P. U. 40(2005)

IN THE MATTER OF the *Public Utilities Act*, RSNL 1990, c. P-47 (the "*Act*");

IN THE MATTER OF the accounting policy of Newfoundland Power Inc. ("NP") concerning revenue recognition and matters related thereto; and

IN THE MATTER OF an application by NP for an order pursuant to Sections 67, 69, 78 and 80 of the *Act*:

(a) approving changes in accounting policy concerning revenue recognition to be effective for 2006 and subsequent years;

(b) approving the recognition of $9,579,000 in 2005 Unbilled Revenue as revenue for regulatory purposes for 2006;

(c) approving the disposition of the balance of the Unbilled Revenue Increase Reserve; and

(d) approving revised values for rate base and invested capital for use in the Automatic Adjustment Formula for the calculation of return on rate base for 2006 pursuant to Order No. P. U. 19(2003).

BEFORE:

Robert Noseworthy
Chairperson and Chief Executive Officer

Darlene Whalen, P.Eng.
Vice-Chair

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I APPLICATION

NP filed an application (the "Application") with the Board on September 29, 2005 seeking an order approving:

1. pursuant to Section 67 of the *Act*, adoption of the Accrual Method of revenue recognition commencing in 2006;
2. pursuant to Sections 69 and 80 of the *Act*, the recognition for regulatory purposes of $9,579,000 of the 2005 Unbilled Revenue as 2006 revenue;
3. pursuant to Sections 69(3) and 80 of the *Act* the Application of $295,000 of the 2005 Unbilled Revenue in 2006 to dispose of the current balance in the Unbilled Revenue Increase Reserve;
4. pursuant to Sections 78 and 80 of the *Act*, that the average value of the unrecognized 2005 Unbilled Revenue be deducted from rate base commencing in 2006;
5. pursuant to Sections 78 and 80 of the *Act*, a 2006 forecast for rate base of $744,326,000 and a 2006 forecast for invested capital of $745,752,000 to be used in the Formula in calculating NP's return on rate base; and
6. such further, other or alternative matters which may, upon the record of proceedings in respect of this Application, appear just and reasonable in all of the circumstances.

In support of the Application NP filed company evidence and a report of its expert witness, Mr. John T. Browne, CA, of J T Browne Consulting.

1. <u>Notice and Hearing</u>

Notice of Application was published in the Telegram on November 12, 2005. The Board received one notice of intervention from Mr. Thomas Johnson, LLB, the Government-appointed Consumer Advocate. The Application and supporting documentation was also made available on the Board's website www.pub.nl.ca.

The Board engaged its financial consultants Grant Thornton LLP to undertake a review of NP's Application and pre-filed evidence and submit a report. Grant Thornton's report was filed on November 29, 2005.

Requests for information were issued by the Board and the Consumer Advocate to NP and by the Consumer Advocate to Grant Thornton. On December 5, 2005 the Consumer Advocate also filed as evidence a report of his expert witness, Mr. John D. Todd, President of Elenchus Research Associates Inc.

The public hearing of the Application was held at the Board's Hearing Room in St. John's on December 7, 8 and 9, 2005. NP was represented by Mr. Ian Kelly, Q.C., and Mr. Peter Alteen, LLB. Mr. Mark Kennedy, LLB, acted as the Board's Hearing Counsel.

At the commencement of the hearing the parties filed a document (Consent #1) which set out an agreed approach in relation to certain issues contained within the Application.

Mr. Karl Smith, CA, President and Chief Executive Officer, and Mr. Robert Meyers, Treasurer, provided testimony on behalf of NP. In addition Mr. John T. Browne, CA, NP's expert witness, provided evidence.

Mr. John D. Todd testified as an expert witness on behalf of the Consumer Advocate.

Mr. William Brushett, FCA, testified on behalf of the Board's financial consultants Grant Thornton LLP.

2. Background

Historically regulated utilities have recognized revenue from customers by one of two methods. One method is to recognize revenue as customers are billed for the service provided to them (the "Billed Method"). The result is that the total revenue in any fiscal year consists of billings for usage from approximately ½ month of the past calendar year plus approximately 11 ½ months of the current calendar year. The Billed Method has always been used by NP to recognize revenue for financial reporting, regulatory and income tax purposes.

The second method is to recognize revenue as service is delivered to customers (the "Accrual Method"). This method is based on the premise that, once the service has been delivered, the resultant revenue has been earned regardless of whether a bill has been rendered or payment received. Under the Accrual Method the total revenue for the year is comprised of the full twelve months of the current year.

