in its entirety with particular emphasis on the following year. Any changes or additions are incorporated into the plan before Projects Reporting finalizes the corporate wide five-year capital plan and sends another copy to the Management Committee and department directors and managers.

In August, department directors and managers will provide Projects Reporting with the latest forecast and revised completion dates for all current year capital projects. This most recent information may potentially effect the capital budget for next year and modifications must be made accordingly. During this same time period explanations for current capital projects greater than $50,000 must also be reviewed by department directors and managers.

In September, the Management Committee will meet to approve the capital budget for next year for presentation to the Board of Directors and the Public Utilities Board. Explanations for current capital projects greater than $50,000 is also reviewed. Later that month, the Board of Directors will approve the capital budget for next year for presentation to the Public Utilities Board.

In October, Hydro's plan is to submit the capital budget to the Public Utilities Board and await a hearing date from the Board to review the budget.

Based on our discussions and review of documentation, it appears that Hydro has a comprehensive process in place for the development of their capital budgets however, we have not performed any detailed analysis to assess its overall effectiveness and efficiency.

Operating Budget - Comparison to Actual Results

Scope: ***Prepare a comparison of the budgeted figures to the actual results for operating expenses. We will prepare this comparison for the 1998 and 1999 fiscal years, and provide comments as to the accuracy of Hydro's budgeting process.***

As per the Board's request, we have prepared an analysis of Hydro's expense budget figures for 1998 and 1999 with the their actual results for the respective years. This analysis uses the original budget figures for 1998 and 1999, and includes the costs before any transfers to capital.

The Company commences the preparation of the operating budget for the next fiscal year in the Spring of the current year and it is presented to the Company's Board for approval in the Fall. For example the Company's Board of Directors approved the operating budget for 2000 on October 29, 1999. Throughout the year the Company updates the budget with forecasts to account for changes that arise during the year that will affect the original operating budget.

The original budget would be similar to the test year data submitted by the Company during a general rate hearing process. The purpose of this analysis is to determine the Company's accuracy in the preparation of their original operating budgets.

Our analysis includes the budget and actual information for the following expense categories indicated in the table below. Based on this information presented, the Company experienced favourable variances of 7.4% and 6.1% in 1998 and 1999, respectively.

Cost	1999 Actual (000)'s	1999 Budget (000)'s	1999 Variance (000)'s	1998 Actual (000)'s	1998 Budget (000)'s	1998 Variance (000)'s
Fuel	$ 35,110	$ 46,627	$(11,517)	$ 26,880	$ 45,989	$(19,109)
Power purchased	$ 18,927	$ 19,451	$ (524)	$ 13,472	$ 8,082	$ 5,390
Interest	$ 93,179	$100,148	(6,969)	$ 98,786	$105,779	$ (6,993)
Other costs	$ 95,965	$ 92,703	$ 3,262	$ 92,700	$ 90,383	$ 2,317
Total	**$243,181**	**$258,929**	**$(15,748)**	**$231,838**	**$250,233**	**$(18,395)**

Fuel

Based on the information included in the table, the most significant variance (in dollars) relates to the fuel costs, both years resulted in a favourable variance, 42% and 25% respectively. The variance for both years is mainly due to an increase in the level of

hydraulic production than originally budgeted and a decrease in the number of barrels of bunker "c" fuel consumed as a result of this increase in hydraulic production.

Power purchased

This cost category experienced a significant unfavourable variance in 1998 of 66.7% and a favourable variance in 1999 of 2.7%. During the last quarter of 1998, the Company purchased power from the two non-utility generators at a cost of $2.2 million that was not included in their original budget. Also, the Company recorded an accrual of $1.7 million in the last quarter of 1998. This represented a conditional purchase of secondary energy from Abitibi-Price in Stephenville. This conditional purchase was contingent on Hydro's reservoir storage later in 1999.

During 1999, the Company purchased power from the non-utility generators at a cost of $10.4 million, which exceeded the budget by $1.2 million. This increase was offset by the reversal of the $1.7 million accrual indicated above. Hydro's hydraulic resources were at capacity in the first quarter of 1999, therefore the Company no longer required this secondary source of power from Abitibi Price.

Interest

This expense category experienced favourable variances of 6.6% and 7.0% in 1998 and 1999, respectively. During both years, the Company redeemed bonds that were not scheduled to mature until 2001 to 2003. Four series of bonds were redeemed in 1998 and an additional two series were redeemed in 1999. The interest rates for these bonds ranged from 10.00% to 13.375%.

Other costs

Our analysis of the information on other costs for 1998 and 1999 indicates that the actual costs exceeded budgeted costs in both years by 2.6% and 3.5% respectively.

Cost	1999 Actual (000)'s	1999 Budget (000)'s	1999 Variance (000)'s	1998 Actual (000)'s	1998 Budget (000)'s	1998 Variance (000)'s
Salary	$57,128	$55,244	$ 1,884	$54,960	$54,654	$ 306
Other costs	$38,837	$37,459	$ 1,378	$37,740	$35,729	$ 2,011
Total	**$95,965**	**$92,703**	**$ 3,262**	**$92,700**	**$90,383**	**$ 2,317**

Based on the information presented above, the budget for 1999 is comparable to the actual costs incurred in 1998, however, these costs experienced additional increases in 1999 in comparison to the budget.

Salary costs experienced unfavourable variances in both years calculated at 0.5% and 3.4%, in 1998 and 1999 respectively.. ~~The unfavourable variance in 1999 is mainly due to extra overtime relating to system equipment maintenance and the implementation of the J.D. Edwards suite of products in the finance division.~~

System equipment maintenance, building rentals and maintenance, professional services, and travel have exceeded the budgeted costs for both years and the actual costs for insurance, transportation, office supplies and equipment rentals are less than budget for both of the years.

Miscellaneous costs were significantly over budget in 1998, however 80% of the variance was the result of settlement costs paid to two Non-Utility Generators (NUGS). In 1998, the Provincial Government decided to undertake an energy policy review, and all new small Hydro projects were suspended pending this review.

Overall, we have observed some significant variances between original budgets and actual results for the 1998 and 1999 fiscal years. ~~While Hydro has provided reasonable explanations for these variances, this does not necessarily provide comfort for the Board in terms of the assessment of budgeted or forecast expenses for a test year~~. In light of our observations, ~~the Board will need to be diligent in~~ their review of Hydro's forecast of test year expenses.

Review Findings Requiring Follow-up

Appendix A

Review Findings Requiring Follow Up

The following is a list of items related to our observations/findings during our review which require follow-up or action on behalf of the parties indicated.

Newfoundland and Labrador Hydro

- The Company should review their approach/methodology to determining intercompany charges to CF(L)Co, and consider updating the 1992 study in preparation for the rate hearing scheduled for 2001. (Ref. Pgs. 21-22)

- The Company should consider having the 1998 deprecation study conducted by KPMG LLP updated for the rate hearing scheduled for 2001. (Ref. Pgs. 26-27)

- The Company should consider the implementation of our recommendations relating to the preparation and maintenance of the CIAC quotations. (Ref. Pg. 34)

Grant Thornton LLP

- During the annual financial review for 2000, analyze Hydro's staffing levels and salary costs using Hydro's calculation of full time equivalent positions (FTE's). (Ref. Pg. 12).

- During the annual financial review for 2000, review expense categories for increasing trends in comparison to prior years and the 2000 budget to determine whether the costs incurred are reasonable and prudent in relation to the sales of power and energy (eg. system equipment maintenance, professional fees, travel and conferences). (Ref. Pgs. 17-19)

- Follow up in the cost control/productivity initiatives and inquire as to any future initiatives currently being evaluated. (Ref. Pg. 32)

- During the annual financial review for 2000, review a sample of the CIAC quotations prepared in 2000, including the administrative processes to ensure the Company is in compliance with Board Order P.U. 4(1997-98). (Ref. Pg. 34)

Newfoundland and Labrador Hydro

Schedule 1

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

(000)'s

	1999	1998	1997
ASSETS			
Fixed assets	$1,241,103	$1,234,963	$1,237,986
Current assets	111,765	113,363	93,924
Rate stabilization plan	17,538	31,744	28,259
Long-term receivable	-	-	-
Deferred charges	110,451	111,128	109,520
Total assets	$1,480,857	$1,491,198	$1,469,689
LIABILITIES AND SHAREHOLDER'S EQUITY			
Long-term debt	$ 997,544	$ 918,927	$ 793,901
Current liabilities			
Accounts payable	66,256	71,628	62,809
Due to affiliates	3,967	4,041	3,071
Promissory notes	54,415	83,665	209,896
Long-term debt within one year	12,150	87,127	114,459
	136,788	246,461	390,235
Unrealized foreign exchange loss provision	8,000	7,000	6,000
Shareholder's equity			
Retained earnings	338,525	318,810	279,553
Total liabilities and equity	$1,480,857	$1,491,198	$1,469,689

Newfoundland and Labrador Hydro **Schedule 2**
Statements of Earnings and Retained Earnings
(Excluding CF(L)Co., LCDC and Contributed Capital - Muskrat Falls)

(000)'s

	1999	1998	1997
Revenue	$ 316,990	$ 304,196	$ 292,658
Expenses			
Fuels	35,110	26,880	43,900
Power purchased	18,927	13,472	5,692
Other costs	85,271	81,729	75,400
Depreciation	36,108	32,072	29,880
Interest	93,179	98,786	106,876
	268,595	252,939	261,748
Write down of capital assets	16,680		
Net earnings	$ 31,715	$ 51,257	$ 30,910
Retained earnings, beginning of year	$ 318,810	$ 279,553	$ 261,000
Net earnings	31,715	51,257	30,910
Dividends	(12,000)	(12,000)	(12,357)
Retained earnings, end of year	$ 338,525	$ 318,810	$ 279,553

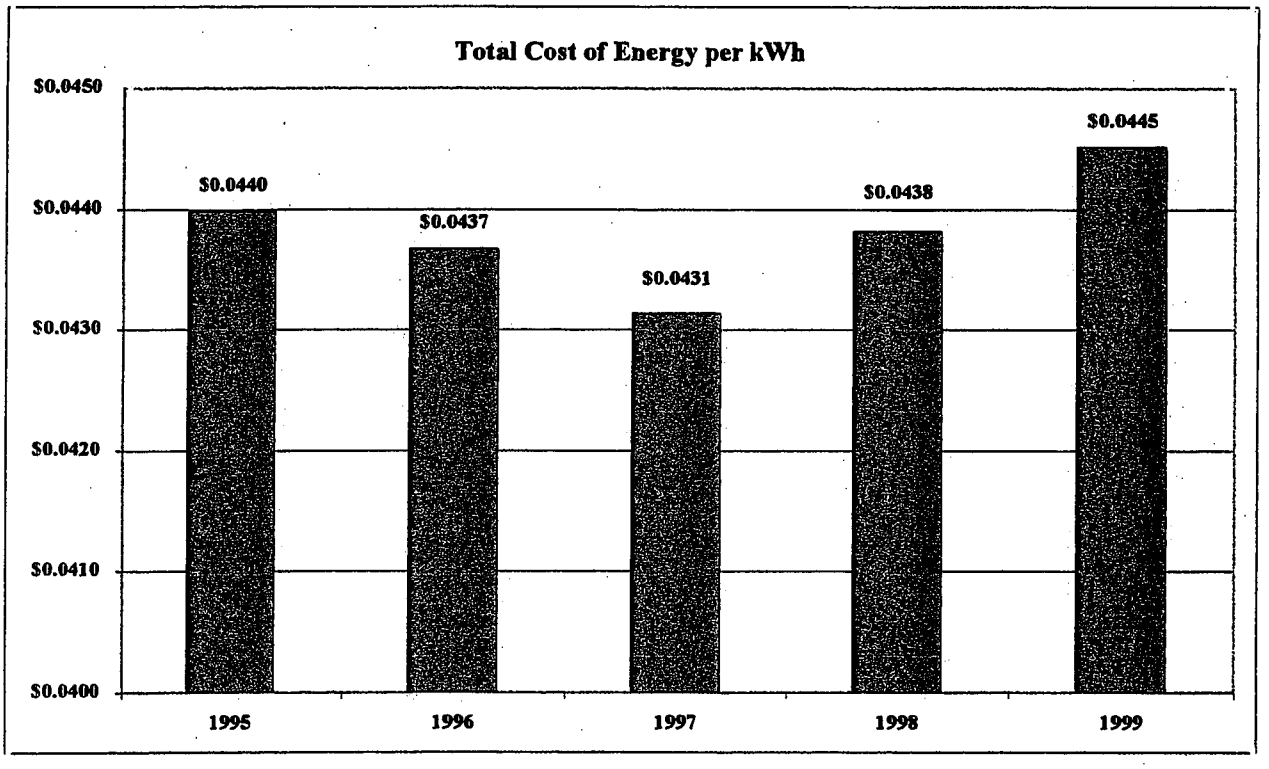
Newfoundland and Labrador Hydro
Reconciliation of Net Income to Revenue Requirement
97 to 1999

