NP 2016/2017 General Rate Application
Consent - #3
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Board of Commissioners of Public Utilities Financial Consultants Report Newfoundland Power Inc. 2016-2017 General Rate Application Hearing (March 8, 2016 Filing)

March 28, 2016

Contents

Introduction

On March 8, 2016, Newfoundland Power Inc. ("the Company") ("Newfoundland Power") submitted an amended 2016/2017 General Rate Application ("March filing") to the Board of Commissioners of Public Utilities ("the Board") with respect to its 2016 - 2017 General Rate Application (the "GRA"). The Amended Application included 2015 actual financial results, update 2016/2017 forecast of customers, energy sales and demand, and changes to 2016/2017 test period costs.

Return on Rate Base and Equity and Capital Structure

Calculation of Average Rate Base

The Company's calculations of its actual average rate base for the year ended December 31, 2015 and its proposed average rate base for the years ending December 31, 2016 and 2017 are included on Exhibit 3 Page 5 of 9, Exhibit 6 and in the Summary of Revisions Schedule 3 of the pre-filed evidence.

We focused our review on the following significant changes in average rate base presented in the Company's Summary of Revisions Schedule 3 which illustrates the changes in rate base from the Company's October 16, 2015 filing of the GRA (the "October filing") compared to the March filing:

Defined Benefit Pension Costs

The 2016 defined benefit pension included in average rate base has increased from $95,025,000, in the October filing, to $96,802,000 in the March filing. The 2017 defined benefit pension has increased from $89,552,000, in the October filing, to $94,045,000 in the March filing. In December 2015 the Company revised two of its actuarial assumptions relating to employee future benefits expense: (1) increased its discount rate used to value employee future benefits obligations and (2) increased the expected average remaining service life of employees. Both of these changes resulted in a reduction in forecast employee future benefits expense for the 2016 and 2017, which has the effect of increasing the defined benefit pension costs component of the average rate base in those years. We have compared forecast funding and expense for 2016 and 2017 included in the March filing to support provided by the Company's actuaries and found no discrepancies.

Revenue Shortfall

The 2016 revenue shortfall included in average rate base has decreased from $1,163,000, in the October filing, to $400,000 in the March filing. The 2017 revenue shortfall has decreased from $1,745,000 in the October filing to $601,000 the March filing. The decrease in revenue shortfall is a result of the Company's proposals for an increase in customer rates from 3.1% in the October filing to 2.5% in the March filing.

Weather Normalization Reserve

The 2016 weather normalization reserve increased from $518,000, in the October filing, to $2,205,000 in the March filing. The change is due to increases from forecast to actual in 2015 within the Hydro Production Equalization portion of the reserve which incorporates year-end adjustments for storage levels used in the calculation of the reserve, as well as additions to the reserve for the period of August to December 2015.

Cost Recovery Deferral - Conservation

The 2016 conservation deferral included in average rate base has decreased from $10,014,000, in the October filing, to $8,893,000 in the March filing. The 2017 conservation deferral has decreased from $13,227,000 in the October filing to $11,991,000 in the March filing. These decreases are a result of decreases from forecast to actual in 2015 and decreases for 2016 costs included in the Small Technologies program. The reduction in 2016 Small Technologies program is due to the Company's pending assessment of new cost effectiveness results which were not concluded at the date of the March filing.

Based upon the results of our review, we did not note any discrepancies in the changes in average rate base as noted above.

In our January 28, 2016 report to the Board we noted that the Company used a HST rate of 15% to calculate the cash working capital allowance proposed for 2016 and 2017 which was not consistent with the 13% HST rate in effect at the date of our report. In the Company's March filing, the cash working capital allowance has been updated with a HST rate of 13% which reflects the HST rate in effect as of the date of our report.

Return on Rate Base

Our procedures with respect to verifying the calculation of forecast rate of return on average rate base included agreeing the data in the calculation to supporting documentation and recalculating the forecast rate of return to ensure it is in accordance with established practice and Board Orders.

The calculation of return on average rate base incorporates accurately the changes to average rate base as well as changes to return on rate base. We also conclude that the proposed rate of return on average rate base accurately reflects the proposals in the March filing as well as the Company's targeted return on equity of 9.50% which will be addressed by cost of capital experts participating in this hearing.

Capital Structure

In P.U. 43 (2009) the Board confirmed its previous position regarding the capital structure for Newfoundland Power comprised of 45% equity, 54% debt and 1% preferred equity. In P.U. 13 (2013), the Board maintained its position for equity not to exceed 45% of capital structure. Average actual common equity for 2015 and forecast common equity for 2016 and 2017, including the proposed average common equity for 2016 and 2017 per the pre-filed evidence is below the approved maximum, and accordingly, no calculation for deeming excess common equity as preferred equity is required.