In 1995 the Canada Revenue Agency (the "CRA") reassessed NP's income tax returns for 1988 through 1993 on a number of grounds, the majority of which related to NP's treatment of general expenses capital ("GEC") for income tax purposes and the appropriateness of NP's use of the Billed Method to recognize revenue. NP objected to the reassessments and, in 2000, the CRA agreed to abandon its position on NP's treatment of GEC for income tax purposes. A revised reassessment for 1993 was issued, which maintained that NP's use of the Billed Method to recognize revenue for income tax purposes was inappropriate. Subsequently, in 2001, the CRA also reassessed NP for 1994 through 1999 on the basis of NP's revenue recognition policy. As at December 31, 2004 the contingent liability associated with the revised reassessments was approximately $16.4 million.

In June 2005 NP and the CRA negotiated a settlement of all outstanding matters in dispute, including those raised in the revised reassessments, regarding NP's method of recognizing revenue for income tax purposes. The terms of the tax settlement required NP to recognize revenue using the Accrual Method for income tax purposes commencing in 2006 and also provided for the recognition of 1/3 of the 2005 unbilled revenue as taxable income in each of the years 2006, 2007 and 2008. The contingent liability of approximately $16 million was eliminated and the CRA refunded, with applicable interest, all amounts held on deposit by the CRA on behalf of NP.

3. Application Proposals

As a result of the tax settlement NP is proposing a change in its accounting policy for revenue recognition for regulatory purposes. NP is proposing to adopt the Accrual Method of revenue recognition for regulatory purposes with effect beginning in 2006. This proposed change will require consideration of a balance sheet accrual of approximately $24.3 million as of December 31, 2005 (the "2005 Unbilled Revenue").

With respect to the 2005 Unbilled Revenue NP is proposing:

i. to apply approximately $9.6 million of the 2005 Unbilled Revenue to offset an increase in depreciation expense and income tax effects related to the tax settlement in 2006;

ii. that the $295,000 balance in the Unbilled Revenue Increase Reserve be applied against the 2005 Unbilled Revenue;

iii. that the disposition of the remaining 2005 Unbilled Revenue of approximately $14.4 million be determined by the Board in a future order; and

iv. that the average of the remaining 2005 Unbilled Revenue be deducted from rate base.

These proposals were outlined in NP's Application and supporting documentation. In addition NP is also proposing that the Board approve the adoption of the Asset Rate Base Model (ARBM) as of 2006 and that this model be used for its next general rate application.

As part of the tax settlement the CRA also refunded approximately $2.1 million in interest to NP in 2005. While not explicitly addressed in NP's Application the regulatory treatment of this interest income was an issue before the Board in its consideration of this Application.

The Board has reviewed the evidence before it in the consideration of this Application and its findings and decisions on NP's proposals and other issues raised are set out below.

II BOARD DECISIONS

1. <u>Accounting Policy Change</u>

NP set out in its Application the reasons why the Board should approve its proposal to adopt the accrual method of revenue recognition for regulatory purposes. According to NP the use of the accrual method will result in a better matching of the company's revenue and expenses. As well NP stated this policy change will move NP's revenue recognition policy into the mainstream of Canadian public utility practice. (Pre-Filed Evidence, NP, pg. 15 of 34)

As part of the supporting documentation for this proposed change NP filed a Revenue Recognition Study (Exhibit NP-3). This study was first requested by the Board in Order No. P.U. 36(1998-99), in which the Board ordered NP to (i) establish an Unbilled Revenue Increase Reserve, and (ii) file a study on the appropriate policy for revenue recognition. This study was originally ordered to be filed by March 31, 2000 but the Board, in Order No. P.U. 28(1999-2000) subsequently deferred the filing requirement pending resolution of the tax dispute between NP and the CRA.

Grant Thornton supported NP's proposal to adopt the Accrual Method. According to Grant Thornton this change would assist in the consistency among the company's reporting for financial, income tax and regulatory purposes. (Pre-Filed Evidence, Grant Thornton, pg. 9/26-28) This proposal was also agreed to by all parties to the hearing as set out in Consent #1.

The Board has reviewed the evidence with respect to this policy change, including the Revenue Recognition Study filed as Exhibit NP-3. The Board notes the parties agreement on this issue and agrees that the adoption of the Accrual Method for revenue recognition for regulatory purposes will make NP's policy for revenue recognition consistent with established regulatory principles, Generally Accepted Accounting Principle (GAAP) and Canadian public utility practice.

The Board will approve NP's proposal to adopt the Accrual Method of revenue recognition for regulatory purposes.