Schedule 3

(000)'s	1999 Financial Statement	1999 Adjust.	1999 Revenue Require.	1998 Financial Statement	1998 Adjust.	1998 Revenue Require.	1997 Financial Statement	1997 Adjust.	1997 Revenue Require.
Depreciation	$ 36,108		$ 36,108	$ 32,072	$ 771	$ 32,843	$ 29,880	$ 806	$ 30,686
Fuel	35,110		35,110	26,880		26,880	43,900		43,900
Power purchased	18,927	(4,756)	14,171	13,472	(3,786)	9,686	5,692		5,692
Other costs									
Salaries	57,128	(58)	57,070	54,960	(56)	54,904	51,905	(42)	51,863
System equip. maint.	14,957	(2)	14,955	11,325	(2)	11,323	11,511	(5)	11,506
Insurance	1,068		1,068	1,056		1,056	1,224		1,224
Transportation	3,481		3,481	3,642	(1)	3,641	3,177		3,177
Office supplies	2,858		2,858	2,715		2,715	2,716		2,716
Bldg. rentals and maint.	2,897		2,897	3,226		3,226	2,210		2,210
Professional services	3,756		3,756	3,398		3,398	2,883	(256)	2,627
Travel	2,459		2,459	2,211		2,211	2,006	(49)	1,957
Equipment rentals	1,602		1,602	2,000		2,000	1,531	(1)	1,530
Miscellaneous	4,341	388	4,729	5,927	215	6,142	3,752	168	3,920
Loss on disposal	923		923	1,137		1,137	691		691
Amortization of studies and software				771	(771)		806	(806)	
Customer costs	495	(495)	-	332	(332)		298	(298)	
Sub-total	95,965	(167)	95,798	92,700	(947)	91,753	84,710	(1,289)	83,421
Allocations									
Other	(49)	49	-	(44)	44		(42)	42	
Hydro capitalized	(8,537)		(8,537)	(8,667)		(8,667)	(6,897)		(6,897)
C.F.(L) Co.	(2,109)		(2,109)	(2,260)		(2,260)	(2,372)		(2,372)
Sub-total	(10,695)	49	(10,646)	(10,971)	44	(10,927)	(9,311)	42	(9,269)
Total	85,270	(118)	85,152	81,729	(903)	80,826	75,399	(1,247)	74,152
Write down of capital assets	16,680		16,680						
Interest	93,179		93,179	98,786		98,786	106,876		106,876
Margin	31,716	(33,602)	(1,886)	51,257	(26,253)	25,004	30,910	441	31,351
Revenue requirement	$316,990	($38,476)	$278,514	$304,196	($30,171)	$274,025	$292,657		$292,657

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

Year	kWh sold and used	Depreciation	Fuel	Purchased Power	Other Costs	Interest	Margin	Total Cost of Energy	Cost per kWh
1995	6,506,000	$ 28,394	$ 40,360	$ 5,053	$ 77,027	$ 112,472	$ 22,829	$ 286,135	$ 0.0440
1996	6,589,000	$ 29,301	$ 41,683	$ 5,225	$ 77,799	$ 113,062	$ 20,693	$ 287,763	$ 0.0437
1997	6,784,000	$ 30,686	$ 43,900	$ 5,692	$ 74,152	$ 106,876	$ 31,351	$ 292,657	$ 0.0431
1998	6,254,000	$ 32,843	$ 26,880	$ 9,686	$ 80,826	$ 98,786	$ 25,004	$ 274,025	$ 0.0438
1999	6,257,000	$ 36,108	$ 35,110	$ 14,171	$ 85,152 [1]	$ 93,179	$ 14,794 [1]	$ 278,515	$ 0.0445



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

Newfoundland and Labrador Hydro
Comparison of Other Costs by Breakdown
1995 to 1999

kWh sold and used	6,506,000			6,589,000			6,784,000			6,254,000			6,257,000		
	Cost	Cost per kWH	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total
Salaries	$ 55,991	0.00861	100.00%	$ 56,724	0.00861	100.00%	$ 51,863	0.00764	100.00%	$ 54,904	0.00878	100.00%	$57,070	0.00912	100.00%

kWh sold and used	6,506,000			6,589,000			6,784,000			6,254,000			6,257,000		
	Cost	Cost per kWH	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total	Cost	Cost per kWh	% of Total
System equip. maint.	$ 9,706	0.00149	31.67%	$ 10,294	0.00156	34.78%	$ 11,506	0.00170	36.46%	$ 11,323	0.00181	30.73%	$14,955	0.00239	38.62%
Insurance	1,208	0.00019	3.94%	1,169	0.00018	3.95%	1,224	0.00018	3.88%	1,056	0.00017	2.87%	1,068	0.00017	2.76%
Transportation	3,366	0.00052	10.98%	3,513	0.00053	11.87%	3,177	0.00047	10.07%	3,641	0.00058	9.88%	3,481	0.00056	8.99%
Office supplies	2,936	0.00045	9.58%	2,842	0.00043	9.60%	2,716	0.00040	8.61%	2,715	0.00043	7.37%	2,858	0.00046	7.38%
Bldg. rentals and maint.	2,435	0.00037	7.94%	1,930	0.00029	6.52%	2,210	0.00033	7.00%	3,226	0.00052	8.75%	2,897	0.00046	7.48%
Professional services	2,513	0.00039	8.20%	2,330	0.00035	7.87%	2,627	0.00039	8.32%	3,398	0.00054	9.22%	3,756	0.00060	9.70%
Travel	1,799	0.00028	5.87%	1,874	0.00028	6.33%	1,957	0.00029	6.20%	2,211	0.00035	6.00%	2,459	0.00039	6.35%
Equipment rentals	1,505	0.00023	4.91%	1,740	0.00026	5.88%	1,530	0.00023	4.85%	2,000	0.00032	5.43%	1,602	0.00026	4.14%
Miscellaneous	3,910	0.00060	12.76%	4,014	0.00061	13.56%	3,920	0.00058	12.42%	6,142	0.00098	16.67%	4,729	0.00076	12.21%
Loss on disposal	1,274	0.00020	4.16%	(110)	(0.00002)	-0.37%	691	0.00010	2.19%	1,137	0.00018	3.09%	923	0.00015	2.38%
Total	$ 30,652	$ 0.00471	100.00%	$ 29,596	$ 0.00449	100.00%	$ 31,556	$ 0.00465	100.00%	$ 36,849	$ 0.00589	100.00%	$38,728	$ 0.00619	100.00%
Grand Total	$ 86,643	$ 0.01332	100.00%	$ 86,320	$ 0.01310	100.00%	$ 83,421	$ 0.01230	100.00%	$ 91,753	0.01467	100.00%	$95,798	0.01531	100.00%

Newfoundland and Labrador Hydro **Schedule 5**
Rate Stabilization Plan Summary
1997 to 1999

(000)'s	1999 Current Variation	1999 Current Interest	1999 Prior Interest	1999 Total	1998	1997
Balance, beginning of year				$48,786	$41,378	$30,162
Water variation	$ (15,859)	$ (945)	$ 19,057	2,253	16,981	9,331
Load variation	5,050	296	(272)	5,074	3,028	-1,129
Fuel variation	9,128	188	(19,212)	-9,896	-6,209	4,887
Recovery	(15,427)		4,188	-11,239	-6,263	-1,400
Rural rate alteration	(394)	1	(89)	-482	19	-546
Labrador interconnected	(171)	(7)	13	-165	-148	73
Net change	$ (17,673)	$ (467)	$ 3,685	-14,455	7,408	11,216
Balance, end of year				$34,331	$48,786	$41,378

Comprised of:

Water variation	$219,175
Load variation	1,980
Fuel variation	-228,591
Recovery	43,279
Rural rate alteration	-1,495
Labrador interconnected	-17
Balance, end of year	$34,331
Current receivable	$16,793
Long-term receivable	17,538
	$34,331

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Board of Commissioners of Public Utilities
2000 Annual Financial Review of Newfoundland and Labrador Hydro

Contents

Introduction

This report to the Board of Commissioners of Public Utilities ("the Board") presents our observations, findings and recommendations with respect to our 2000 Annual Review of Newfoundland and Labrador Hydro ("the Company")("Hydro").

Scope and Limitations

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

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

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

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

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

4. Verify Hydro's reconciliation of Net income to Revenue Requirement for 2000. Review and assess the reasonableness of adjustments in the calculation of revenue requirement.

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

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

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

8. Review Minutes of Board of Director's and Management Committee meetings.

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

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

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

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

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

The financial statements of the Company for the year ended December 31, 2000 have been audited by Ernst and Young LLP, Chartered Accountants, who have expressed their opinion on the fairness of the statements in their report dated February 9, 2000. In the course of completing our procedures we have, in certain circumstances, referred to the audited financial statements and the historical financial information contained therein.

Accounting System and Code of Accounts

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

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

During 1998 Hydro implemented its new accounting system, J.D. Edwards. This new system resulted in a new chart of accounts, and several changes in a number of the account groupings. Then in 2000 several additional changes affecting the account groupings of inventory and non-inventory items were implemented. This change was expected to eliminate supplier dependency in the preparation of budgets and other financial information.

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

In regards to Section 58 of the *Public Utilities Act*, correspondence from the Board dated October 4, 2000 indicated that Hydro's current code of accounts was approved on a provisional basis, subject to final approval at a general rate hearing. Hydro's system of accounts provides adequate flexibility to allow the Company to meet its own and the Board's reporting requirements.

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

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

Return on Rate Base

We have calculated the average rate base for 2000 and restated 1999 and 1998 using the methodology and criteria that Hydro proposed in their rate application filed with the Board on May 31, 2001. It is important to note that the components of this calculation have not been approved by the Board and will be subject to review and approval as part of the rate hearing in the fall of 2001. However, until the rate base is fixed and approved, utilization of the above methodology and criteria provides a reasonable indication of the return on rate base achieved by Hydro.

In addition to utilizing the proposed methodology as noted above, the 1999 and 1998 net income and interest expense have been restated to reflect the adjustments made by Hydro to the calculation of the profit contribution from the Hydro Quebec recall. These adjustments are described in more detail in the revenue requirement section of our report.

We have calculated the return on rate base for 2000 at 7.69% as compared to 6.88% for 1999 and 9.20% for 1998. Details with respect to the calculation of average rate base and return on rate base are as follows:

(000)'s	2000	1999	1998
Plant investment	$ 1,678,600	$ 1,640,900	$ 1,641,300
Less: Accumulated depreciation	(380,500)	(351,700)	(331,500)
CIAC's	(89,000)	(89,800)	(90,500)
	1,209,100	1,199,400	1,219,300
Balance previous year	1,199,400	1,219,300	1,228,000
Average	1,204,250	1,209,350	1,223,650
Cash working capital allowance	2,947	2,940	2,682
Fuel inventory	20,005	10,238	11,478
Supplies inventoy	21,251	21,933	21,536
Deferred realized foreign exchange loss	87,300	88,300	89,300
Average rate base	$ 1,335,753	$ 1,332,761	$ 1,348,646
Net income (as adjusted per Schedule 3)	$ 5,850	$ (3,647)	$ 25,132
Hydro net interest expense	96,900	95,300	98,900
Adjusted net income	$ 102,750	$ 91,653	$ 124,032
Return on rate base	**7.69%**	**6.88%**	**9.20%**

The above calculation excludes the profit contribution of approximately $11.6 million from the Hydro Quebec recall (1999 - $35.5 million; 1998 - $25.9 million). The return on rate base would be 8.36% (1999 - 9.38%, 1998 - 11.11%) if this profit contribution were included in the regulated net income and the net interest expense was adjusted for the savings that was considered to be a direct result of the increase in cash flows.