In its pre-filed evidence, the Company is proposing to maintain a capital structure which is consistent with the structure established by Board Order P.U. 16 (1998-99), P.U. 19 (2003), P.U. 32 (2007), P.U. 43 (2009) and P.U. 13 (2013).

We recalculated the debt portion of the cost of capital using the average debt, included in the average capital structure above, and the finance charges presented in Exhibits 3 & 5 (Page 7 of 9).

The proposed capital structure for 2016 and 2017 is consistent with the position confirmed by the Board in P.U. 13 (2013). The calculations of capital structure are consistent with Exhibit 3 (Page 6 of 9) and Exhibit 5 (Page 6 of 9) presented in the 2016/2017 GRA.

Based on the results of our review we noted an error in Cost of Capital - Debt for actual 2015 presented in Exhibit 3 Page 6 of 9. The Company used the embedded cost of debt of 6.50% which does not reflect the appropriate AFUDC deduction in the calculation of Cost of Capital - Debt. Based on our review, the actual Cost of Capital – Debt incorporating the deduction of AFUDC is 6.28%. As a result of the error the Company's Weighted Average Cost of Capital – Debt and total Weighted Average Cost of Capital is misstated at 3.57% and 7.60% respectively. Based on our review

the Company's Weighted Average Cost of Capital – Debt and total Weighted Average Cost of Capital should be presented as 3.45% and 7.48% respectively. The error has no impact on test years 2016 and 2017.

Revenue Requirement

The Company's comparison of its revenue requirement from the October filing compared to the March filing for test years 2016 and 2017 is included in the Summary of Revisions Schedule 4 of the March filing. We reviewed the following significant changes in revenue requirement:

Power Supply Cost

In 2016, the increase in revenue requirement from purchased power is primarily caused by excess block charges on additional forecasted purchases of 8.1 GWh in the March filing compared to the October filing. In 2017, the increase in revenue requirement from purchased power is primarily caused by excess block charges on additional forecasted purchases of 6.7 GWh in the March filing compared to the October filing. We agreed the forecasted purchased energy to the Company's Customer, Energy and Demand Forecast dated February 2016.

Employee Future Benefit Costs

As discussed earlier in our report the Company revised two of its actuarial assumptions relating to employee future benefits expense in the March filing which resulted in a reduction in forecast employee future benefits expense from $22,176,000 to $18,564,000 for 2016 test year and from $17,892,000 to $15,852,000 for 2017. We have compared revised forecast expense for 2016 and 2017 included in the March filing to support provided by the Company's actuaries and found no discrepancies.

Amortization of Deferred Cost Recoveries

The change in the amortization of deferred cost recoveries from the October filing to the March filing relates to the 2016 revenue shortfall. In the October filing the 2016 shortfall was $4,095,000 compared to a revised shortfall of $1,410,000 in the March filing. As a result of this revision, the change in revenue requirement for 2016 is a decrease in the revenue deferral from $3,276,000 to $1,128,000 and a decrease in amortization in 2017 from $1,638,000 to $564,000. We recalculated the impact of the revenue shortfall and related amortization on revenue requirement and found no discrepancies.

Proposed Revenue from Rates

The Company is proposing that the Board approve rates, tolls and charges effective for service provided on and after July 1, 2016, to provide an average increase by class in electrical rates of 2.5%, based upon:

a) a forecast average rate base for 2016 of $1,061,342,000 and for 2017 of $1,106,324,000;
b) a rate of return on average rate base for 2016 of 7.66% in the range of 7.48% to 7.84% and for 2017 of 7.64% in a range of 7.46% to 7.82%; and
c) a forecast revenue requirement to be recovered from electrical rates, following implementation of the proposals set out in paragraphs 11 of the Application, of $669,160,000 for 2016 and $680,421,000 for 2017.

We have reviewed the Company's proposed rates effective July 1, 2016. Specifically, the procedures we have performed include the following:

1. A recalculation of the revenue that results from using the revised rates, ensuring that it agrees with the revenue requirement submitted by the Company;

2. Agreement of the factors used in the revenue calculations (number of customers, energy and demand usage, etc.) to those presented by the Company;

3. Agreement of the rates used in the revenue calculations to those in the proposed Revised Schedule of Rates, Tolls and Charges; and

4. A recalculation of the percentage increase in revenue by rate class and the percentage increase in individual rates, tolls and charges.

Based on our procedures, we find that the revenue requirement proposed by the Company is calculated based upon the revised Schedule of Rates, Tolls and Charges effective July 1, 2016 and the factors proposed in the March filing.