Q. CA 23.0 NP

Reference: **Exhibit NP-9, Table 1 (Reconciliation of Average Invested Capital and Average Rate Base, 2004 Test Year) and Table 4 (Pro Forma Reconciliation of Average Invested Capital and Average Rate Base, 2006-2009)**
PUB 10.0 NP

Preamble: **NP-9 Table 1 shows "Corporate Income Tax Deposit" in the amount of $6,674,000 (sic) as one of the reconciling items. Table 4 shows that the deposit is reduced to zero.**

Question PUB 10.0 states: "It was noted in NP's Quarterly Report issued for the period ended June 30, 2005 Tab 1, page 7, that the increase in revenue is partially due to the $2.1 million of interest revenue arising from the tax settlement."

Does NP consider it to be appropriate to credit the $2.1 million interest revenue in a manner that corresponds to the incidence of the capital costs associated with the corporate income tax deposit? If not, please explain the rationale for NP's position.

A. **1. General**

Newfoundland Power does not consider it to be appropriate to credit the $2.1 million interest revenue in a manner that corresponds to the incidence of the capital costs associated with the corporate income tax deposit.

The incidence of capital costs associated with the deposit does not support the conclusion that the interest revenue received upon final resolution in June 2005 should be treated any differently than it would in the normal course.

In particular, the incidence of capital costs associated with the deposit does not alone provide a fair view of the potential financial liabilities and benefits to customers and the Company of final resolution of the tax case. The analysis contained in the Response provides a fair broad based estimate of the potential liabilities and benefits associated with the final resolution of the tax case.

2. The Tax Deposit & Risk

When a corporate taxpayer such as Newfoundland Power is reassessed for tax under the provisions of the *Income Tax Act*, it is legally required to place at least ½ of the amount of the reassessment on deposit with the Minister of National Revenue if it wishes to contest the reassessment.

The decision of Newfoundland Power to contest the tax reassessments necessarily required the deposit of at least ½ of the amount of the reassessments at issue. Accordingly, the cost of financing the corporate income tax deposit (i.e., the capital costs associated with the corporate income tax deposit) was a necessary cost of the Company's management of the overall risk to both the Company and its customers presented by the reassessments.

Newfoundland Power's historical tax accounting has provided meaningful financial benefits for the Company's customers. It has not resulted in any benefit to Newfoundland Power in terms of increased returns.

When Newfoundland Power was confronted with the reassessments, it made a decision to contest them because it believed the federal tax reassessments were inappropriate and that it was in the interests of its customers to do so. The Company could have chosen to accept the reassessments and pay the tax and interest.

The original decision to contest the reassessments and the subsequent management of the reassessments avoided substantial *potential* financial liabilities for Newfoundland Power's customers. Any fair assessment of the potential financial liabilities and benefits associated with the final resolution of the tax case must take this into account.

3. Net Customer Financial Benefits

3.1 Customer Benefit: Avoided Interest Costs

The 1995 reassessments totaled approximately $33.2 million, approximately $7.7 million of which was interest charged on tax claimed in the reassessments ("Arrears Interest"). Arrears Interest is not deductible for tax purposes. By contesting the original 1995 reassessments and the subsequent 2000-2001 reassessments which were made by the federal tax authorities, Newfoundland Power ultimately avoided the payment of any Arrears Interest.

The avoidance of the payment of Arrears Interest was a principal financial benefit of Newfoundland Power's management of the risk presented to the Company and its customers by the reassessments.

Attachment A provides a present value analysis of the potential liability to customers that have been avoided by Newfoundland Power's decision to contest the reassessments. It indicates the revenue requirement impact of the avoided payment of Arrears Interest of $7.7 million in 1995.

Table 1 summarizes the present value of the avoided Arrears Interest in 2005 dollars at discount rates ranging from 6.9% to 10.8%.

Table 1
Customer Benefit:
Avoided Interest Costs

Discount Rate	Present Value*
6.9%	$25.9
8.5%	$30.0
10.8%	$37.0

* Avoided Arrears Interest Costs in Revenue Requirement in millions of 2005 dollars.

Table 1 clearly indicates that the present value of the potential liability of the avoided Arrears Interest is substantial, in the range of $26 to $37 million.

3.2 Customer Costs

The costs borne by Newfoundland Power's customers in terms of rates included the capital costs associated with the income tax deposit and legal fees. A portion of these costs was effectively offset by customer rebates resulting from income tax refunds associated with the tax dispute.