In February 2000, the Board issued P.U.5 (2000 - 2001) authorizing Hydro to abandon the woodchip fired thermal generating station located in Roddickton. This resulted in a write-down of capital assets of $16.7 million, which Hydro has reflected in the 1999 financial statements. The return on rate base for 1999 would be 8.99% excluding this write-down of capital assets. Adjusting 1999 for both the capital asset write-down and the profit from the Hydro Quebec recall would result in a return of 11.35%.

Return on Equity

The return on equity for 2000 has been calculated at 2.10% as follows:

(000)'s	2000	1999	1998
Shareholder's equity			
2000	$ 267,900		
1999	$ 289,700	$ 289,700	
1998		294,300	294,300
1997			279,500
Average equity	$ 278,800	$ 292,000	$ 286,900
Net income (as adjusted per Schedule 3)	$ 5,850	$ (3,647)	$ 25,132
Return on equity	**2.10%**	**-1.25%**	**8.76%**

The above calculation also excludes the profit contribution from the Hydro Quebec recall of approximately $11.6 million in 2000, $35.5 million in 1999 and $25.9 million for 1998. The return on equity would be 5.46% for 2000, 9.69% for 1999 and 17.08% for 1998 if these profit contributions were included in the 2000, 1999 and 1998 net income respectively. Also, the net income indicated above for 1999 includes a write-down of capital assets of $16.7 million. The return on equity would be 4.34% if this transaction were normalized in the net income calculation. Adjusting 1999 for both the capital asset write-down and the profit from the Hydro Quebec recall would result in a return on equity of 14.4%.

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

(000's)	2000	1999	1998
Equity per non-consolidated financial statements	$ 568,600	$ 626,280	$ 591,650
Less: Contibuted capital			
- Lower Churchill Development	(15,400)	(15,400)	(15,400)
- Muskrat Falls Project	(2,200)	(2,200)	(2,200)
Share capital issued to finance investment in CF(L)Co.	(22,500)	(22,500)	(22,500)
Net retained earnings attributable to CF(L)Co. (income recorded minus dividends flowed through to government)	(228,500)	(247,700)	(232,800)
Net retained earnings attributable to the sale of recall power to Hydro Quebec (income recorded minus allocation of dividends)	(32,116)	(48,776)	(24,434)
"Regulated Equity"	$ 267,884	$ 289,704	$ 294,316

The adjustment to regulated equity relating to the net retained earnings attributable to the sale of recall power to Hydro Quebec is based on Hydro's revised calculation of profit from the sale of recall power and incorporates an allocation of dividends between the regulated versus non-regulated earnings. We will review the appropriateness of this notional adjustment to regulated equity as part of our review performed for the scheduled general rate hearing.

Overall, the above calculations provide a reasonable indication of the rate of return on equity achieved by Hydro during the year.

Interest Coverage

Interest coverage for 2000 has been calculated at 1.18 times as follows:

(000's)	2000	1999	1998
Total interest	**$ 96,034**	$ 94,288	$ 100,682
Less: CF(L)Co	**(1,841)**	(1,109)	(1,896)
Hydro net interest	**94,193**	93,179	98,786
Less: Guarantee fee	**(10,610)**	(10,849)	(11,153)
Add: Interest earned and IDC			
Power bills	**16**	85	250
RSP	**3,217**	3,217	4,150
Sinking funds	**5,323**	8,689	28,269
IDC	**3,694**	1,984	428
Gross interest	**$ 95,833**	$ 96,305	$ 120,730
Net income (per Schedule 3)	**$ 17,296**	$ 31,715	$ 51,257
Gross interest	**95,833**	96,305	120,917
Adjusted income	**$ 113,129**	$ 128,020	$ 171,174
Interest Coverage	**1.18**	**1.33**	**1.42**

In 2000 gross interest costs continued to decline compared to 1999 and 1998. This decrease is a result of lower average interest rates, net debt retirement, higher interest charged to capital, and interest savings from increased cash flows from the Hydro Quebec recall. The decrease in net income in 2000 is largely attributed to a lower net profit from the recall since the Company reached the revenue cap set in the agreement in May 2000.

Interest coverage has been calculated at 1.06 times when the profit contribution from the Hydro Quebec recall is also excluded from net income.

The Company's interest coverage appears fairly reasonable and comparable to prior years, considering the maximum revenue cap of $78.9 million from the Hydro Quebec recall was reached in early 2000.

Capital Structure

The capital structure of Hydro, excluding its subsidiary companies, can be determined from Schedule 1. For the years 1998 to 2000, the capital structure was as follows:

(000)'s	2000	%	1999	%	1998	%
Debt	$ 1,153,996	79.4%	$ 1,134,332	77.0%	$ 1,165,400	78.5%
Equity	300,050	20.6%	338,525	23.0%	318,800	21.5%
	$ 1,454,046		$ 1,472,857		$ 1,484,200	

For the 2000 fiscal year Hydro declared and paid dividends totaling $69.9 million to the provincial government which included a $33.3 million dividend based on a partial flow through of CF(L)Co revenue. The dividend policy approved by the Board of Directors of Hydro in November, 1995 provides for the payment of dividends annually up to 75% of net operating income provided such payment will not cause the debt: equity ratio to fall below 80:20. In addition, the policy provides for the payment annually of all dividends received from CF(L)Co after payment of debt servicing (including $1 million principal) associated with the CF(L)Co loan.

In comparison to 1999's improvement over 1998 and 1997 ratios, Hydro's debt:equity ratio for 2000 has deteriorated slightly. This deterioration can be attributed primarily to the lower equity level at the end of 2000. The decrease to equity is largely a result of the implementation of the accrual accounting for employee future benefits as required by new recommendations of the Canadian Institute of Chartered Accountants. The impact from this change is a reduction in the opening retained earnings of $22.6 million. The variance in debt is primarily attributed to increases in short-term promissory notes.

Other Costs

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

Schedule 3 of our report provides a breakdown of other costs for the years 1998 to 2000. This schedule shows that the total other costs (before transfers to capital and cost recoveries) have increased in 2000 relative to 1999 by $6.868 million ($102,666,000 - $95,798,000). This 7.2 % increase in 2000 is a continuation of the upward trend, which began in 1998.

On a net basis, other costs show a similar trend with an increase in 2000 relative to 1999 of $7.992 million ($93,144,000 - $85,152,000). The additional increase on a net basis is attributable to the lower transfers to capital and C.F.(L) CO. in 2000 as compared to 1999.

The most significant expense variances in 2000 relate to an increase in salaries of $4.2 million and system equipment maintenance of $4 million. These two categories of expenses are the driving force behind the continuous increase in other costs since 1998. The salary increase is a result of four main factors: 1) a general scale increase of 2% for union and non-union employees; 2) a new collective agreement in 2000 resulted in the reclassification of some positions; 3) temporary employees back filling vacant permanent positions in the Transmission and Rural Operations division due to long term leave, promotions, transfers and assignments to special work; and 4) new recommendations by the Canadian Institute of Chartered Accountants (CICA) resulted in the accrual of employee future benefits. Secondly, the reasons for the increase to system equipment maintenance is two-fold: 1) addition maintenance work in the Transmission and Rural Operations division, mainly repairs to gas turbine and diesel plants in the central and Labrador regions; and 2) the introduction of a newly restructured code of accounts for all inventory and non-inventory items.

During 2000, it was decided that some additional restructuring to the J.D. Edwards code of accounts was necessary in order to provide more practical financial information and facilitate in the preparation of budgets. In 1998 there was a cost coding change that impacted the amount of expenses recorded within system equipment maintenance. Items supplied from inventory for routine operations were all coded to system equipment maintenance. Approximately a year and a half after the introduction of this change, the company realized this cost coding was not providing the useful information that was anticipated. Therefore in early 2000, a steering committee was created and allocated the task of assigning object codes to all purchases both inventory and non-inventory items. There was four object codes developed and assigned to commodity groups with items

currently in inventory and commodity groups with no items currently in inventory. Three of the four codes, maintenance material, tools and operating supplies and gases lubricants and chemicals are recorded within system equipment maintenance, the final code, safety equipment and supplies is recorded within building maintenance and rentals. This cost code restructuring accounts for many of the variances in the operations and administrative expenses. However, for the most part these fluctuations offset each other.

Schedule 4C of our report provides an analysis of the "other costs" on a kWh's sold basis for the years 1996 to 2000. While the schedule reveals an overall increase in total "other costs" and the amount of kWh's sold for 2000, the schedule also clearly indicates a slight drop in the total "other costs" per kWh, thus reversing its upward trend which began in 1998.

On an individual basis, the various expense categories in other costs showed inconsistent trends in 2000; several categories showed increases, while others showed decreases. Schedule 3 provides the details on expenses for the period 1998 to 2000. We have reviewed the various expense categories on an individual basis and our observations and comments are noted below for your consideration.

Based on the results of our procedures, nothing has come to our attention to indicate that the operations and administration expenses, fuels, power purchased, and interest costs are imprudent or unreasonable in relation to sales of power and energy. However, as noted throughout this section of the report, there are several expenses that are experiencing trends that will require monitoring and will be subject to our review in preparation for the 2001 fall rate hearing.

Salaries and benefits

Gross payroll costs for 2000 were $61,374,000, which was 7.4%, or $4.2 million higher than 1999 levels. The salaries and benefits costs are summarized below by category:

(000)'s	2000	1999	1998
Salaries	**$ 41,169**	$ 40,503	$ 39,386
Directors fees	**21**	77	108
Hourly wages	**6,482**	5,727	4,681
Overtime	**3,998**	3,946	4,074
Employee future benefits	**2,243**		
Fringe benefits	**6,205**	5,514	5,437
Group insurance	**1,129**	1,289	1,200
Labrador travel benefit	**127**	71	74
	$ 61,374	$ 57,127	$ 54,960

While salaries and benefits increased in almost every category in 2000, the majority of the overall increase can be attributed to the following categories: employee future benefits - $2.243 million; hourly wages - $755,000; and fringe benefits - $691,000. These three categories account for $3.689 million (or 87%) of the overall increase.

The adoption of new CICA recommendations for accounting for employee future benefits has resulted in new costs of $2.243 million this year. Hydro applied this change retroactively and reduced its opening retained earnings by $22.6 million, however, the prior years costs were not restated.

The breakdown of hourly wages by division is as follows:

(000)'s	2000	1999	1998
Finance	**$ 657**	$ 667	$ 615
Human resources and legal	**1,181**	951	604
Transmission and rural operations (TRO)	**2,951**	2,344	2,119
Production	**1,653**	1,752	1,330
Internal audit	**40**	13	13
	$ 6,482	$ 5,727	$ 4,681

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

- Backfilling vacant permanent positions in the TRO division with temporary employees.

- In the Human Resources and Legal division there was an increase in the number of filled apprentice positions in preparation of anticipated retirements plus the implementation of a Graduate Trainee Program**.**

However, the regular salaries category, which has risen consistently for the past three years and represents the largest portion of payroll costs for the year incurred a much lower increase at 1.6% for 2000. The breakdown of salaries only, by division, is as follows:

(000)'s	**2000**	1999	1998
Finance	**$ 3,901**	$ 3,894	$ 5,261
Human resources and legal	**3,165**	2,857	2,990
Transmission and rural operations (TRO)	**17,410**	17,227	17,360
Production	**15,344**	15,057	12,720
Internal audit	**206**	207	194
Management	**1,143**	1,261	861
	$ 41,169	$ 40,503	$ 39,386

The increase in salary costs relating to the Human Resources & Legal division and the decrease in Management divisions is mainly the result of the transfer of the legal staff from Management to Human Resources. Addition explanations for the variances experienced within the Management division are due to the elimination of the Vice President for the Churchill River Negotiations, partially offset by the full year's effect of the Director for the Production division.

On an overall basis, increases in the salaries category can be attributed to the following items:

- A general scale increase of 2% was provided to all union and non-union workers and Management Committee in 2000.