2. Treatment of 2005 Unbilled Revenue

NP's adoption of the Accrual Method of revenue recognition for regulatory purposes will result in an accounting accrual of approximately $24.3 million at the end of 2005, as set out in Exhibit NP-4 (the "2005 Unbilled Revenue"). Under the Billed Method this 2005 Unbilled Revenue would have been recognized by NP in January 2006. NP pointed out that, in either case, the actual cash received by NP is the same and that, accordingly, the 2005 Unbilled Revenue represents an accounting accrual as opposed to cash revenues. For financial reporting purposes the 2005 Unbilled Revenue will be reported as both an asset and a liability in NP's balance sheets as of December 31, 2005. (Pre-Filed Evidence, NP, pg. 18/19-24)

Given the magnitude and non-cash nature of the 2005 Unbilled Revenue, NP proposed it be recognized on a prospective basis over a period of years. NP stated that the length of the transition period requires balancing of two essential issues. Firstly the 2005 Unbilled Revenue can be used to offset future revenue that would otherwise be required from NP's customers through rates. Secondly, because recognition of the 2005 Unbilled Revenue does not provide additional cash, the amount that can be recognized in any single year is limited by the need to maintain NP's financial integrity. (Pre-Filed Evidence, NP, pg. 19/13-21)

The methodology and calculations used by NP to estimate the accrual of the 2005 Unbilled Reserve, as set out in NP Exhibit NP-4, were reviewed by Grant Thornton and found to be reasonable and without errors. During the hearing no issues were raised with respect to the methodology and calculation of the amount of $24,262,000 and, as such, the Board accepts NP's methodology and calculation of the 2005 Unbilled Revenue.

The Board also agrees with NP's proposed treatment of the 2005 Unbilled Revenue for financial reporting purposes. To comply with a recent accounting guideline (AcG-19) issued by the Canadian Institute of Chartered Accountants, the 2005 Unbilled Revenue must be recognized as both an asset and a liability in its financial statements as of December 31, 2005. (Pre-Filed Evidence, NP, Exhibit NP-3, pg. 2) This means that the 2005 Unbilled Revenue will be reported as accounts receivable with a corresponding regulatory liability. Grant Thornton supported NP's position on this issue.

With respect to the appropriate recognition of the 2005 Unbilled Revenue for regulatory purposes the parties to the hearing agreed that the accounting accrual forecast of $24,262,000 to arise from the change in NP's accounting policy to the Accrual Method should be dealt with over a transition period, as opposed to recognizing all of it in one year. (Consent #1) According to NP this transitional methodology was proposed as a means of balancing the interests of the company with those of customers. Under this approach NP stated customers would receive the benefit of the 2005 Unbilled Revenue by way of offset with respect to future revenue that would otherwise be required through rates. (Pre-Filed Evidence, John T. Browne, pg. 16, para. 1)

There was no agreement however on the manner in which the 2005 Unbilled Revenue should be recognized or disposed. In particular there was no agreement on how much, if any, of the balance of the 2005 Unbilled Revenue should be recognized as revenue in 2006.

3. NP's Proposals for Partial Disposition of the 2005 Unbilled Revenue

NP has proposed that an amount of $9,579,000 of the 2005 Unbilled Revenue be recognized for regulatory purposes to offset certain increased costs for 2006. The increased costs include:

i. an increase in depreciation expense of $6,950,000; and

ii. income tax effects of $3,086,000 relating to recognition of the 2005 Unbilled Revenue for tax purposes in accordance with the tax settlement.

NP also proposed that a portion of the 2005 Unbilled Revenue be applied to eliminate the balance of $295,000 in the Unbilled Revenue Increase Reserve.

The increased costs identified above will, according to NP, result in a return on rate base for 2006 below the current allowed range as approved by the Board and below what NP considers a fair and reasonable return. NP's proposal to apply a portion of the 2005 Unbilled Revenue to cover these increased costs will give NP the opportunity to earn a forecast rate of return on rate base in 2006 of 8.56%, which is near the lower end of the Board approved range of rate of return. (Transcript, Dec. 9, 2005, pg. 26/9-12)

In final argument the Consumer Advocate submitted that, in the absence of the settlement of the tax case and the accounting policy application, NP would not be seeking to cover its forecast revenue shortfall for 2006 in the manner proposed outside the context of a general rate application. In the alternative the Consumer Advocate suggested that the Board should recognize the 2005 Unbilled Revenue in the same manner as the tax settlement, which requires NP to recognize 1/3 of the 2005 Unbilled Revenue in each of 2006, 2007 and 2008. This would result in the 2005 Unbilled Revenue being recognized for regulatory purposes in the same manner as the revenue would be recognized for tax purposes and would result in a matching of recognized revenue and associated income tax expenses. This can be done without reference to the need to cover a forecast revenue deficiency for 2006. This scenario was outlined in NP's response to PUB 7.0.

The Board has considered NP's proposals for the treatment of a portion of the 2005 Unbilled Revenue and the arguments put forth by both NP and the Consumer Advocate. The Board finds it appropriate to consider the proposals to deal with increased depreciation expense and the income tax effects of the tax settlement separately and to evaluate each on its own merits.

i) Increased Depreciation Expense

The increased depreciation expense of $6,950,000 for 2006 consists of an amount of $5,793,000 relating to the conclusion of the depreciation true-up adjustment approved by the Board in Order No. P. U. 19(2003) and an amount of $1,157,000 relating to the impact of increased plant investment. Although both increases are related to depreciation expenses, there are fundamental differences and, for that reason, the Board has considered each of these separately as below.