Attachment B provides a present value analysis of the costs reflected in customers' rates.

Table 2 summarizes the present value of these costs in 2005 dollars at discount rates ranging from 6.9% to 10.8%.

Table 2
Customer Costs of
Tax Dispute

Discount Rate	Present Value*
6.9%	$9.7
8.5%	$10.7
10.8%	$12.3

* In millions of 2005 dollars.

3.3 Net Potential Customer Financing Costs and Benefits

A summary of the net potential financing liabilities and benefits to Newfoundland Power's customers (i.e., the net customer benefits) of the Company's management of the tax dispute is provided in Table 3.

Table 3
Net Customer Benefits

Discount Rate	Customer Benefit*	Customer Costs*	Net Customer Benefits*
6.9%	$25.9	($9.7)	$16.2
8.5%	$30.0	($10.7)	$19.3
10.8%	$37.0	($12.3)	$24.7

* In millions of 2005 dollars.

Table 3 shows net benefits to customers as a result of the Company's successful management of the tax dispute in a range of $16.2 to $24.7 million. This is clearly substantial.

3.4 Other Customer Financial Benefits

The Deposit

Newfoundland Power chose to deposit ½ of the amount of the reassessments at issue. It could have placed the full amount of the reassessments on deposit. By placing the full amount on deposit, further accumulation of Arrears Interest would have been avoided.

Depositing the lower amount effectively increased the net customer benefits, by reducing the costs borne by customers of financing the deposit.

Tax Rates

The tax reassessments dealt principally with tax practices in the 1990s. Tax rates in the 1990s were materially higher than they are currently. Insofar as the overall resolution of the tax reassessments effectively reduced the tax rate paid on the amounts in dispute, it effectively reduced the tax expense borne by customers in rates.

Because of this, the June 2005 resolution of the tax dispute actually *increased* the value to customers of the unbilled revenue. By the terms of the tax settlement, the tax paid on the unbilled revenue will be at rates in effect for 2006 to 2008 which are forecast to be approximately 36%. This tax rate is materially lower than the average 43% tax rate in effect through the period 1993 to 2005. The effect of this aspect of the resolution, which will accrue to customers, is approximately $1.7 million in tax[1], or approximately $3.1 million in revenue requirement.[2]

Tax Deferral

The overall resolution of the tax dispute also had the effect of deferring the payment of the tax reassessed. Conceptually, an amount of tax payable in, say, 2006 will necessarily have a lower present value cost than an equal amount of tax payable in 1996. This benefit is passed on to customers in rates that are lower than they would otherwise be.

General

The effects of (i) electing to minimize the amount of the deposit, (ii) lower tax rates and (iii) tax deferral, all provide tangible economic benefits to Newfoundland Power's customers. None have been attributed a value in the analysis of financial costs and benefits calculated in the Attachments to this Response.

4. Newfoundland Power Costs

Not all costs, including the financing costs associated with the income tax deposit, were recovered in Newfoundland Power's customers' rates. The costs associated with the reassessments, including the financing of the initial deposit in 1995, were not incorporated into customer rates until 1997. Effectively, this resulted in the Company bearing these financing costs in both 1995 and 1996.

Attachment C provides a present value analysis of the costs not recovered by the Company through customers' rates.

Table 4 summarizes the present value of these costs in 2005 dollars at discount rates ranging from 6.9% to 10.8%.

Table 4
Newfoundland Power Costs
of Tax Dispute

Discount Rate	Present Value*
6.9%	$1.2
8.5%	$1.7
10.8%	$2.4

* In millions of 2005 dollars.

[1] Weighted Average Tax Rates 1995-2005 minus Forecast Tax Rate multiplied by 2005 Unbilled Revenue (43.29% - 36.12%) × $24,252,000 = $1,740,000 (rounded).
[2] Tax savings divided by (1 – tax rate) = $1,740,000 ÷ (1 – 0.4329) = $3,068,000.

These Company costs were not recovered through customer rates and incorporate the impact of the interest received in 2005.

There is a net cost to Newfoundland Power as a result of the reassessments.

5. Concluding

Newfoundland Power's customers have received, and will continue to receive material financial benefits from the overall resolution of the tax reassessments. On the other hand, the net cost of the tax reassessments to Newfoundland Power are in the order of $1.2 to $2.4 million, even after including the impact of the 2005 refund interest.

