

Introduction

In response to PUB 14.0 NP, Newfoundland Power has shown the effects of deferring the depreciation true-up amount of \$5,793,000 and reducing the proposed accrual of 2005 unbilled revenue by a similar amount.

The Company's response indicates that this would result in unfavourable income tax effects of approximately \$1.7 million. Under the PUB 14.0 NP scenario, Newfoundland Power forecasts a rate of return on rate base for 2006 of 8.19%. This rate of return on rate base is significantly below the current approved range of 8.50% - 8.86%.

Grant Thornton, in its evidence, has recognized the unfavourable income tax effects and notes that they would need to be addressed by the Board if it were to consider a deferral of depreciation expense for 2006.¹

In his direct evidence on December 7, 2005, Mr. Smith stated that:

“both [Grant Thornton and Mr. Todd] identify deferral of costs as an alternative to the accrual of 2005 unbilled revenue as a means of disposing of this part of the application.”²

In his direct evidence on December 7, 2005, Mr. Meyers stated:

“The Company's response to PUB-14 indicates that deferring depreciation expense per se has unfavourable income tax effects. Grant Thornton suggests that these unfavourable tax effects should be considered in the event that a deferral of depreciation expense is deemed by the Board to be appropriate. Newfoundland Power agrees. As an alternative, if the Company were to record depreciation expense for 2006 as forecast and were the Board to order a cost recovery of an equivalent amount be deferred for consideration in the context of Newfoundland Power's next test year costs, deferred cost recovery, as opposed to the deferral of depreciation expense, would have no unfavourable tax effects.”³

Deferral of Expense vs. Deferred Cost Recovery

Deferral of Expense

Deferral of expense would require Newfoundland Power to record a lesser amount of expense in 2006 than would be the case under the proposals in this Application. In the case of the Depreciation Deferral Scenario addressed in PUB 14.0 NP the reduction in depreciation expense for 2006 (PUB 14.0 NP, Attachment A, line 14) is \$5,793,000. This reduction in depreciation expense would trigger the unfavourable income tax effects to which both Newfoundland Power and Grant Thornton have referred.

¹ Evidence of Grant Thornton, Page 19, lines 13 to 14.

² Transcript, December 7, 2005, Page 37, line 25 to Page 38, line 3.

³ Transcript, December 7, 2005, Page 65, line 14 to Page 66, line 4.

Deferred Cost Recovery

Under a deferred cost recovery scenario, as referred to by Mr. Meyers on December 7, 2005 (the “Deferred Cost Recovery Scenario”), Newfoundland Power would record depreciation expense for 2006 of \$39,079,000, as proposed in its Application. Newfoundland Power would also record a deferral of 2006 costs in the amount of \$5,793,000 for recovery at a future date. This amount is equivalent to the depreciation true-up adjustment which concludes in 2005, the impacts of which is not reflected in current customer rates. This would reduce the costs to be recovered in 2006 and would not result in the unfavourable income tax effects that would result from the Depreciation Deferral Scenario addressed in PUB 14.0 NP.

The deferral of 2006 costs would be recorded on Newfoundland Power’s Balance Sheet as of December 31, 2006 as a deferred charge.⁴ The deferred charge would remain on Newfoundland Power’s Balance Sheet until recovery of these costs could be dealt with in the context of Newfoundland Power’s next test year.⁵

Comparison to PUB 14.0 NP

A Comparison of the Deferred Cost Recovery Scenario to the Depreciation Deferral Scenario addressed in PUB 14.0 NP is provided as Attachment A.

Attachment A shows that under the Deferred Cost Recovery Scenario, Newfoundland Power’s Depreciation Expense for 2006 (as per line 14) would increase by \$5,793,000 as compared to the Depreciation Deferral Scenario addressed in PUB 14.0 NP.

Deferred Costs in the amount of \$5,793,000, under the Deferred Cost Recovery Scenario, are shown on line 15.

Line 20 shows that the unfavourable income tax effects shown in PUB 14.0 NP would not result under the Deferred Cost Recovery Scenario.

Under the Deferred Cost Recovery Scenario, Newfoundland Power forecasts a rate of return on rate base for 2006 of 8.41%. This compares to the forecast rate of return on rate base for 2006 of 8.19% under the Depreciation Deferral Scenario addressed in PUB 14.0 NP.

Comparison to Newfoundland Power Proposal

A comparison of the Deferred Cost Recovery Scenario to the proposal contained in Newfoundland Power’s Application is provided in Attachment B.

⁴ The deferred costs would be treated in the same manner as other deferred charges in the calculation of Newfoundland Power’s 2006 forecast rate base.

⁵ As referred to by Mr. Meyers on December 7, 2005 (see above).

Attachment B, line 5, shows a reduction in the 2005 Unbilled Revenue Accrual of \$6,950,000.⁶ This reduction is equivalent to the increased amount of depreciation expense forecast for 2006.

The amount of the 2006 deferred costs of \$5,793,000 is shown on line 15.