<u>Conclusion of Depreciation True-Up Adjustment</u>

The depreciation true-up adjustment was approved by the Board in Order No. P.U. 19(2003). This true-up adjustment was based on NP's 2002 depreciation study, which calculated a reserve variance of approximately $17.2 million. This variance was amortized over a three-year period from 2003 to 2005. This amortization reduced depreciation expense in these years and resulted in lower rates for NP's customers. NP stated that this true-up adjustment will have been effectively amortized as of December 31, 2005 and hence there will be an increase in 2006 depreciation expense equal to the annual true-up adjustment of $5,793,000. (Pre-Filed Evidence, NP, pgs. 20/16-18; 21/1-4)

The Consumer Advocate does not agree with NP's proposal to recognize a portion of the 2005 Unbilled Revenue in 2006 to offset the increase in depreciation expense arising as result of the amortization of the true-up. As outlined above the Consumer Advocate proposed that the 2005 Unbilled Revenue be recognized on the same basis as the tax settlement (1/3 in each of 2006, 2007 and 2008) without reference to any revenue shortfall.

The amount of the increased depreciation costs of $5,793,000 attributable to the conclusion of the depreciation true-up was identified and tested in NP's 2003 general rate hearing and accepted by the Board in Order No. P. U. 19(2003). The amortization of the reserve variance adjustment over a three-year period was proposed by NP in its 2003 general rate application and accepted by the Board. The reason given by NP at the time was that this three-year adjustment period coincided with the next depreciation study expected in 2006, based on plant in service as of December 31, 2005. (Order No. P.U. 19(2003), pg. 81) The Board accepts this increased depreciation cost for 2006 of $5,793,000 as presented and will allow NP to recover this amount.

However the Board is not persuaded that a portion of the 2005 Unbilled Revenue should be recognized in 2006 to offset this increased cost. NP is currently completing an updated depreciation study, which will be considered as part of NP's next general rate application. The Board finds that it would be more appropriate to consider recovery of this increased cost in conjunction with its review of the 2005 depreciation study and the recommendations and impacts of this updated study. NP will be permitted to defer recovery of this cost.

The Board will allow NP to recover in future rates by use of a deferral account the increased depreciation expense of $5,793,000 related to the amortization of the depreciation true-up.

Deprecation Expenses Related to Increased Plant Investment

The increase in depreciation expense related to increased plant investment is related to the ongoing annual capital programs undertaken by NP. In its Application (pg. 21) NP stated that depreciation expense, based on increased plant investment and depreciation rates approved by the Board in Order No. P.U. 19(2003), is forecast to increase from $37,922,000 in 2005 to $39,079,000 in 2006; an increase of $1,157,000.

Grant Thornton noted in its report (pg. 17/7-11) that in normal circumstances the ongoing annual investment in plant by the company does not in itself impact revenue requirement to the extent that NP would seek rate relief between general rate hearings. Grant

Thornton suggested that the Board may want to consider all related impacts on revenue requirement before accepting NP's proposal.

While the Board acknowledges that the higher expense related to increased plant investment is a real cost, the Board is not persuaded that circumstances are such that this increased cost should be considered as part of this Application. NP undertakes a capital program and incurs capital expenditures each year and these expenditures impact the revenue requirement in other ways, in addition to depreciation. The portion of capital expenditures incurred for example as a result of customer growth will be offset somewhat by higher revenues from increased energy sales. Other capital expenditures may impact maintenance expenses. As noted by Grant Thornton the ongoing annual investment by the company in capital programs does not normally result in adjustments to revenue requirement between rate hearings. This expense increase would have been contemplated by NP on a go forward basis during its 2003 general rate application and the Board does not have any evidence before it that would indicate that it is appropriate to consider these costs in isolation of other revenue impacts. These expenses are properly dealt with in the context of a general rate application.

The Board will not approve NP's proposal to recognize a portion of the 2005 Unbilled Revenue to offset the $1.157 million increase in depreciation expense attributable to plant investment.

ii) Income Tax Effects of the Tax Settlement

Under the terms of the tax settlement NP will recognize for tax purposes 1/3 of the 2005 Unbilled Revenue in each of 2006, 2007 and 2008. This will result in additional income taxes of $3,086,000 in 2006, and a similar amount in each of the following years. (Exhibit NP-2). The final 2006 income tax effects include i) $2.921 million related to the recognition of the 2005 Unbilled Revenue for income tax purposes equally over 2006-2008, and ii) $165,000 related to the adoption of the Accrual Method of revenue recognition for income tax purposes in 2006. Grant Thornton has reviewed NP's calculation of these tax impacts and has expressed the opinion that the calculations are appropriate and reasonable. (Pre-Filed Evidence, Grant Thornton, pg. 17/17-19)