- In 2000, a new collective agreement was signed which allowed for the reclassification of some positions.

The gross payroll costs for 1998 to 2000 were allocated to operations and capital as follows:

(000)'s	**2000**	1999	1998
Payroll charged to operating	**$ 54,155**	$ 48,954	$ 46,765
Payroll charged to capital	**7,219**	8,173	8,195
	$ 61,374	$ 57,127	$ 54,960

The payroll costs charged to capital continued its downward trend in 2000. Capitalized salaries are made up of more than 25 separate projects, however 6 of these projects represent approximately 43% of total salary costs. Some of these projects are continuations of the larger projects capitalized in 1999 such as the Lower Churchill River project, upgrading work on TL217 and service extensions and upgrading in the Central Region. Several of the larger projects in 2000 included the Granite Canal development and the service extensions and upgrading in the Northwest Region.

The Lower Churchill River project refers to the negotiations with Hydro Quebec relating to hydro electric development on the Lower Churchill River in Labrador. All costs associated with these negotiations are capitalized. Upgrading and service extensions includes the erection of new poles, upgrading existing transmission lines and providing services to new customers. The Granite Canal development relates to the new generation project started in 2000.

Executive salaries for the years 1998 to 2000 are as follows:

	2000	1999	1998
Total executive salaries and benefits	**$ 838,578**	$ 811,139	$ 770,999
Number of executives	**5**	5	5
Average salary	**$ 167,715**	$ 162,230	$ 154,200

The total executive salaries and benefits and the average salary per executive increased by 3.4% in 2000 in comparison to 1999.

The Compensation Committee recommended a salary increase for the President and Vice-Presidents consistent with the increase provided for non-union staff. They also approved step progression for those who were not at their job rate. Salary adjustments were effective January 1, 2000 following an evaluation of their performance.

The staff complement for 1998 to 2000 is as follows:

	2000	1999	1998
Production	**318**	320	278
TRO	**411**	412	406
Finance	**84**	85	121
Internal audit	**4**	4	4
Management	**8**	9	9
Human resources and legal	**66**	71	71
	891	901	889

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

	2000	1999	1998
Production	**312**	312	271
TRO	**382**	383	395
Finance	**81**	81	118
Internal audit	**4**	4	4
Management	**8**	9	9
Human resources and legal	**66**	70	71
	853	859	868

The above tables reflect staffing numbers as at the end of the fiscal year.

The staff complement for 2000 is fairly consistent with 1999, with only a slight decline in the Human Resources and Legal department due to the elimination of several positions relating to the purchasing and control of inventory.

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

The following is a schedule of the average number of temporary employees on staff for 1998 to 2000. The monthly numbers were taken at the end of each particular month.

	2000	1999	1998
January	**99**	94	84
February	**115**	93	131
March	**110**	115	107
April	**123**	134	140
May	**133**	168	141
June	**187**	240	236
July	**195**	231	248
August	**212**	235	199
September	**174**	207	195
October	**161**	183	155
November	**119**	150	162
December	**88**	100	99
Monthly average	**143.0**	162.5	158.1

System equipment maintenance

In 2000, system equipment maintenance costs increased from 1999 levels by $4,020,000 or 26.9%. This increase is made up of several significant variances within the account groupings for this category. The changes in system equipment maintenance costs in 2000 as compared to 1999 are as follows:

• Higher maintenance costs for TRO	$ 4,170,000
• Lower maintenance costs for hydro generation	(341,000)
• Lower maintenance costs for thermal generation	(891,000)
• Higher maintenance and inventory costs for Human resources & legal	528,000
• Higher inventory costs for Finance	136,000
• Higher costs for lubricants, gases and chemicals	194,000
• Other miscellaneous variances – net	224,000
	$ 4,020,000

The costs for 1998 to 2000 for the system equipment maintenance portion of this expense only (excluding tools and equipment, freight and lubricants, gases and chemicals) are broken down by department as follows:

(000)'s	**2000**	1999	1998
Transmission and rural operations	**$ 8,666**	$ 4,497	$ 4,776
Production	**8,439**	9,544	5,577
Human Resources & Legal	**536**		
Finance	**137**		
Other	**2**	9	8
	$ 17,780	$ 14,050	$ 10,361

Extra maintenance requirements in the Central and Labrador regions of the province is the main contributing factor to the increased costs within transmission and rural operations. The extra maintenance requirements in these regions included $1,800,000 of gas turbine repairs and $300,000 for overhaul at the Nain Diesel Plant. The remaining portion of the increase is attributed to costs transferred to the maintenance material object code from other accounts as a result of the account code restructuring that the Company implemented in April 2000.

In 1999, extra maintenance requirements for the hydro generation division contributed to the increased costs within the production department. The extra maintenance projects in 1999 amounting to over $1,000,000 were not part of the regular routine maintenance at the Cat Arm and Upper Salmon hydro plants, and as such were non-recurring. Several smaller maintenance projects at Bay D'Espoir in 2000 offset the $1,000,000 anticipated savings resulting in a net reduction in costs of $681,000. The introduction of the account

code restructuring resulted in additional costs allocated to this category of approximately $340,000 leaving a net overall decrease of $341,000.

The Holyrood thermal plant costs are as follows:

(000)'s	2000	1999	1998
Unit # 1 overhaul	**$1,433**	$1,428	$909
Unit # 2 overhaul	**1,148**	3,268	965
Unit # 3 overhaul	**1,170**	1,193	1,323
Annual routine maintenance	**2,769**	1,522	1,333
	$6,520	$7,411	$4,530

Maintenance costs at Holyrood are subject to a high degree of variability. Based on information provided by the Company, Unit # 1 had a minor overhaul in 2000, 1999 and 1998, however the overhaul for Unit #1 in 2000 also included costs relating to work performed on the valves. The costs incurred in 1999 and 2000 when compared to 1998 are largely due to the scope of the overhaul, since the last major overhaul performed on Unit #1 was in 1997. Unit # 2 had a minor overhaul in 2000 versus a major overhaul in 1999. The cost differential between a minor and major overhaul on Unit # 2 accounts for a majority of the variance between 2000 and 1999. Unit # 3 had minor overhauls done in 2000, 1999, and 1998. Annual routine maintenance has risen significantly since 1998. Approximately $856,000 of this cost increase can be attributed to the account code restructuring mentioned earlier in the report whereby property costs are now charged to system equipment maintenance. However, even if the effect of the account code restructuring is eliminated, the annual routine maintenance costs have increased significantly. This increasing trend is evident from 1997 to 2000 and further analysis of this cost category is warranted, particularly in light of the rate application now before the Board, which is based on 2002 forecast information.

Again, due to the account code restructuring in 2000, variance increases were noted in the lubricants, gases and chemicals account and the finance and human resources & legal departments. All inventory and non-inventory items that fall under the object code “gases lubricants and chemicals” are now recorded to the lubricants, gases and chemicals account. The departmental increases are the result of coding the office supplies group of expenses to system equipment maintenance. In addition to the code restructuring, roof repairs of approximately $75,000 to Hydro Place account for a portion of the increase in the human resources & legal department. These roof repairs are expected to continue over the next several years.

Insurance (including director's liability)

Insurance costs decreased overall by $31,000 or 2.92% in 2000 over 1999.

The All-risk (property) premium decreased by $225,500 and the Boiler and Machinery premium increased by $168,000 due to the negotiation of a new three-year policy, which combined both premiums, and the result was a slightly lower overall premium.

Miscellaneous changes to other premiums paid in the year net to a increase of $26,500.

Transportation

Transportation expense is comprised of aircraft rentals, vehicle expenses (fuel, labour and repairs) and mobile equipment expenses (fuel, labour and repairs). This expense category decreased overall by $589,000 (16.9%) in 2000 as compared to 1999. The majority of this decrease is due to lower vehicle repairs of $413,000 and lower mobile equipment repairs of $325,000. However, this decrease was partially offset by an increase in fuel costs for vehicles of $159,000. Other miscellaneous variances such as an increase in aircraft rentals of $71,000 and a decrease in the fuel costs for mobile equipment of $81,000 netted to a decrease of $10,000.

The combined reduction in vehicle and mobile equipment repairs is primarily a result of the introduction of the account code restructuring in the spring of 2000. These expenses are now coded to maintenance materials in system equipment maintenance. The increase in maintenance costs within the Transmission and Rural Operations division, the primary user of Hydro's vehicles and equipment, is reflective of this cost coding change. The decrease in mobile equipment repairs and fuel costs is also a result of the type of maintenance incurred in the Transmission and Rural Operations in 2000. Installation of an engine at the Stephenville Gas Turbine and overhauls at the Nain Diesel Plant did not provide heavy demands on the use of mobile equipment, however overhauls at the Nain Diesel Plant does explain some of the increase in aircraft rentals.

Despite, the overall decrease in transportation expenditures for 2000 as compared to 1999, the fuel costs for vehicles has risen steadily due to increasing fuel prices.

Based on information provided by Hydro, in 1999 the fleet included 356 vehicles and 355 mobile equipment units, and in 2000 the Company had 371 vehicles and 360 mobile equipment units.

Office expenses, including membership fees

Office expenses in 2000 (including heat and light, telephone, supplies, postage, advertising, cleaning, office equipment maintenance, books and subscriptions and membership fees) decreased by $777,000 or 27.2% over 1999. The large decrease was in the areas of printing forms and supplies of $353,000, cleaning and janitorial supplies of $205,000, and office equipment and maintenance of $235,000. Other miscellaneous variances result in a net increase of $16,000.

The decreases within the account groupings of this category were primarily attributable to the new method of allocating inventory and non-inventory items to account codes. These accounts include costs for approximately the first four months of the year with costs for the remainder of the year coded to the object code maintenance materials in system equipment maintenance.

Membership dues continued to increase in 2000 as they did in 1999. The increase in 2000 is approximately $42,000. These increases are largely a result of additional initiatives undertaken by the Canadian Electrical Association. The costs associated with these initiatives are generally cost shared among the members.

Building rental and maintenance

In 2000 building and rental maintenance decreased from 1999 levels by $1.9 million or 65.6%. The decrease is attributed entirely to restructuring the code of accounts. This category originally consisted of the accounts relating to building rentals, safety equipment & supplies and property costs. When the new object codes were introduced in the spring of 2000, the account “property costs” became inactive and all related expenses were then recorded to system equipment maintenance. This resulted in a decrease to the account of approximately $2,150,000. This decrease was slightly offset by an approximate increase of $250,000 to the “safety equipment & supplies” account when items of protective clothing, originally part of miscellaneous expense, were coded to the new object code.

Professional services

In 2000, professional services costs of $3,814,854 increased from 1999 levels by $58,500. While this overall increase of 1.6% is only slight, there were some significant variances within the account groupings for this category. The changes in professional services costs in 2000 as compared to 1999 are as follows:

• Lower professional fees	$ (429,000)
• Higher PUB related costs	561,500
• Lower software acquisitions	(74,000)
	$ 58,500

The professional fees category decreased in 2000 primarily because of several non-recurring projects in 1999 relating to the information security architecture and IT governance consulting work. These non-recurring project costs were approximately $385,000 in 1999.

With respect to the increase in PUB related expenses, the Company hired consultants during the year to complete an analysis of the cost of service and the rate stabilization plan model at a cost of approximately $400,000. These consultants were contracted in preparation for the 2001 rate hearing. In addition to these consultant costs, there were increased billings from the Board during the year relating to regulatory reviews.

The third variance noted above, which offsets a portion of the overall increase to the professional services category, relates to software acquisition and maintenance. In 1999 there was a rollout of the Microsoft suite of products, and as a result there were fewer requests for additional software in 2000. The actual costs in this category came in under budget by approximately $137,000.

