

Q. If the Board were to determine that the change in the revenue recognition policy of NP could not be dealt with without a GRA, what effect, giving detailed reasons, would this decision have on the financial and operational plans of NP?

A. 1. General

If the Board were to determine that the proposed change in the revenue recognition policy of Newfoundland Power could not be dealt with without a general rate application (“GRA”), the Company would practically be required to file a GRA to deal with the matters raised in the 2006 Accounting Policy Application.

The overall effect of such a decision on Newfoundland Power would be to increase the uncertainty associated with its 2006 finances and operations. For Newfoundland Power’s customers, there would be increased uncertainty associated with 2006 rates. This is because it would be likely that the proposals in the 2006 Accounting Policy Application concerning 2006 revenues and costs (which are related to the proposed change in revenue recognition policy) might not be decided in a GRA before 2007.

The filing of a GRA for 2006 would require the Company to consider filing in advance of receipt of the next depreciation study to ensure reasonable cost recovery in 2006. It would also require consideration of applying for interim rate relief for 2006 in advance of a hearing of the GRA.

Newfoundland Power’s assessment of the appropriate regulatory process to deal with the matters raised in the 2006 Accounting Policy Application follows. In all of the circumstances, it is Newfoundland Power’s assessment that the approach proposed by the Company provides the best practical means of ensuring a reasonable degree of regulatory balance for the Company and its customers for 2006 and 2007.

2. Assessment

Prevailing Circumstances

In June 2005, Newfoundland Power’s income tax dispute with the Canada Revenue Agency concerning its historical policy of revenue recognition was resolved. This event provided certainty concerning the Company’s historical accounting policy.

The \$5.8 million annual depreciation true-up (the “Depreciation True-up”) concludes in 2005. As a result, it is forecast that Newfoundland Power will face a revenue shortfall in 2006 due to rising depreciation expense.

Future depreciation expense will be the subject of the next proposed depreciation study to be based on December 31, 2005 plant in service. For practical reasons, this study will not be completed until April 2006.¹

¹ The impact, if any, that the next proposed depreciation study will have on future depreciation expense is uncertain.

Regulatory Process Considerations*Costs vs. Rates*

Not every matter which affects Newfoundland Power's costs and, ultimately, its rates has historically been considered and determined by the Board in the context of a GRA.

Annual capital expenditures are perhaps the most prominent matter affecting Newfoundland Power's costs. Capital expenditures are not typically reviewed in the context of a GRA.²

In many cases, the Board's orders will affect Newfoundland Power's costs. Relatively few of these orders, however, immediately affect customers' rates.

Prospective Ratemaking

The principal focus of a GRA is the establishment of future rates, tolls and charges to be paid by customers. Those rates, tolls and charges are determined following detailed examination of Newfoundland Power's forecast costs.

A GRA is the most complex of regulatory processes. For this reason, the period required to complete a GRA is currently in the order of 10 – 11 months from initial filing to the implementation of customer rates. And because of the complexity involved, the time required to prepare the GRA itself for filing is in the order of 3 – 4 months.

For reasons of both public transparency and process efficiency a GRA should, upon filing, include the most certain indication of forward looking costs reasonably available. Historical experience has shown this to be the case.³

The 2006 Accounting Policy Application

The 2006 Accounting Policy Application concerns itself principally with a proposed change in accounting policy. The proposal will bring the Company's revenue recognition policy into the mainstream of Canadian public utility practice. Given that every other public utility in Canada appears to recognize revenue on the accrual basis proposed in the 2006 Accounting Policy Application, the policy change is, in the Company's view, uncontroversial.

The second principal issue which arises as a result of the proposed accounting policy change is the accounting accrual of approximately \$24.3 million. In the 2006 Accounting Policy Application, Newfoundland Power has proposed a portion of this

² Similarly, the Board has historically considered other material matters affecting costs outside of a GRA. For example, in Order No. P.U. 49 (2004) the Board approved the amortization of a forecast \$9.7 million in costs associated with the Company's 2005 Early Retirement Program over a 10-year period. In Order No. P.U. 17 (2001 – 2002), the Board approved Newfoundland Power's acquisition of approximately \$40 million in joint use support structures from Aliant Telecom Inc. based upon the forecast revenues and costs associated with the acquisition. In Order No. P.U. 3 (1995 – 96), the Board approved changes to the Company's accounting policy for allocating general expenses to capital.