NP is proposing that $3,086,000 of the 2005 Unbilled Revenue be recognized in 2006. This amount is equal to the pro-forma income tax in that year. In its Application NP notes that recovering the 2006 income tax cost through revenue from rates would attract additional taxes and require additional revenue of $1,745,000 for a total of $4,831,000 in increased revenue. Offsetting the income tax effects with a portion of the 2005 Unbilled Revenue would not result in additional taxes and is, according to NP, the least cost means of recovering the tax effects from the ratepayer perspective. (Pre-Filed Evidence, NP, pg. 13/1-11)

Mr. Todd, on behalf of the Consumer Advocate, stated in his report (pg. 34) that it would be appropriate to recognize at most sufficient revenue from the 2005 Unbilled Revenue to offset the tax effects attributable to the tax settlement.

Grant Thornton stated that NP's proposal to deal with the tax impacts of the tax settlement is reasonable and appropriate. (Pre-Filed Evidence, Grant Thornton, pg. 18/4-5)

The Board is satisfied that this proposal presents the least cost means of addressing the tax impacts associated with the tax settlement. The increased income taxes payable by NP for 2006 are directly related to the recognition of the unbilled revenue for tax purposes and NP is entitled to recover this cost.

The Board will accept NP's proposal to recognize $3,086,000 of the 2005 Unbilled Revenue in 2006 to offset the income tax effects associated with the tax settlement.

iii) Unbilled Revenue Increase Reserve

In Order No. P.U. 36(1998-99) the Board established an Unbilled Revenue Increase Reserve to account for the impact of the recovery lag which occurs under the Billed Method of revenue recognition when electricity rates change. The disposition of this reserve was directly linked to the revenue recognition study. The balance in this reserve is now $295,000 and represents revenue recognized by NP which is, in theory, due from customers but which has not yet been billed. NP proposed that $295,000 of the 2005 Unbilled Revenue be used to eliminate the reserve balance, which will dispose of the reserve without affecting rates.

Grant Thornton reviewed this proposal and stated that, based on their understanding of the circumstances under which this reserve was established, NP's proposal to apply a portion of the 2005 Unbilled Revenue to eliminate the reserve balance is reasonable and appropriate. (Pre-Filed Evidence, Grant Thornton, pg. 18/20-22)

The Board notes the parties agreement on this issue (Consent #1). The Board is satisfied that NP's proposal to apply the amount of $295,000 of the 2005 Unbilled Revenue in 2006 so as to dispose of the current balance in the Unbilled Revenue Increase Reserve is appropriate in the circumstances. This is consistent with the Board's intentions as set out in Order No. P.U. 36(1998-99) and will dispose of the reserve balance with no increase in customer rates.

The Board will accept NP's proposal to apply the amount of $295,000 of the 2005 Unbilled Revenue in 2006 so as to dispose of the current balance in the Unbilled Revenue Increase Reserve.

4. Interest Income for 2005 as a Result of the Tax Settlement

As a result of the tax settlement the CRA refunded to NP approximately $2.1 million in interest in 2005. This fact was not explicitly identified in NP's Application. In its response to PUB 10.0 NP stated:

> *"Newfoundland Power's recording of the refund interest resulting from the June 2005 Tax Settlement was done in accordance with (i) the Company's system of accounts, (ii) Canadian Generally Accepted Accounting Principles ("GAAP") and (iii) past practice with respect to similar interest revenue. This required that the refund interest be recognized by Newfoundland Power as revenue in 2005. Accordingly, the Company did not consider the 2005 refund interest in conjunction with the unbilled revenue and related income tax impacts beginning in 2005."*

NP stated that the interest revenue was recorded in the company's system of accounts, which requires that interest revenue derived from income tax refunds be recorded as miscellaneous non-consumer revenue. It was noted that interest income received in 2000 and 2001 as a result of the settlement of other issues in the tax dispute were also recorded in the same manner in the year received.

In its response to PUB 11.0 NP identified the impact of the interest revenue on the company's 2005 financial results. The additional $2.1 million in miscellaneous non-consumer revenue will increase earnings by approximately $1.4 million. The impact of the refund interest on NP's rates of return for 2005 was stated in PUB 11.0 as below:

Rates of Return
2005

	Forecast (including refund interest)	**Pro Forma** (excluding refund interest)
Rate of Return on Rate Base[1]	8.57%	8.38%
Rate of Return on Regulated Common Equity	9.61%	9.20%

1. NP's rate of return on rate base used to set customer rates for 2005, as approved by the Board in Order No. P.U. 50(2005), is 8.68% in a range of 8.50% to 8.86%.