The professional services expense category has exhibited a significant upward trend over the past four years (64% increase from 1996 to 2000). Consequently, in order to obtain a better understanding of the nature of the items included in this expense category, we conducted a more detailed review of professional fees by department. The significant consulting/professional services that have been contracted out by individual departments during 2000 are as follows:

Department	Professional Services	Cost
Management	• Hydro's Strategic Planning Initiative	$52,000
	• Audit Services	59,000
Human resources & legal	• Valuation of post retirement non-pension benefits	16,000
	• Job classification review	32,600
	• Implementation of Career Succession software	65,000
Finance	• Conversion of the cost of service (COS) model from DOS and conduct 1996 and 1997 COS studies	32,000
	• Implementation of the Capital Asset Projection Software Module	86,000
	• Training session for customer service employees on the process of analyzing customer data	15,300
	• Annual report fees	42,500
	• Consulting work for the development of Hydro's Communication Plan	37,000
	• Media Monitoring	11,300
	• Design, produce and coordinate outlet newsletter	21,000
	• Insurance Broker Selection	16,300
TRO	• Proposal for a management environmental system	28,000
	• Proposal for a enviromental audit system	28,700
	• Environment effects and monitoring studies	137,000
Production	• Monthly consulting services for unit 1, 2, and 3 at Holyrood Plant	182,000
	• Environment effects, monitoring studies and tests on water, marine and wildlife around the Holyrood plant	30,000
	• Stack emmissions testing	25,000
	• High pressure safety valves testing	33,500
		$950,200

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

Travel and conferences

In 2000 the travel and conference expense category increased from 1999 levels by $376,000 or 15.3%. Travel costs increased from $2.3 million to $2.6 million and conference costs increased from $145,000 to $193,000.

The most significant increase in travel costs was noted in transmission and rural operations. The travel costs in this department increased by approximately $287,000. This increase is attributable to relocation expenses related to internal reorganization, increase travel associated with ongoing maintenance, and extra travel associated with the Reliability Centered Maintenance Program.

The increased spending on conferences in 2000 was primarily attributable to the Production and Finance departments. Increased spending of $43,000 in the Production department is due to a number of the EMS & telecontrol employees attending 3 separate conferences in Rochester, Denver and Orlando. In the Finance department conference costs for 2000 exceeded 1999 by approximately $13,500. Several treasury employees attended conferences in 2000 regarding management reporting and cash and risk management. The increased spending in these two departments in 2000 was slightly offset by a decrease in costs of $17,600 within the management department. This decrease is a result of fewer conferences attended by executive management in 2000 compared to 1999.

Similar to our 1999 findings, we noted during our review of the travel accounts that management travel includes several payments for spousal travel costs. While these items are accepted practice by Hydro, we believe that it is not prudent to include expenditures of this nature in the revenue requirement.

Equipment rentals

Equipment rental expense decreased by $202,000 or 12.6% in 2000, as compared to 1999. This decrease is attributable to a decline in computer costs of $395,000, with an offset of $187,000 due to increased expenditures on equipment rentals.

The decrease in computer costs is primarily due to the ownership and or financing arrangements of the mainframe computers, currently in use. Over the past couple of years, Hydro has gradually moved from the older Amdhal system to the AS400. In 1999, both mainframes were run parallel, but in 2000, the full transition was made to the AS400, which has lowered computer costs significantly.

The increase in equipment rentals is attributed to the extension of the bandwidth to facilitate the wide area network rollout of Lotus Notes and various J.D. Edwards suite of applications to areas such as Happy Valley /Goose Bay, Wabush, Springdale, Flowers Cove and Lance au Loup.

Miscellaneous

In 2000, miscellaneous expense increased by $550,000 or 12.7% from 1999. The major variances in this expense category are as follows:

Increase in staff training	$ 374,000
Increase in payroll and municipal taxes	148,000
Decrease in employee expenses	(97,000)
Net increase in other variances	125,000
	$ 550,000

The type and the amount of staff training available to Hydro employees in 2000 tended to vary across all departments. Similar seminars were offered in both 2000 and 1999, with additional training programs related to diesel plant operators, Reliability Centered Maintenance, Work Protection code and JD Edwards.

The increase in "payroll and municipal taxes" is primarily due to an increase in payroll tax as a result of increased salaries and a slight increase in municipal taxes.

As noted previously in the report, the cost of personal protective clothing has been removed from "employee expenses" and reallocated to the object code for "safety equipment and supplies", as a result employee expenses has decreased.

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

Capitalized expenses

Capitalized expenses for 2000 were $7.852 million as compared to $8.537 million for 1999 and $8.667 million in 1998.

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

	2000	1999	1998
Salaries	$ 7,218,993	$ 8,173,343	$ 8,194,967
Fleet expense	502,400	255,218	381,387
Travel direct work orders	131,110	108,145	90,700
	$ 7,852,503	$ 8,536,706	$ 8,667,054

The costs incurred in 2000 and allocated to capitalized salaries are made up of more than 25 projects. However, a large portion of these allocations can be attributed to six main projects: upgrading work on TL217, the Lower Churchill River project, service extension and upgrading in the central and northwest regions, Granite Canal development, and lightning arrestor replacement of TL206. While the number of capitalized projects has increased over 1999 the amount of capitalized salaries has dropped by 11.7%. This decrease in costs is primarily due to a reduction in the amount of internal forces required for capital projects related to P2000 and the Lower Churchill River Project. Decreases for these projects are partially offset by higher involvement of internal forces in the Granite Canal Project.

The decrease in capitalized salaries has been partially offset by the increase in the cost of capitalized fleet expenses of approximately $247,000. This increase in costs or usage of fleet vehicles is a result of the type of capital projects in progress. The projects ongoing in 2000 required more extensive use of vehicles and equipment, furthermore, in 1999 the Company contracted more outside forces to perform the fieldwork.

The methodology employed by Hydro with respect to capitalizing expenses is outlined below. This methodology has not changed during 2000.

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

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

All categories of capitalized expenditures other than capitalized direct salaries are allocated to work orders using percentages or standard rates developed by the Company. These allocations are intended to ensure that capital projects are adequately charged with the cost of support functions such as accounting and finance, engineering, and other such expenses which cannot be directly charged to specific capital projects.

For 2000, the percentages used to capitalize fringe benefits and overhead costs were as follows:

Benefits (% of direct salaries)	35.9%
Departmental overhead	
Non-field (% of direct salaries and benefits of engineers and office staff)	37.6%
Field (% of salaries and benefits of crews)	19.8%
Non-departmental overhead (% of work order total costs)	6.0%

Intercompany charges

Intercompany charges to CF(L)Co. for 2000 have decreased by $439,100 or 20.8% compared to 1999. The breakdown of intercompany charges by department is as follows:

	2000	1999	1998
Production	$ 226,864	$ 792,042	$ 715,390
Finance	430,496	345,557	495,858
Transmission and Rural Operations	73,247	20,000	20,000
Internal Audit	10,670	87,055	87,055
Management	40,694	184,020	135,379
Human Resources and Legal	887,979	680,355	806,389
	$ 1,669,950	$ 2,109,029	$ 2,260,071

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

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

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

As noted above, the recovery of costs for services provided to CF(L)Co have decreased overall by $439,100 from 1999. This decrease is made up of wide fluctuations in costs as indicated in the table above. There is a significant decrease in the production and management departments, which is partially offset by the increase in charges from the transmission and rural operations and human resources departments. The change in approach and methodology for allocating intercompany costs makes it difficult to compare intercompany charges to prior years. However, since these costs recoveries are now based more on actual documentation and less on management judgment, it should provide a more accurate picture of true costs. We concur with Hydro's comments in their report that these changes make the recoveries less subjective and more verifiable than in previous years.

This change in methodology should be reviewed and assessed by the Board during the scheduled rate hearing. We will undertake a more detailed review of the methodological changes implemented by Hydro and present our findings in our rate hearing report.

Fuels

In 2000 fuel expense increased overall by $7,458,000 or 21.24% over 1999. The cost of Bunker "C" increased by approximately $20,283,000 over 1999, however net of RSP recoveries, this fuel only increased by approximately $49,000. The reason for the large variation is attributed to the increase in average price of fuel consumed. In both 2000 and 1999, Hydro consumed approximately 1,593,000 barrels, but the average price in 2000 rose from $18.18 per barrel to $30.92 per barrel.

The hydraulic production and load variation components of the Rate Stabilization Plan provide an increase of $5,283,000 in comparison to 1999. The adjustment for hydraulic production (or water variation) is consistent with the increase in actual hydraulic production in 2000 of approximately 4.5%, however, the impact of this increase is partially offset by a special adjustment in 1999 relating to spilled energy which was banked in 1998 for an industrial customer. The adjustment for load variation is consistent with the increase in energy sales. Energy sales (excluding Hydro Quebec Recall) were up 483 GWh (7.7%) in 2000 in comparison to 1999. The increase in energy

sales in 2000 was the result of adverse weather conditions in the fall, which increased Newfoundland Power's need for more energy to meet consumer demand and also the Iron Ore Company of Canada increased production after experiencing a slow down in 1999 that occurred throughout the industry. Sales to these companies increased by a total of 367 GWhs in 2000**.** All variations relating to the Rate Stabilization Plan are calculated using actual results for the year in comparison to the 1992 cost of service data.

Another significant contributor to the increase in the fuel expense category is the variance in diesel fuel for rural operations. This category increased by $2,351,000 primarily due to a rise in the average cost per litre of fuel.

Power purchased

The Company's purchased power expense increased by $2,176,000 in 2000 (excluding the Hydro Quebec Recall). This increase is due to a credit balance in 1999 of $1,745,000 relating to secondary energy and an increase of approximately $1,155,000 relating to additional power purchased from a number of suppliers to allow Hydro to fill its excess sales demand over that generated. These increases were partially offset by a decrease of $859,000 in capacity expansion.

The credit included in 1999 secondary energy was the result of the reversal of an accrual that was recorded in 1998 for banked energy for Abitibi Price. In 1999, it was determined that the energy was no longer required and the accrual was reversed. The cost of secondary energy purchased in 2000 was $6,065.

During 2000, the generation of hydraulic and thermal energy increased by 4.5% and 5.7% respectively over 1999, however this production was still insufficient to meet sales demand. Approximately 2,523 GWh's was purchased in 2000 of which 1494 GWh's related to the Hydro Quebec Recall. The increase in the expense is primarily due to the power purchased from the non-utility generators and CF(L)Co

The Company purchased 161 GWh's of power from two non-utility generators at a cost of approximately $10.9 million as compared to 156 GWh's of power at $10.4 million in 1999. The cost variance of approximately $536,000 is the result of an increase in the average cost per GWh from 1999 for Star Lake and the Algonquin Project. In 2000 the average cost per GWh was $67 and $70 respectively compared to $66 and $69 in 1999. Also, 868 GWh's was purchased from CF(L)Co. as compared to 645 GWh's in 1999. This represented an increase of approximately $619,000.

The decrease in capacity expansion of $859,000 is due to a major repair job that was completed in 1999 on the Synchronous Condenser #1 at the Wabush Terminal Station. Hydro was required to pay 53.6% of the cost of the repair as per Clause 5.01 of the Power Contract.

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

Interest

Interest expense for 2000 increased slightly compared to 1999, showing an overall increase of $1 million or 1%. This increase is primarily attributable to a decline in the amount of interest earned on investments, sinking funds and the rate stabilization plan. This increase was largely offset by the amount of interest capitalized during construction.

The following is a summary of interest expense for 2000 and 1999:

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

Revenue Requirement

Scope: ***Verify Hydro's reconciliation of net income to revenue requirement for 2000. Review and assess the reasonableness of adjustments in the calculation of revenue requirement.***

Reconciliations of Net Income to Revenue Requirement for the years 1998 to 2000 have been provided in Schedule 3 of our report. Our review of the revenue requirement reconciliation for 2000 included examining support for the adjustments and assessing the reasonableness in comparison to prior years.

In 2000, Hydro introduced a new revenue requirement adjustment relating to interest expense and revised the reported revenue requirement for prior years. This interest adjustment is an increase to interest expense relating to "interest avoided" on regulated operations. Hydro's rationale for this adjustment is that due to the increased cash flow from the sale of recall power to Hydro Quebec, the Company was able to pay down its short-term debt and thus reduce or save $2.675 million of interest expense in 2000. The 1999 and 1998 revenue requirement were adjusted by $2.148 million and $0.117 million respectively for calculated interest savings in those years. In addition to the interest adjustment, Hydro revised the calculations of the cost of recall power purchased. These revisions, which more accurately reflect the cost of recall power, had the effect of decreasing the profit contribution from recall power by $244,000 and $386,000 in 1998 and 1999 respectively.

