Q. In Hydro's Request for Information to the PUB numbered NLH 32 PUB, Hydro asks in part (b) whether "Dr. Cannon's recommendation would be contrary to ratemaking principles which are based on test year values." Please:

(a) State whether it is Hydro's contention that Dr. Cannon's recommendation (as referenced in NLH 32 PUB) "would be contrary to ratemaking principles which are based on test year values."

(b) If the answer to part (a) hereof is "yes", please specifically identify and fully define the ratemaking principles (with citations) which Hydro is referring to and which Hydro is contending that Dr. Cannon's recommendation is contrary to.

(c) Fully and specifically explain how, in Hydro's contention, Dr. Cannon's recommendation is contrary to the principles as identified and defined in response to part (b) hereof.

(d) Provide citations and relevant extracts of regulatory precedents, decisions, orders or treatises on which Hydro would rely for its contention that Dr. Cannon's recommendation is contrary to ratemaking principles which are based on test year values.

(e) Fully explain by reference to the principles identified and defined in part (b) hereof, why not using the test year values for the cost of equity in Newfoundland Power's Automatic Adjustment Mechanism (or in the Mechanism proposed by Hydro) would not also be "contrary to ratemaking principles which are based on test year values."

A. (a) Yes, it is Hydro's contention that Dr. Cannon's recommendation is contrary to ratemaking principles established in this jurisdiction and which are based on values/costs for a single test year.

(b) Hydro refers to the following:

(i) section 3(a)(ii) of the Electrical Power Control Act (1994) SN 1994 Chapter E – 5.1 (The "EPCA") which states the power policy for the Province and specifies that the "rates to be charged for the supply of power should be established wherever practicable, based on forecast costs for that supply of power for one or more years."

(ii) section 4 of the EPCA which states that the Board shall "implement the power policy declared in section 3, and in doing so, shall apply tests which are consistent with generally accepted sound public utility practice."

(iii) Section 80 of the Public Utilities Act RSN 1990 Chapter P-47 which establishes the regulatory framework of the Board founded in rate base regulation.

(iv) The Newfoundland Court of Appeal in Newfoundland (Board of Commissioners of Public Utilities) (Re) (1998) 64 N and PEIR 60 stated at para 77:

"The process of rate setting is generally prospective by nature. Although the Board must set rates for the future, it only has data from past experience, the evidence from utility officials as to planned changes in operations and the opinions of experts as to future economic trends as a guide to what the revenue requirements of the utility will likely be. It is therefore, necessarily speculative. In developing the utility's requirements, the Board focuses on a 'test year' as the basis for its estimates and adjustments. Traditionally, in North America the test year was chosen as the latest 12 month period for which complete data were available [FN60]. More recently, due largely to inflation, boards

adopted a forward-looking test year which in effect amounts to a forecast of what expenses and costs, and hence revenue requirements, will be. This has been the practice of the Board [FN61], and is supported by the Act [FN62] and the EPC Act [FN63]. Past experience of course remains relevant, however, insofar as it gives insight into the possibility of forecasting error [FN64]."

(v) In PU 36 (1998-1999) at pages 69-70 the Board determined the parameters of an Automatic Adjustment Mechanism appropriate for Newfoundland Power (NP) and ordered that test year values would be used for each of the dependent variables in determining the rate of return on rate base with the exception of the cost of common equity which would be established pursuant to PU 16 (1998-99).

(vi) In PU 19 (2003) at pages 67-70 the Board addressed its financial advisor's concerns respecting variances between the embedded forecast cost of debt and actual cost of debt for NP in the operation of its Automatic Adjustment Mechanism over a three year period, confirmed that it did not want to discourage a utility from seeking efficiencies to lower costs and stated at page 68 that "in implementing a formula the Board must select reasonable and justified test year values based on the evidence. In the Board's view this is consistent with the prospective nature of setting rates. Changes in test year values are expected." To address how the benefit of lower costs (through reduced debt rates) would be passed on to consumers, the Board concluded that a triggering mechanism tied to the overall cost of capital would be appropriate and that NP would be required to provide additional information on changes in the embedded cost of debt as part of its annual returns. (see page 121).

(vii) Regulatory principles generally were set out by the Board in PU 14 (2004) at pages 23-24. Relative to section 80 of the Public Utilities Act, the Board confirmed at page 19 that Hydro's rates were to be based on "forecast costs for the supply of power for one (1) or more years. This timeframe in practice is generally referred to as the 'test year(s)'." Further at page 25, the Board stated "the focus of return on rate base regulation is on earnings, in particular the allowed return per dollar of investment (rate base). Rates are set to give the regulated utility the opportunity to recover its revenue requirement consisting of its estimated operating costs and a fair return on its rate base. These costs are generally estimated for a test year(s) for which the rates are set."

(viii) The Regulation of Public Utilities, (3rd ed), Phillips, Charles F. Jr., states at page 196:

"The Company, with the concurrence of the commission or its staff, will generally select a 'test year', frequently the latest twelve-month period for which complete data are available. The purposes of such a test year are as follows. In the first place, the commission's staff must audit the utility's books. For rate-making purposes, only just and reasonable expenses are allowed; only used and useful property (with certain exceptions) is permitted in the rate base. In the second place, the commission must have a basis for estimating future revenue requirements. This estimate is one of the most difficult problems in a rate case. A commission is setting rates for the future, but it has only past experience (expenses, revenue, demand conditions) to use as a guide.

"Philosophically, the strict test year assumes the past relationship

> *among revenues, costs, and net investment during the test year will continue into the future[86]." To the extent that these relationships are not constant, the actual rate of return earned by a utility may be quite different from the rate allowed by the commission[87]. For many years, commissions have adjusted test year data for 'known changes'; that is, a change that actually took place during or after the test period (such as a new wage agreement that occurred toward the end of the year). More recently, due largely to inflation, a few commissions have modified the traditional historic test-year approach by using a forward-looking test year (either a partial or a full forecast)[88] or by permitting pro forma expense and revenue adjustments."*

(c) Hydro refers to the answer to (b) above and repeats its contention that Dr. Cannon’s recommendation to establish at this hearing, the values to be utilized for the embedded cost of debt for 3 years, beyond the test year, in Hydro's proposed Automatic Adjustment Mechanism is inconsistent with the legislation, Board Orders, Court of Appeal commentary and text book referred to in paragraph (b) above. From Hydro's perspective, such a recommendation would be akin to using 'multiple' test year values for one factor only in the formula (cost of debt), and a single test year value (2007) for all other dependent variables in the formula, with the exception of the cost of common equity.

(d) Hydro refers to the citations and extracts contained in the answer to (b) above.

(e) Hydro believes that its proposed Automatic Adjustment Mechanism is consistent with the ratemaking principles established in this jurisdiction and outlined in the answer to (b) above. It proposes to adjust only the rate of return on equity (based on the Province's marginal cost of debt) and to use single test year values for all other dependent variables of the formula. The Province's marginal cost of debt is a rate that can be readily determined in an objective fashion in a non test year, thus rendering "automatic" the computation of a revised cost of equity. In comparison, the projection of the embedded cost of Hydro's debt beyond the test year is predicated on financial assumptions (see Table 1 to Hydro's answer to CA 218 NLH) that have not been subject to the same scrutiny as test year forecast values.