Since the 2005 refund interest is not forecast to result in excess revenue that would be rebated to customers, NP stated customers are not expected to benefit directly from this instalment of refund interest. However, according to NP, customers have received other tangible benefits as a result of the 2005 tax settlement. These benefits include the fact that no additional income tax or interest has to be paid by the company as set out in the tax reassessments, and the elimination of a material contingent liability which presented a risk to NP's customer rates. NP also noted that customers have already received approximately $8.8 million in the form of rebates as a result of refund interest associated with the settlement of the original tax reassessments paid in 2000 and 2001. (PUB 11.0)

The Consumer Advocate disagreed with NP's position on this issue. In addressing the issue of how the 2005 interest revenue on the tax deposit should be recognized for regulatory purposes the Consumer Advocate's expert Mr. Todd referenced Order No. P.U. 19(2003), which dealt with the revenue recognition issue. In Order No. P.U. 19(2003) the Board stated at pg. 87 that it "*will deal with any issues arising from the final decision of the tax case, including any potential liabilities or benefits to ratepayers, once the case has been resolved.*" Mr. Todd stated:

> *"The implication of this statement is that all matters related to the Tax Settlement would be addressed at a future time. This approach is analogous to placing all of the consequences of the Tax Settlement into deferral accounts for future disposition in a manner that the Board considers to be just and reasonable."* (Pre-filed Evidence, John D. Todd, pg. 28/8-11)

Mr. Todd further stated (pg.30) that it is *"incumbent upon the Board to determine whether it is more appropriate to recognize this revenue in 2005 or to direct the company to establish a deferral account so that the revenue can be disposed of at a later date to the benefit of ratepayers."* It was Mr. Todd's position that NP's proposed treatment of the $2.1 million in interest revenue arising from the tax settlement is not consistent with standard regulatory policies and practices. The interest revenue is essentially an offset to the carrying cost that was borne by ratepayers to finance the income tax deposits that NP was required to make over the years. It is therefore clear, according to Mr. Todd, that this revenue is not required to compensate the company for costs it has incurred in order to provide regulated service to its customers. (Pre-filed Evidence, John D. Todd, pg. 28/8-11)

In final argument the Consumer Advocate submitted that, as a result of the language of Order No. P. U. 19(2003), the Board not only reserved to itself the jurisdiction to deal with any issues arising from the final decision of the tax case but also, in effect, set up a reserve. (Transcript, Dec. 9, 2005, pg. 50/7-11) The Consumer Advocate further stated:

> *"If a defacto deferral account was created which captured the liabilities and benefits, then Newfoundland Power erred when in 2005 it received the interest refund and entered it on its approved book of account. It should have been placed in a deferral account. If it had been placed in a deferral account, it would not have become the Company's revenue until this Board had determined its appropriate disposition…"* (Transcript, Dec. 9, pg. 51/17-25)

> *"If the Board's Order created a defacto deferral account, the Stated Case clearly posed no legal or jurisdictional impediment to the Board's disposition of this money. The Stated Case only prohibits the Board from removing revenue retroactively from the Company's just and reasonable return. This prohibition would not apply to funds that are properly placed in a deferral account, whose deferral accounts the existence of which predates the receipt of the funds. There's nothing retroactive about that. Was -- this is the question. Was a defacto deferral account created in 2003?"* (Transcript, Dec. 9, pg. 52/1-19)

On the question of who is entitled to the interest the Consumer Advocate argued that, as a matter of symmetry, if the $16.2 million of contingent liability would have been picked up by ratepayers, the $2.1 million should go to ratepayers. The Consumer Advocate also submitted that NP delayed the settling of the case so as to ensure a more favourable financial arrangement for the company, thus incurring additional costs to be paid by customers. He stated that an earlier settlement would have avoided a significant portion of the ten million dollars in present value in carrying costs and legal costs. In his view these financing and legal costs were unnecessary and imprudently incurred by the company and should not have been recovered from ratepayers. (Transcript, Dec. 9, pg. 57/2-22)

The question before the Board with respect to the recognition of the $2.1 million in interest income for 2005 arising as a result of the tax settlement is whether NP's treatment of the income is appropriate. In making this determination the Board will consider generally accepted public utility principles in the context of the Board's authority and framework for regulating NP.

The Board notes that NP's treatment of the revenue is consistent with generally accepted accounting principles. In its report Grant Thornton confirmed that the 2005 refund interest revenue has been recorded in accordance with generally accepted accounting principles, which requires the revenue to be recorded in the year that it is received. It is also noted that NP followed its system of accounts when recording this income. As pointed out by Mr. Myers during his testimony, the Board has approved a system of accounts for NP and Section 5.00(j) of this system of accounts requires NP to record interest revenue derived from income tax refunds as miscellaneous non-consumer revenue. (Transcript, Dec. 7, 2005, pg. 75/15-25; pg. 76/1-4)