We have reviewed the calculations of interest avoided as prepared by Hydro. We believe the rationale and approach used by Hydro with regard to this interest adjustment should be reviewed in more detail considering the scheduled rate hearing and the potential impact on the 2002 test year revenue requirement. We will undertake to analyze this issue further and report on our findings in our rate hearing report to be filed with the Board.

The largest adjustments to the revenue requirement were to eliminate $13.331 million in energy sales to Hydro Quebec and $4.424 million in power purchased from Upper Churchill. These adjustments, which first began in 1998 under a three-year contract with Hydro Quebec, changed slightly in 2000 once NF & Labrador Hydro reached its revenue cap of $78.9 million in May. Based on the contract, Hydro was able to purchase power from Upper Churchill at the mil rate of $2.7202 per MWh and resell it to Hydro Quebec at $23.90/ MWh. The contract also stated that if the revenue cap was achieved before the end of the three year contract then all power sold above the cap would be for the same price that NF & Labrador Hydro purchased the power (i.e. $2.7202/MWh). On March 9, 2001, a new contract was negotiated with Hydro Quebec to extend the original agreement to March 31, 2004. Under this agreement the revenue cap is set at $97.53 million and all power purchased from Upper Churchill is set at $2.5426/MWh and sold to Hydro Quebec at $23.90/MWh. As in the previous contract all power sold to Quebec after the aggregate amount of $97.53 million shall be sold for the purchase price.

In 2000, donations and management contributions of approximately $132,000 have been eliminated from revenue requirement as per the Board's direction.

In addition, costs of $4,000 related to Muskrat Falls have also been eliminated as they relate to the development of the Lower Churchill, a project which is non-regulated and therefore does not impact Hydro's revenue requirement.

These above noted adjustments combine to decrease the margin (earnings) per Schedule 3 by $11.446 million.

Depreciation

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

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

During 2000 Hydro reported depreciation expense of $35.5 million as follows:

Location	Asset Class	Net Cost	Method	2000 Expense
Hydro	Hydraulic stations Terminal stations Transmission lines	$1,005.6 million	Sinking Fund	$9.7 million
Hydro	All other classes	205.7 million	Straight Line	25.8 million
		$1,211.3 million		$35.5 million

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

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

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

In our 1997 report we provided the Board with the alternatives, observations and recommendations included in a depreciation study conducted by KPMG LLP. The final report relating to this study is dated October 7, 1998. In its rate application now before the Board, Hydro has requested approval for proposed changes in its depreciation policies, which are based on certain recommendations flowing from this 1998 depreciation study. These proposed changes will need to be reviewed in detail during the scheduled rate hearing.

As a result of completing our procedures, no significant discrepancies were noted and therefore, we report that depreciation expense for 2000 appears reasonable.

Rate Stabilization Plan

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

Our examination of the Rate Stabilization Plan (RSP) for 2000 included reviewing the adjustments and components of the Plan in 2000 and assessing their reasonableness and compliance with Board directives. We also assessed the reasonableness of the interest charged and credited to the Plan during the year.

Schedule 5 of our report summarizes the changes in the RSP for the three years from 1998 to 2000. The fuel variation adjustment of approximately $29.4 million represents the most significant change in the plan in 2000. This increase is the direct result of the cost of oil per barrel in 2000. Hydro's consumption of oil has remained very consistent with 1999, but the actual cost of oil per barrel was as high as $36.00 in December 2000 compared to $12.50 from the 1992 cost of service study. Another significant change in 2000 is the water variation adjustment of approximately $16.6 million. This adjustment partially offsets the increase in the plan attributable to fuel costs. The water variation adjustment represents a savings to the plan arising because hydraulic production during the year was higher than the level forecast in 1992 cost of service.

Based upon our review, we report that the adjustments made to the RSP in 2000 are reasonable and it has been operating in accordance with Board directives.

Deferred Charges

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

The following table shows the transactions in the deferred charges account from 1997 to 2000:

(000)'s	Balance Dec./97	Net Add.	Amort.	Balance Dec./98	Net Add.	Amort.	Reclass	Balance Dec./99	**Net Add.**	**Amort.**	Balance Dec./00
Studies and software	$439	$429	($271)	$597			($597)				
CF(L) Co.	8	335	-50	$293	1,564	-379		$1,478	-2	-383	$1,093
Realized foreign exchange losses	96,278			$96,278				$96,278			$96,278
Unrealized foreign exchange losses											
Discounts and issue costs on long term debt	12,795	2,738	-1,574	$13,959	10	-1,274		$12,695		-1,140	$11,555
	$109,520	$3,502	($1,895)	$111,127	$1,574	($1,653)		$110,451	**($2)**	**($1,523)**	$108,926

During the year there were no additions to deferred charges.

Foreign Exchange Losses

Total deferred foreign exchange losses remained unchanged between 2000 and 1999 at $96.278 million.

As noted in our previous reports, section 17(4) of the Hydro Corporation Act (as amended by Bill 35) states that for purposes of the Public Utilities Act (including Subsection 80(2)), the foreign exchange losses as at December 31, 1994 were considered to be reasonable and prudent expenses of Hydro and therefore properly chargeable to operating account. Section 17(3)(e) establishes the period of amortization for these losses to be 40 years commencing in the year when Hydro's rates are first altered under the Public Utilities Act. If Hydro was to commence amortizing the foreign exchange losses based on the 1999 balance noted above, the annual amortization to be included in the revenue requirement would be $2.4 million.

In 2000 Hydro accrued $1 million towards its foreign exchange losses consistent with prior years and in compliance with the Board's recommendation from the 1992 hearing.

Based on the results of our procedures, nothing has to come to our attention to indicate that the changes to deferred charges are imprudent or unreasonable in relation to sales of power and energy.

Cost Control/Productivity Initiatives

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

The Company has undertaken a number of initiatives to explore the possibility of future savings and increased productivity. In our 1999 report, we noted a number of initiatives that the Company was in the process of implementing. An update on the progress of these initiatives as provided to us by Hydro senior management is outlined below.

Joint Steering Committee (Coordination of Utility Activities)

This is a joint committee consisting of union representatives from Hydro and Newfoundland Power. The Committee was established in early 1997 to review potential opportunities for co-ordination that could result in lowering the overall cost of providing electrical service. The overall mandate of the Steering Committee is to advise and make recommendations to the utilities based on reviews that are carried out on their behalf.

It was indicated by management in 1999 that most of the review of the Joint Steering Committee has been conducted, however, a report was not finalized. According to an update provided by management, there were some minor opportunities for change identified and implemented, however towards the end of the process there was little value added in finalizing a written report.

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

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

In our 1998 report, we indicated that Hydro had completed a RCM pilot in the transmission, distribution; and diesel generation areas, and that an implementation team would be trained in the RCM process, templates would be drafted and the analysis of Hydro's systems would be scheduled to start in September 2000.

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

Diesel Plant Operation Review

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

Based on recent correspondence from Hydro officials, the cost savings and productivity improvements resulting from this initiative will be realized due to reduced travel requirements and a multi-skilled approach to maintenance.

TRO – Review of Work Processes and Practices

The work processes and practices within TRO were reviewed to determine the most effective and efficient way of providing services. Hydro completed an extensive review of how it deploys lineworker crews in relation to their current transmission and distribution lines. As a result of this review, they have reorganized their current lineworker crews so they can operate more efficiently and cost-effectively.

Based on recommendations resulting from this review, Hydro announced a realignment of certain staffing. On February 15, 2001, Hydro's announcement indicated that they were adjusting their operations and that forty-one positions would be eliminated.

As part of the annual review process, we will monitor the results of the above initiatives and obtain an update from the Company during the 2001 review and inquire as to any future initiatives that are being evaluated. We will also inquire about these and any future initiatives as part of our review in preparation for the 2001 fall rate hearing.

Contributions in Aid of Construction (CIAC's)

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

Our procedures in this area included the following:

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

As part of our review, we have held discussions with Mr. Barry Brophy of Hydro regarding the Company's CIAC policies and procedures and we have selected and reviewed documentation supporting a sample of five (5) CIAC calculations prepared during 2000.

Based on the results of our inquiry and review of documentation, we noted that the Board's requirements for the approval, review and calculation processes as specified in P.U.4 (1997-98), are being complied with. However, certain observations were noted during our review which are noted below for your information:

- Hydro essentially uses a manual system to monitor all CIAC quotes. The Company did implement a spreadsheet system in 1997 that is updated on a regular basis for new CIAC quotes. Mr. Brophy indicated that any CIAC quotes prior to 1997 are more difficult to accumulate due to the previous filing system. The most significant deficiency resulting from the manual system is the manual calculation of the individual quotes. However, to compensate, Hydro requires the manual calculations be checked and approved by the appropriate supervisor. No calculation errors were found in the sample quotes. In 2001, Hydro obtained a copy of Newfoundland Power's computerized CIAC program. This software is expected to be implemented sometime during the 2001 year.

- P.U. 4 (1997-98) suggests residential and seasonal CIACs may be reviewed after a period of 24 months from the date of service to determine whether the residential or seasonal service has been designated properly. The coordinator of the CIAC process has tried to take the responsibility in performing these reviews however, due to time constraints he has not been able to set up a formal review policy, instead he reviews when possible the annual consumption reports for seasonal residents who request to be billed as permanent residents.

- We also noted that P.U. 4 (1997-98) suggests for Hydro to make all reasonable efforts to identify refunds to existing customers when additional customers are connected to an already existing line extension. In 1998 Hydro staff implemented an informal annual review process to identify these changes. The CIAC database (spreadsheet) was sorted by region at head office and a listing of all CIAC quotes were sent to the

applicable region to be reviewed. Any required adjustments were forwarded to staff at Head Office for updating. However, during 2000, Hydro decided to abandon its annual review process since it was proving to be a slow and non-productive practice. Therefore, in lieu of the annual review process, Hydro's head office has instructed the regional technicians for all new quotes, to review the requested area for possible adjustments to previously accepted CIAC quotes prior to the calculation of a new CIAC. While this process has delegated all authority to the regional offices, without any type of assessment of the work in place all accountability has been removed.

- All customers are to be advised of the conditions relating to refunds of CIACs. Four of the five of the customers selected in our sample were advised of these conditions in writing.

- Hydro does not include sketches with the customer letters. However they are maintained in the file for Hydro's review.

Based on our discussions, we believe that the shortfalls in Hydro's procedures are partially due to the manual process. The onus is on the regional technicians who perform the fieldwork to ensure that they have their sketches precise and their line measurements exact. Also, it is the responsibility of the regional offices to ensure all CIAC quotes are documented, filed and reported to Head Office. However for 2001, the installation of a computerized CIAC should solve many of these present problems.

In addition to the shortfalls noted above, the 1999 review revealed several other concerns that fell outside the general need of a computerized system. It was concerns such as poorly organized files and lack of documentation that became part of our focus during the 2000 review. Based on our review of five CIAC quotes in 2000, we noted that each of the files were very detailed, containing a written request from the customer, appropriate sketches of the area to calculate a correct quote, letters to interested parties outlining the details of the quote; and the necessary approval from supervisors. Since these files contained complicated CIAC calculations, all copies of the documentation was held at head office and may explain the orderly fashion in which the files were prepared. However, one of the employee's responsible for running the CIAC program at head office informed us that he has recently returned from a mini-training session in the central region with representatives from other regions as well, instructing them on how to maintain a CIAC file. He also provided to each of them a sample of what should be included in a CIAC file.

We recommend in the preparation of CIAC quotes, all employees should follow a standardized set of policies and procedures in order to maintain consistency. We also recommend all CIACs quotes should contain a written request for service and documentation regarding refunds should be provided to all customers. Finally, Hydro should develop a standardized form that is required to be completed by the appropriate personnel at the regional offices, in a timely manner, indicating their review of the annual CIAC quote listing provided to them by the Head Office. This will ensure that the CIAC's are being reviewed on an annual basis.

Based on the results of our inquiry and review of documentation, we noted that the Board's requirements for the approval, review and calculation processes as specified in P.U.4 (1997-98), are being complied with. However, we have noted a number of observations and provided several recommendations for improvement in the CIAC process.

