

**Pre-filed Evidence****Ludlow/Delaney**

**Q. Confirm that if the amount of \$30 million is approximately the same as the depreciation expense incurred each year by the Company, that the remaining portion of the capital budget as proposed, some \$24 million dollars, is in excess of the current depreciation rate and will therefore increase the depreciation expense, increase the rate base, increase the equity component of NP's capital structure, and increase the allowed return expressed in absolute dollars, in subsequent years (Ludlow/Delaney, p.3, line 16-17).**

**A. *Plant Replacement***

As indicated in Newfoundland Power's 2004 Capital Budget Plan dated July 25, 2003 and filed as part of the Company's 2004 Capital Budget Application, plant replacement has accounted for an increasing proportion of capital expenditures since 1999.

Consistent with the past five years, replacement of deteriorated, defective and obsolete electrical equipment will continue to dominate capital projects and account for approximately 60% of total capital expenditures, or about \$30 million per year.

As part of its 2003 general rate application the Company filed a new depreciation study, conducted by depreciation experts Gannett Fleming Inc. The study recommended lower annual depreciation rates principally because the Company's assets, including its distribution assets, are expected to last longer. The Company believes that the outcome of this depreciation study is an indication that its plant replacement strategy is working.

While depreciation is not intended to reflect replacement cost, the fact that the order of magnitude of the depreciation expense and the amount expended on asset replacement are similar does provide some indication of the appropriateness of the Company's plant replacement strategy.

***Total Capital Expenditures and Depreciation Expense***

Newfoundland Power's capital planning is a deliberate effort to balance customer needs, reliability, productivity, safety and environmental needs with prudent capital expenditures. The investment in plant and equipment required to provide safe and reliable service to customers means that capital expenditures are required for reasons other than plant replacement. Examples include: investment in assets required to meet growth in energy sales and the number of customers; and, technology investments aimed at improving customer service and operational productivity.

Generally, as the Company's investment in property, plant and equipment increases, depreciation expense will also increase.

***Rate Base***

Changes to the Company's rate base are principally the result of two factors:

1. Capital expenditures, which increase the rate base; and,
2. Depreciation expense, which decreases the rate base.

When annual capital expenditures exceed annual depreciation expense, rate base increases.

***Return on Rate Base***

As Newfoundland Power's rate base increases the Company's allowed return on rate base, expressed in absolute dollars, will increase. This relationship provides the Company with an *opportunity* to recover its investment in the electrical system, together with a just and reasonable return on that investment. However, it does not guarantee realization of the allowed return on rate base. This can only be achieved through additional revenue generation or a reduction in operating expenses, finance charges, depreciation expense or income taxes.

***The Equity Component in Newfoundland Power's Capital Structure***

Changes in the equity component in Newfoundland Power's capital structure will depend upon several factors including the Company's ability to realize its allowed return on rate base and the level of dividends paid to shareholders. Newfoundland Power manages the equity component in its capital structure to remain close to 45 per cent, which is the level required to protect the interests of its debt holders.