NP's treatment of the 2005 interest income is also consistent with its treatment of interest income received in 2000 and 2001 as a result of the settlement of other issues contained in the tax dispute. In both these cases the Board was required to make a determination with respect to the disposition of revenue captured in the Excess Earnings Account as a result of NP's receipt and recording of the refund interest revenue in each of 2000 and 2001. The Excess Earnings Account was set up as a mechanism to deal with any windfall revenue resulting in the possibility of earnings to shareholders in excess of those allowed by the Board. Under cross-examination by NP Mr. Brushett of Grant Thornton confirmed that, based on his experience and knowledge of what occurred in 2000 and 2001, NP's approach is consistent with the treatment of past refund interest. (Transcript, Dec. 9, 2005, pg. 3/21 to pg. 4/23)

The Consumer Advocate argued that NP's treatment of the $2.1 million was inappropriate as it was inconsistent with a defacto deferral account established by the Board. The Consumer Advocate argued that the Board's language in Order No. P.U. 19(2003) in effect set up a defacto deferral account for all benefits and liabilities arising from the tax dispute and, as such, the $2.1 million in refund interest revenue should not have been recorded as revenue by NP.

In the circumstances the Board will not find that a defacto deferral account was created in the absence of clear language setting up an account. Order No. P.U. 19(2003) makes no mention of a deferral account and in fact makes no mention of the interest revenue at all. The Board's comments in Order No. P.U. 19(2003) must be read in the context from which they arise. These comments were in consideration of a request from NP in its 2003 general rate application to defer dealing with the outstanding issues relating to the Revenue Recognition Study pending resolution of the dispute with CCRA. In keeping with the principal of regulatory certainty the Board will not make a determination that a defacto deferral account was created. In the circumstances the requirement for NP to establish a deferral account contrary to the provisions of GAAP, the language of the system of accounts and historical practice would arise only with an express direction from the Board. The Board finds that the language of Order No. P. U. 19 (2003) does not establish such a direction.

However, even in the absence of a deferral account, the Board may in certain circumstances determine that it is appropriate to order a different treatment of this revenue for regulatory purposes. The Board however, in exercising its authority with respect to the regulatory treatment of this revenue, must be satisfied that it is appropriate to deviate from GAAP, the system of accounts approved by the Board, and historical practice.

The Consumer Advocate further suggested that the Board should consider a different approach as NP acted imprudently or improperly in the handling of the tax dispute. Having considered the matter the Board finds that there is insufficient evidence to establish that NP was imprudent or improper in settling the tax dispute. The benefits and liabilities associated with the tax dispute and the settlement agreement were identified by NP. While the Consumer Advocate argued that NP unnecessarily delayed the settlement of the tax case to its advantage there is little evidence suggesting that this is the case. It is evident that consumers have benefited from NP's actions through the avoidance of payment of additional tax and interest liabilities arising from the tax reassessments. There is now certainty for both consumers and NP on a go-forward basis with respect to this outstanding tax issue. As well the change in accounting policy to the Accrual Method for revenue recognition for regulatory purposes starting in 2006 brings NP's regulatory practice in line with its reporting for accounting and tax purposes and also with other utilities in Canada. The Board views these outcomes as very positive and has no reason to disallow any of the expenditures or revenues associated with the tax dispute on an imprudence basis.

In these circumstances the Board will not exercise its discretion to order a different treatment of the interest revenue than that argued by NP respecting this Application. The Board is satisfied that the settlement of the tax dispute was prudent and that the language of Order No. P. U. 19(2003) does not sufficiently establish a defacto deferral account. The Board is satisfied that NP has properly recorded the 2005 refund interest in accordance with GAAP, its system of accounts, past regulatory practice and previous orders of the Board.

The Board accepts NP's treatment of the 2005 refund interest revenue arising from the settlement of the tax case.

5. Impact on Rate Base of the Unrecognized 2005 Unbilled Revenue

In its Application NP proposed that the average value of the unrecognized 2005 Unbilled Revenue, reported in the company's balance sheets as *other liabilities*, be deducted from rate base commencing in 2006 until the transition period for recognition of the 2005 Unbilled Revenue is complete. Once the entire amount of the 2005 Unbilled Revenue has been recognized, no further adjustments to rate base will be required as a result of the 2005 Unbilled Revenue.

In their reports both expert witnesses, Mr. Brown on behalf of NP (pg. 24) and Mr. Todd on behalf of the Consumer Advocate (pg. 34), agreed with this treatment of the unrecognized 2005 Unbilled Revenue. Mr. Todd stated that this proposal is appropriate in light of the fact that the balance in the 2005 Unbilled Revenue account at any time represents a zero-cost source of capital for NP.

Grant Thornton also reviewed NP's proposal with respect to this issue and stated that it is reasonable. (Pre-Filed Evidence, Grant Thornton, pg. 14/15-17)

The unrecognized 2005 Unbilled Revenue is revenue for which recognition has been deferred until future accounting periods. As such this represents a deferred liability and should be deducted from NP's rate base in the same manner as other deferred assets are currently treated. The Board is satisfied that NP's proposal to reduce the rate base by the average value of the unrecognized 2005 Unbilled Revenue is appropriate and is consistent with the Board's practice with respect to certain other accounts.