During the 2001 annual financial review we will continue to review a sample of the CIAC quotations prepared in 2001, including the administrative processes to ensure the Company is in compliance with the Board Order.

Review Findings Requiring Follow-up

Appendix A

Review Findings Requiring Follow Up

The following is a list of items related to our observations/findings during our review which require follow-up or action on behalf of the parties indicated.

Newfoundland and Labrador Hydro

- The Company should consider the implementation of our recommendations relating to the preparation and maintenance of the CIAC quotations. (Ref. Pg. 37-39)

Grant Thornton LLP

- During the annual financial review for 2001, compare Hydro's staffing levels and salary costs for 2000 and 2001 using Hydro's calculation of full time equivalent positions (FTE's). (Ref. Pg. 15).

- Follow up in the cost control/productivity initiatives and inquire as to any future initiatives currently being evaluated. (Ref. Pg. 36)

- During the annual financial review for 2001, review a sample of the CIAC quotations prepared in 2000, including the administrative processes to ensure the Company is in compliance with Board Order P.U. 4(1997-98). (Ref. Pg. 37-39)

Newfoundland and Labrador Hydro **Schedule 1**

Balance Sheet

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

(000)'s

	2000	1999	1998
ASSETS			
Fixed assets	$1,254,627	$1,241,103	$1,234,963
Current assets	98,232	111,765	113,363
Rate stabilization plan	24,113	17,538	31,744
Long-term receivable	-	-	-
Deferred charges	108,927	110,451	111,128
Total assets	$1,485,899	$1,480,857	$1,491,198
LIABILITIES AND SHAREHOLDER'S EQUITY			
Long-term debt	$ 808,004	$ 997,544	$ 918,927
Current liabilities			
Accounts payable	57,943	66,256	71,628
Due to affiliates	4,016	3,967	4,041
Promissory notes	121,170	54,415	83,665
Long-term debt within one year	162,863	12,150	87,127
	345,992	136,788	246,461
Employee future benefits	22,851		
Unrealized foreign exchange loss provision	9,000	8,000	7,000
Shareholder's equity			
Retained earnings	300,052	338,525	318,810
Total liabilities and equity	$1,485,899	$1,480,857	$1,491,198

Newfoundland and Labrador Hydro **Schedule 2**

Statements of Earnings and Retained Earnings

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

(000)'s

	2000	1999	1998
Revenue	$ 303,192	$ 316,990	$ 304,196
Expenses			
Fuels	42,568	35,110	26,880
Power purchased	20,385	18,927	13,472
Other costs	93,281	85,271	81,729
Depreciation	35,469	36,108	32,072
Interest	94,193	93,179	98,786
	285,896	268,595	252,939
Write down of capital assets		16,680	
Net earnings	$ 17,296	$ 31,715	$ 51,257
Retained earnings, beginning of year	$ 338,525	$ 318,810	$ 279,553
Adjust future employee benefits	$ (19,169)		
Net earnings	17,296	31,715	51,257
Dividends	(36,600)	(12,000)	(12,000)
Retained earnings, end of year	$ 300,052	$ 338,525	$ 318,810

Newfoundland and Labrador Hydro **Schedule 3**

Reconciliation of Net Income to Revenue Requirement

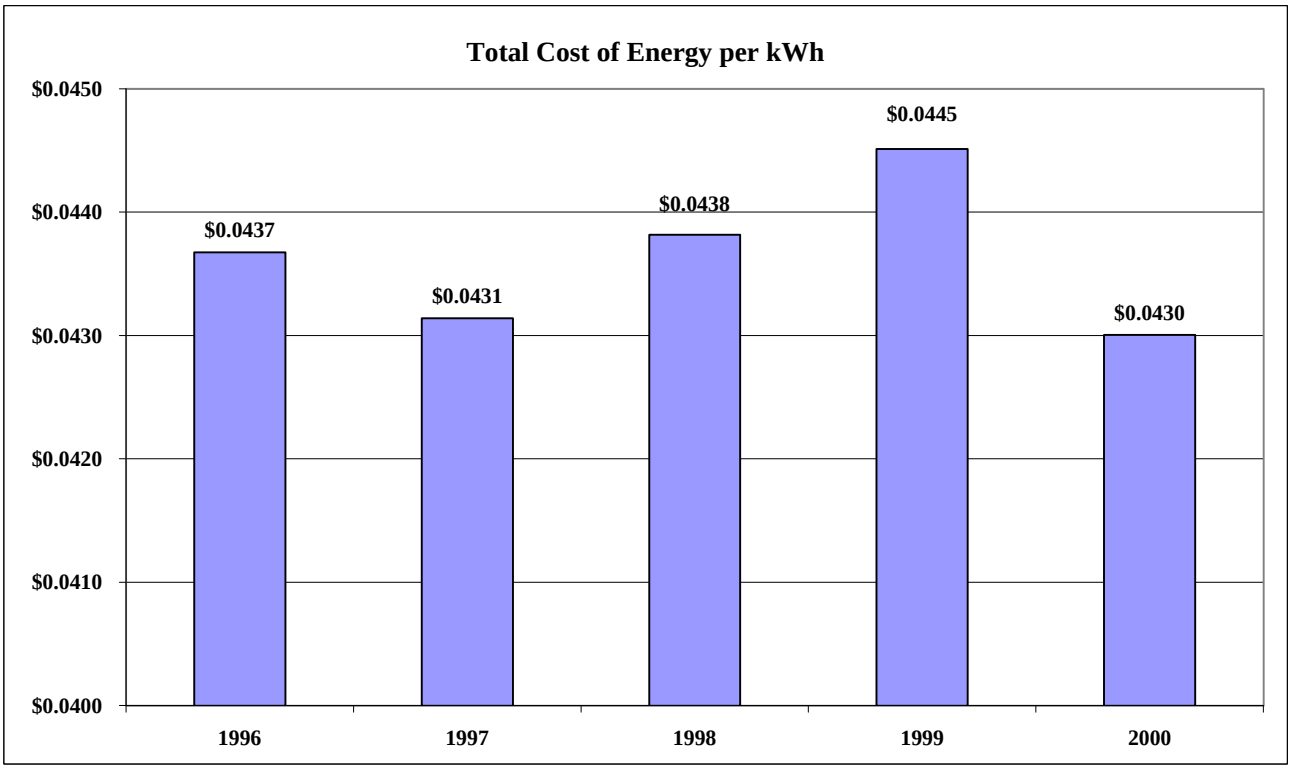
1998 to 2000

(000)'s	2000			1999			1998		
	Financial Statement	Adjust.	Revenue Require.	Financial Statement	Adjust.	Revenue Require.	Financial Statement	Adjust.	Revenue Require.
Depreciation	$ 35,469		$ 35,469	$ 36,108		$ 36,108	$ 32,072	$ 771	$ 32,843
Fuel	42,568		42,568	35,110		35,110	26,880		26,880
Power purchased	20,385	(4,424)	15,961	18,927	(5,142)	13,785	13,472	(4,030)	9,442
Other costs									
Salaries	61,374	(107)	61,267	57,128	(58)	57,070	54,960	(56)	54,904
System equip. maint.	18,977	(1)	18,976	14,957	(2)	14,955	11,325	(2)	11,323
Insurance	1,037		1,037	1,068		1,068	1,056		1,056
Transportation	2,892		2,892	3,481		3,481	3,642	(1)	3,641
Office supplies	2,081		2,081	2,858		2,858	2,715		2,715
Bldg. rentals and maint.	998		998	2,897		2,897	3,226		3,226
Professional services	3,815		3,815	3,756		3,756	3,398		3,398
Travel	2,835		2,835	2,459		2,459	2,211		2,211
Equipment rentals	1,400		1,400	1,602		1,602	2,000		2,000
Miscellaneous	4,891	288	5,179	4,341	388	4,729	5,927	215	6,142
Loss on disposal	2,186		2,186	923		923	1,137		1,137
Amortization of studies and software							771	(771)	
Customer costs	420	(420)	-	495	(495)	-	332	(332)	
Sub-total	102,906	(240)	102,666	95,965	(167)	95,798	92,700	(947)	91,753
Allocations									
Other	(104)	104	-	(49)	49	-	(46)	46	
Hydro capitalized	(7,852)		(7,852)	(8,537)		(8,537)	(8,666)		(8,666)
C.F.(L) Co.	(1,670)		(1,670)	(2,109)		(2,109)	(2,260)		(2,260)
Sub-total	(9,626)	104	(9,522)	(10,695)	49	(10,646)	(10,972)	46	(10,926)
Total	93,280	(136)	93,144	85,270	(118)	85,152	81,728	(901)	80,827
Write down of capital assets			-	16,680		16,680			
Interest	94,193	2,675	96,868	93,179	2,148	95,327	98,786	117	98,903
Margin	17,296	(11,446)	5,850	31,716	(35,363)	(3,647)	51,258	(26,126)	25,132
Revenue requirement	$303,191	($13,331)	$289,860	$316,990	($38,475)	$278,515	$304,196	($30,169)	$274,027

Schedule 4A

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

Year	kWh sold and used	Depreciation	Fuel	Purchased Power	Other Costs	Interest	Margin		Total Cost of Energy		Cost per kWh
1996	6,589,000	$ 29,301	$ 41,683	$ 5,225	$ 77,799	$ 113,062	$ 20,693		$ 287,763		$ 0.0437
1997	6,784,000	$ 30,686	$ 43,900	$ 5,692	$ 74,152	$ 106,876	$ 31,351		$ 292,657		$ 0.0431
1998	6,254,000	$ 32,843	$ 26,880	$ 9,442	$ 80,827	$ 98,903	$ 25,132		$ 274,027		$ 0.0438
1999	6,257,000	$ 36,108	$ 35,110	$ 13,785	$ 85,152	$ 95,327	$ 13,033	[1]	$ 278,515	[1]	$ 0.0445
2000	6,740,000	$ 35,469	$ 42,568	$ 15,961	$ 93,144	$ 96,868	$ 5,850		$ 289,860		$ 0.0430



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

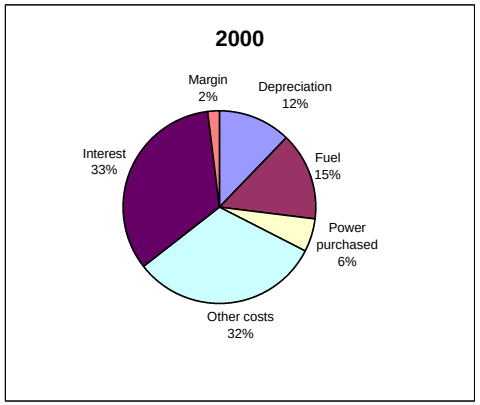
Schedule 4B

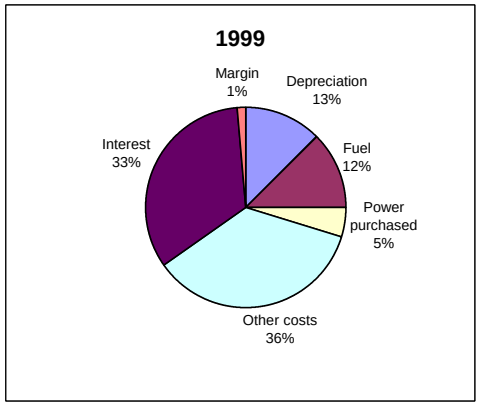
Newfoundland and Labrador Hydro
Comparison of Costs as a Percentage of kWh Sold and Used