In these circumstances, no justification exists to deal with the 2005 income tax interest any differently than in the normal course. Treating the interest in the normal course simply (i) lowers the overall net cost borne by Newfoundland Power and (ii) does not impact the substantial benefits provided to customers by way of the Company's actions in successfully managing and resolving the tax dispute.

For further detail on treatment of refund interest associated with the tax reassessments, please see the Response to PUB 12.0 NP.

Newfoundland Power Inc.
Customer Benefit: Avoided Interest Costs
($000s)

Year	Avoided Interest Cost[1]	Tax Effect[2]	Avoided Revenue Requirement
1995	7,700	5,576	13,276
1996	-	-	-
1997	-	-	-
1998	-	-	-
1999	-	-	-
2000	-	-	-
2001	-	-	-
2002	-	-	-
2003	-	-	-
2004	-	-	-
2005	-	-	-
PV (2005$)[3]			
NPV @ 6.9%			25,873
@ 8.5%			30,017
@ 10.8%			37,022

[1] Per 1995 CRA Notice of Assessment.

[2] Based on 1995 statutory tax rate of 42%, avoided costs x 42% / (1-42%).

[3] Present value is based on three discount rate scenarios:
6.9% (Newfoundland Power's after tax weighed average cost of capital)
8.5% (Newfoundland Power's weighted average cost of capital)
10.8% (Newfoundland Power's pre tax weighted average cost of capital)

Newfoundland Power Inc.
Customer Costs of Tax Dispute
As Reflected in Customer Rates
($000s)

Year	Financing Costs[1]	Legal Fees[2]	Total Cost	Refunds[3]	Net Cost
1995	-	-	-	-	-
1996	-	-	-	-	-
1997	2,137	16	2,153	-	2,153
1998	1,924	26	1,950	-	1,950
1999	1,901	165	2,066	-	2,066
2000	1,942	118	2,060	-	2,060
2001	1,942	147	2,089	(6,569)	(4,480)
2002	837	32	869	-	869
2003	809	90	899	(944)	(45)
2004	789	113	902	-	902
2005	765	53	818	-	818
PV (2005$)[4]					
NPV @ 6.9%					9,683
@ 8.5%					10,700
@ 10.8%					12,343

[1] Per CA 22.0 NP.

[2] Per CA 16.0 NP. In 1995 and 1996, costs had not been built into rates. Beyond 1996, these legal costs would have had some impact on test year forecasts. Actual amounts built into rates not available.

[3] Per PUB 12.0 NP. The 2000 excess revenue was rebated in 2001 and the 2001 excess revenue was rebated in 2003. Ignores M.T.A. and H.S.T. impacts.

[4] Present value is based on three discount rate scenarios:
6.9% (Newfoundland Power’s after tax weighed average cost of capital)
8.5% (Newfoundland Power’s weighted average cost of capital)
10.8% (Newfoundland Power’s pre tax weighted average cost of capital)

Newfoundland Power Inc.
Newfoundland Power Cost of Tax Dispute
($000s)

Year	Financing Costs[1]	Legal Fees[2]	Total Cost	Refunds[3]	Net Cost
1995	532	10	542	-	542
1996	1,261	19	1,280	-	1,280
1997	-	-	-	-	-
1998	-	-	-	-	-
1999	-	-	-	-	-
2000	-	-	-	(160)	(160)
2001	-	-	-	(458)	(458)
2002	-	-	-	-	-
2003	-	-	-	-	-
2004	-	-	-	-	-
2005	-	-	-	(1,350)	(1,350)
PV (2005$)[4]					
NPV @ 6.9%					1,220
@ 8.5%					1,670
@ 10.8%					2,428

[1] The after tax impact of financing the tax deposit based on the weighted average cost of capital for 1995 and 1996 respectively.

[2] After tax impact of legal fees for 1995 and 1996 as per CA 16.0 NP.

[3] After tax benefit as per PUB 12.0 NP. For 2005, the ($1,350) is the after tax value of the $2.1 million interest refund.

[4] Present value is based on three discount rate scenarios:
6.9% (Newfoundland Power’s after tax weighed average cost of capital)
8.5% (Newfoundland Power’s weighted average cost of capital)
10.8% (Newfoundland Power’s pre tax weighted average cost of capital)