The calculation of Income Taxes on line 20 indicates that there are no unfavourable income tax effects associated with the Deferred Cost Recovery Scenario.

Line 32 indicates that, under the Deferred Cost Recovery Scenario, Newfoundland Power's 2006 forecast Rate of Return on Rate Base is 8.41%. This compares to the forecast rate of return on rate base of 8.56% as shown in Exhibit NP-14 as contained in Newfoundland Power's 2006 Accounting Policy Application.

⁶ \$5,793,000 + \$1,157,000 = \$6,950,000.

Newfoundland Power Inc.

2006 Forecast
PUB 14.0 NP vs. Deferred Cost Recovery Scenario
(000s)

	<u>PUB 14.0 NP¹</u>	<u>Deferred Cost Recovery Scenario²</u>	<u>Difference</u>
1			
2			
3	Billed Revenue	\$ 417,069	\$ 417,069
4	2006 Unbilled Revenue Accrual	457	457 ³
5	2005 Unbilled Revenue Accrual	2,629	2,629 ³
6		<u>420,155</u>	<u>420,155</u>
7	Purchased Power Expense	265,498	265,498
8	Contribution	154,657	154,657
9			
10	Other Revenue	9,950	9,950
11			
12	Other Expenses:		
13	Operating Expenses	54,153	54,153
14	Depreciation	33,286	39,079
15	Deferred Costs	-	(5,793) ⁴
16	Finance Charges	32,637	32,637
17		<u>120,076</u>	<u>120,076</u>
18			
19	Income Before Income Taxes	44,531	44,531
20	Income Taxes	17,034	15,335
21			
22	Net Income	27,497	29,196
23	Preferred Dividends	591	591
24			
25	Earnings Applicable		
26	to Common Shares	\$ 26,906	\$ 28,605
27			
28			
29	Rate of Return Metrics		
30			
31	Regulated Return on Book Equity	8.41%	8.90%
32	Rate of Return on Rate Base ⁵	8.19%	8.41%

¹ As filed in response to PUB 14.0 NP.

² Assumes recognition of revenue for regulatory purposes based on the accrual method and all consequential matters as detailed in the 2006 Accounting Policy Application adjusted to reflect the deferral of costs equivalent to the depreciation true-up.

³ The total accrual of \$457,000 and \$2,629,000 equals the \$3,086,000 tax expense associated with the income tax settlement.

⁴ The \$5,793,000 in deferred costs is equivalent to the depreciation true-up.

⁵ In Order No. P.U. 50 (2004), Newfoundland Power's rate of return on rate base, used to set customer rates for 2005, was approved at 8.68% in a range of 8.50% to 8.86%.

Newfoundland Power Inc.

2006 Forecast
Newfoundland Power Proposal vs. Deferred Cost Recovery Scenario
(000s)

	<u>Newfoundland Power Proposal¹</u>	<u>Deferred Cost Recovery Scenario²</u>	<u>Difference</u>	
1				
2				
3	Billed Revenue	\$ 417,069	\$ 417,069	\$ -
4	2006 Unbilled Revenue Accrual	457	457 ³	-
5	2005 Unbilled Revenue Accrual	9,579	2,629 ³	(6,950)
6		427,105	420,155	(6,950)
7	Purchased Power Expense	265,498	265,498	-
8	Contribution	161,607	154,657	(6,950)
9				
10	Other Revenue	9,950	9,950	-
11				
12	Other Expenses:			
13	Operating Expenses	54,153	54,153	-
14	Depreciation	39,079	39,079	-
15	Deferred Costs	-	(5,793) ⁴	(5,793)
16	Finance Charges	32,637	32,637	-
17		125,869	120,076	(5,793)
18				
19	Income Before Income Taxes	45,688	44,531	(1,157)
20	Income Taxes	15,335	15,335	-
21				
22	Net Income	30,353	29,196	(1,157)
23	Preferred Dividends	591	591	-
24				
25	Earnings Applicable			
26	to Common Shares	\$ 29,762	\$ 28,605	\$ (1,157)
27				
28				
29	Rate of Return Metrics			
30				
31	Regulated Return on Book Equity	9.24%	8.90%	-0.34%
32	Rate of Return on Rate Base ⁵	8.56%	8.41%	-0.15%

¹ See Exhibit NP-14, Page 1 of 5.

² Assumes recognition of revenue for regulatory purposes based on the accrual method and all consequential matters as detailed in the 2006 Accounting Policy Application adjusted to reflect the deferral of costs equivalent to the depreciation true-up

³ The total accrual of \$457,000 and \$2,629,000 equals the \$3,086,000 tax expense associated with the income tax settlement.

⁴ The \$5,793,000 in deferred costs is equivalent to the depreciation true-up.

⁵ In Order No. P.U. 50 (2004), Newfoundland Power's rate of return on rate base, used to set customer rates for 2005, was approved at 8.68% in a range of 8.50% to 8.86%.