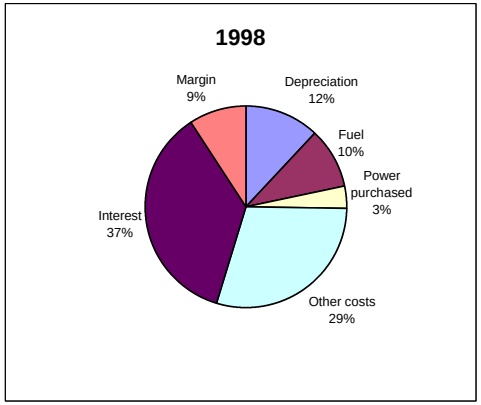
	1996			1997			1998			1999			2000		
kWh sold and used	6,589,000			6,784,000			6,254,000			6,257,000			6,740,000		
	Cost	**Cost per kWh**	**% of Total**	**Cost**	**Cost per kWh**	**% of Total**	**Cost**	**Cost per kWh**	**% of Total**	**Cost**	**Cost per kWh**	**% of Total**	**Cost**	**Cost per kWh**	**% of Total**
Depreciation	$ 29,301	0.0044	10.18%	$ 30,686	0.0045	10.49%	$ 32,843	0.0053	11.99%	$ 36,108	0.0058	12.96%	$ 35,469	0.0053	12.24%
Fuel	41,683	0.0063	14.49%	43,900	0.0065	15.00%	26,880	0.0043	9.81%	35,110	0.0056	12.61%	42,568	0.0063	14.69%
Power purchased	5,225	0.0008	1.82%	5,692	0.0008	1.94%	9,442	0.0015	3.45%	13,785	0.0022	4.95%	15,961	0.0024	5.51%
Other costs	77,799	0.0118	27.04%	74,152	0.0109	25.34%	80,827	0.0129	29.50%	101,832	0.0163	36.56%	93,144	0.0138	32.13%
Interest	113,062	0.0172	39.29%	106,876	0.0158	36.52%	98,903	0.0158	36.09%	95,327	0.0152	34.23%	96,868	0.0144	33.42%
Margin	20,693	0.0031	7.19%	31,351	0.0046	10.71%	25,132	0.0040	9.17%	(3,647)	(0.0006)	-1.31%	5,850	0.0009	2.02%
Total	$ 287,763	0.0437	100.00%	$ 292,657	0.0431	100.00%	$ 274,027	0.0438	100.00%	$ 278,515	0.0445	100.00%	$ 289,860	0.0430	100.00%

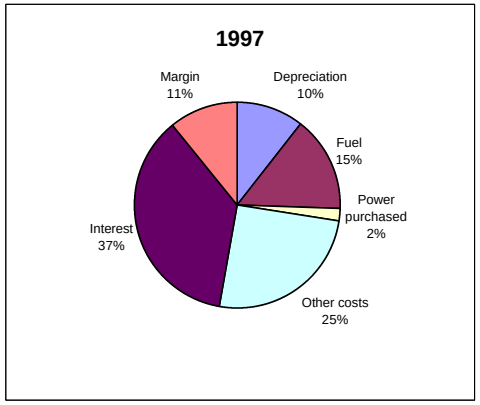
Newfoundland and Labrador Hydro
Comparison of Costs as a Percentage of kWh Sold and Used

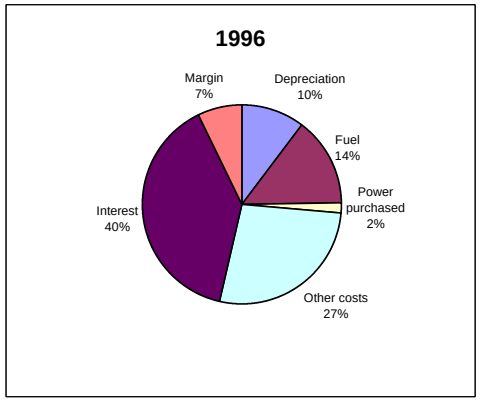
Schedule 4B











Schedule 4C

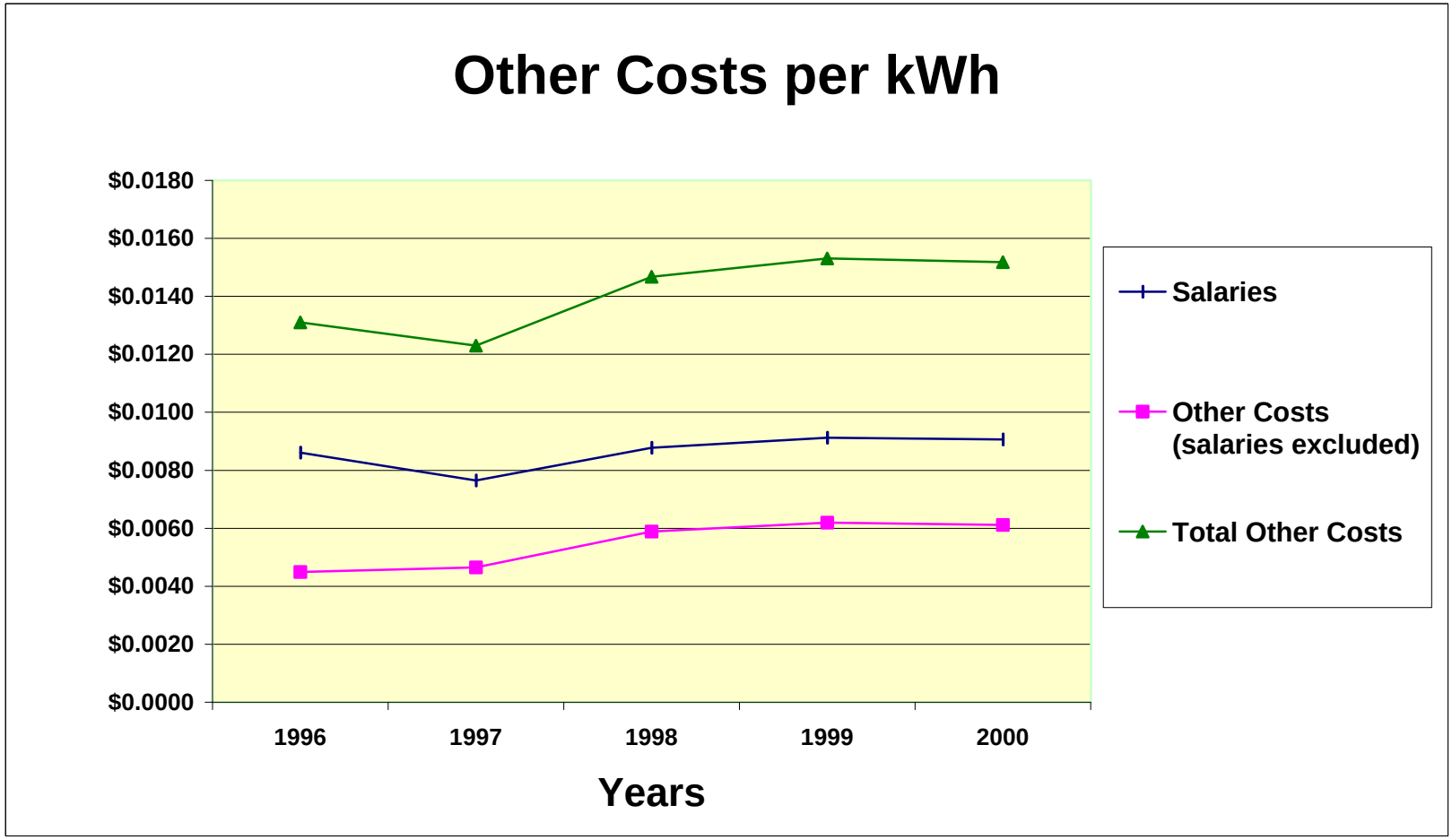
Newfoundland and Labrador Hydro
Comparison of Other Costs by Breakdown
1996 to 2000

	1996			1997			1998			1999			2000		
kWh sold and used	6,589,000			6,784,000			6,254,000			6,257,000			6,740,000		
	Cost	**Cost per kWh**	**% of Total**	**Cost**	**Cost per kWh**	**% of Total**	**Cost**	**Cost per kWh**	**% of Total**	**Cost**	**Cost per kWh**	**% of Total**	**Cost**	**Cost per kWh**	**% of Total**
Salaries	$ 56,724	0.00861	100.00%	$ 51,863	0.00764	100.00%	$ 54,904	0.00878	100.00%	$ 57,070	0.00912	100.00%	$ 61,267	0.00909	100.00%

	1996			1997			1998			1999			2000		
kWh sold and used	6,589,000			6,784,000			6,254,000			6,257,000			6,740,000		
	Cost	**Cost per kWh**	**% of Total**	**Cost**	**Cost per kWh**	**% of Total**	**Cost**	**Cost per kWh**	**% of Total**	**Cost**	**Cost per kWh**	**% of Total**	**Cost**	**Cost per kWh**	**% of Total**
System equip. maint.	$ 10,294	0.00156	34.78%	$ 11,506	0.00170	36.46%	$ 11,323	0.00181	30.73%	$ 14,955	0.00239	38.62%	$ 18,976	0.00282	45.84%
Insurance	1,169	0.00018	3.95%	1,224	0.00018	3.88%	1,056	0.00017	2.87%	1,068	0.00017	2.76%	1,037	0.00015	2.50%
Transportation	3,513	0.00053	11.87%	3,177	0.00047	10.07%	3,641	0.00058	9.88%	3,481	0.00056	8.99%	2,892	0.00043	6.99%
Office supplies	2,842	0.00043	9.60%	2,716	0.00040	8.61%	2,715	0.00043	7.37%	2,858	0.00046	7.38%	2,081	0.00031	5.03%
Bldg. rentals and maint.	1,930	0.00029	6.52%	2,210	0.00033	7.00%	3,226	0.00052	8.75%	2,897	0.00046	7.48%	998	0.00015	2.41%
Professional services	2,330	0.00035	7.87%	2,627	0.00039	8.32%	3,398	0.00054	9.22%	3,756	0.00060	9.70%	3,815	0.00057	9.22%
Travel	1,874	0.00028	6.33%	1,957	0.00029	6.20%	2,211	0.00035	6.00%	2,459	0.00039	6.35%	2,835	0.00042	6.85%
Equipment rentals	1,740	0.00026	5.88%	1,530	0.00023	4.85%	2,000	0.00032	5.43%	1,602	0.00026	4.14%	1,400	0.00021	3.38%
Miscellaneous	4,014	0.00061	13.56%	3,920	0.00058	12.42%	6,142	0.00098	16.67%	4,729	0.00076	12.21%	5,179	0.00077	12.51%
Loss on disposal	(110)	(0.00002)	-0.37%	691	0.00010	2.19%	1,137	0.00018	3.09%	923	0.00015	2.38%	2,186	0.00032	5.28%
Total	$ 29,596	$ 0.00449	100.00%	$ 31,558	$ 0.00465	100.00%	$ 36,849	$ 0.00589	100.00%	$ 38,728	$ 0.00619	100.00%	$ 41,399	$ 0.00614	100.00%

Grand Total	$ 86,320	$ 0.01310	100.00%	$ 83,421	$ 0.01230	100.00%	$ 91,753	0.01467	100.00%	$ 95,798	0.01531	100.00%	$ 102,666	0.01523	100.00%

Schedule 4C


Other Costs per kWh
$0.0180
$0.0160
$0.0140
$0.0120
$0.0100
$0.0080
$0.0060
$0.0040
$0.0020
$0.0000
1996
1997
1998
1999
2000
Years
Salaries
Other Costs (salaries excluded)
Total Other Costs

Newfoundland and Labrador Hydro **Schedule 5**

Rate Stabilization Plan Summary

1998 to 2000

(000)'s	2000 Current Variation	2000 Current Interest	2000 Prior Interest	2000 Total	1999	1998
Balance, beginning of year				$34,331	$48,786	$41,378
Water variation	$ (16,614)	$ (707)	$ 18,711	1,390	2,253	16,981
Load variation	521	72	169	762	5,074	3,028
Fuel variation	29,359	1,052	(19,515)	10,896	(9,896)	(6,209)
Recovery	(13,886)		3,098	(10,788)	(11,239)	(6,263)
Rural rate alteration	(880)	(38)	(128)	(1,046)	(482)	19
Labrador interconnected	53	(3)	11	61	(165)	(148)
Net change	$ (1,447)	$ 376	$ 2,346	1,275	(14,455)	7,408
Balance, end of year				$35,606	$34,331	$48,786

Comprised of:

Water variation	$220,565
Load variation	2,742
Fuel variation	(217,695)
Recovery	32,491
Rural rate alteration	(2,541)
Labrador interconnected	44
Balance, end of year	$35,606
Current receivable	$11,506
Long-term receivable	24,100
	$35,606