³ In 1996, Newfoundland Power filed a GRA *prior* to its filing of a depreciation study. Once the depreciation study was filed, the GRA was required to be refilled to reflect the results of the study. The refilled GRA was materially different than that originally filed. This development rendered Newfoundland Power's overall 1996 GRA process both less efficient and less transparent than it might otherwise have been.

1 accrual be used to offset a forecast 2006 revenue shortfall principally driven by increased
2 depreciation expense. Because forecast depreciation expense is calculated by applying
3 rates approved by the Board to plant balances which result from capital expenditures
4 approved by the Board, the appropriate calculation of depreciation expense is, in the
5 circumstances, uncontroversial.

6 7 **Assessment**

8 Newfoundland Power was aware that the Depreciation True-up was concluding at the end
9 of 2005.

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11 Accordingly, the Company could have filed a GRA early in 2005 to consider the matter
12 in the context of 2006 customer rates. Any GRA filed at that time would have
13 necessarily not reflected the results of the tax settlement (which was not concluded) or
14 the proposed change to the Company's accounting policy for revenue recognition (which
15 was integrally related to the tax dispute). In addition, filing of a GRA in early 2005 to
16 deal with the 2006 revenue shortfall could not have included the results of the next
17 required depreciation study which will not be available until early 2006.⁴

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19 Resolution of the outstanding tax dispute enabled Newfoundland Power to bring certainty
20 to matters associated with its historic revenue recognition policy. This, in turn, enabled
21 the Company to file the 2006 Accounting Policy Application to essentially deal with both
22 the proposed accounting policy change and the forecast 2006 revenue shortfall. In the
23 Company's view, it provided the best available basis in the circumstances for transparent
24 and efficient prospective ratemaking in the near term.

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26 The approach adopted by Newfoundland Power of filing the 2006 Accounting Policy
27 Application in 2005 and a GRA in 2006 is not typical. But the prevailing circumstances
28 are not typical. The approach taken was assessed by Newfoundland Power to be
29 practically responsive to the prevailing circumstances. It is neither unprecedented, nor
30 contrary to, broad regulatory process considerations. And it permits orderly and
31 transparent consideration of future customer rates in a reasonably timely manner.

32 33 **3. Concluding**

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35 If the Board were to determine that a change in Newfoundland Power's accounting
36 policy for revenue recognition must be dealt with in a GRA, Newfoundland Power would
37 file a GRA as soon as practicable. The timing and complexity associated with such a
38 GRA would have the tendency to reduce both the regulatory efficiency and transparency
39 associated with it.

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4 ⁴ Whether future depreciation expense increases or decreases as a result of the next depreciation study, customers will not be disbenefited as a result of the proposals in the 2006 Accounting Policy Application. If depreciation expense decreases as a result of the next depreciation study, the lower expense will be reflected in customer rates from 2007 onward. If depreciation expense increases as a result of the next depreciation study, the higher expense will not be further increased as a result of a deferral in dealing with increased 2006 depreciation expense as suggested in Request for Information PUB 14.0 NP.

1 In the prevailing circumstances, Newfoundland Power believes that determination of the
2 matters raised in the 2006 Accounting Policy Application in advance of its next GRA is
3 the most appropriate course to adopt.
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5 By considering and settling the appropriate accounting policy for revenue recognition in
6 advance of the next GRA, it will moderate the overall complexity (and improve the
7 transparency) associated with the next GRA. Similarly, by considering and settling
8 matters associated with the forecast 2006 revenue shortfall, it will enable the next GRA
9 to be filed, and future rates to be considered, in a timeframe which will ensure that the
10 most certain forward looking costs reasonably available are before the Board (and
11 available to all participants) in an orderly manner. Such an approach serves the best
12 interest of both Newfoundland Power and its customers.