The Board will approve NP's proposal to deduct from the rate base commencing in 2006 the average value of the unrecognized 2005 Unbilled Revenue, reported in the company's balance sheets as other liabilities, until a further Order of the Board.

6. Reporting

NP will be required to file, with its 2005 and 2006 annual returns, a schedule which provides a reconciliation of the balance in the deferred 2005 Unbilled Revenue account.

7. Asset Rate Base Method

In its Application NP is requesting the approval of two proposals to facilitate the adoption of the ARBM. The first proposal is the change in accounting policy for revenue recognition to the Accrual Method, and the second is the discontinuation of the use of regulated common equity in the calculation of return on rate base and the use of book common equity instead.

This issue was addressed by the Board in Order No. P. U. 19(2003), in which the Board found that the ARBM should replace the invested capital approach currently used to calculate the company's rate base. The move to the ARBM commenced in 2003 with NP incorporating deferred charges in rate base. In making this decision the Board recognized that there were a number of reconciling differences between rate base and invested capital which will have to be addressed. In Order No. P.U. 19(2003) the Board directed NP to:

> *"…review no later than its next general rate application, the appropriateness and approach to including the remaining reconciling items in the Rate Base. This review will address the issue of discontinuing the use of regulated common equity in favour of book equity."*

The Board has, with this decision, accepted NP's proposal to change its accounting policy to the Accrual Method for revenue recognition. As noted in Grant Thornton's report and as evident in Exhibit NP-10, this change will result in substantial reduction in the difference between working capital included a part of invested capital and the cash working capital allowance calculated for inclusion in rate base.

The issue of using regulated common equity versus book equity is also an issue that should now be addressed given the other changes to be implemented that will reduce the difference between rate base and working capital. As NP stated in its Application *"the inclusion of cumulative non-regulated equity is essentially a legacy issue for Newfoundland Power. As there appears to be no regulatory policy justification for continuing this practice, it would be practical and in the interests of regulatory transparency to discontinue its use."* (Exhibit NP-9, pg. 4) The move to using regulated common equity will also result in a consistent regulatory policy for the calculation of rate base for both NP and Newfoundland and Labrador Hydro.

The Board notes the parties agreement on this issue (Consent #1). The Board is satisfied that NP's proposal to discontinue the use of regulated common equity in the calculation of return on rate base is appropriate and reasonable. Approval of NP's proposal on this issue will facilitate the move to full adoption of the ARBM in advance of NP's next general rate application and will provide for a consistent regulatory treatment of both public utilities in the province.

The Board will approve NP's proposal to discontinue the use of regulated common equity in the calculation of return on rate base.

8. Values for Rate Base and Invested Capital

In its Application NP requested the Board approve the forecast values for rate base of $744,326,000 and invested capital of $745,752,000 for use in the Automatic Adjustment Formula for the calculation of NP's rate of return on rate base for 2006. These values incorporate NP's proposals as set out in its Application. As the Board has not accepted in their entirety NP's proposals with respect to the application of the 2005 Unbilled Revenue for regulatory purposes, NP will have to file a further application with revised 2006 forecast values for rate base and invested capital.

III ORDER

IT IS THEREFORE ORDERED THAT:

1. NP's proposal to adopt the Accrual Method of revenue recognition commencing in 2006 is approved.

2. NP's proposal to apply $295,000 of the 2005 Unbilled Revenue in 2006 to dispose of the current balance in the Unbilled Revenue Increase Reserve is approved.

3. NP's proposal to recognize for regulatory purposes $3,086,000 of the 2005 Unbilled Revenue in 2006 to account for income tax effects arising from the tax settlement is approved.

4. NP shall defer recovery of an increase in 2006 depreciation expense of $5,793,000 in 2006 related to the amortization of the depreciation true-up as approved in Order No. P.U. 19(2003) until a further Order of the Board.

5. NP shall deduct the average value of the unrecognized 2005 Unbilled Revenue shall be deducted from rate base commencing in 2006.

6. NP shall, for regulatory purposes commencing in 2006, discontinue the use of regulated common equity and substitute book common equity in the calculation of return on rate base.

7. NP shall file with its 2005 and 2006 annual returns a schedule which provides a reconciliation of the balance of the unrecognized 2005 Unbilled Revenue.

8. NP shall pay the expenses of the Board arising from this Application, including the expenses of the Consumer Advocate incurred by the Board.

Dated at St. John's, Newfoundland and Labrador this 23rd day of December 2005.

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Robert Noseworthy
Chairperson and Chief Executive Officer

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Darlene Whalen, P. Eng.
Vice-Chair

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G. Cheryl Blundon
Board Secretary