

**Section 1: Introduction**

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**1.1 OVERVIEW**

Newfoundland Power (“the Company”) is principally an electricity delivery and customer service organization. Newfoundland Power’s electricity system is mature. The electricity system serves a relatively low-growth market.

Table 1 shows the number of customers served by Newfoundland Power and the annual weather adjusted sales of Newfoundland Power for the period 2002 to 2008F.<sup>1</sup>

**Table 1**  
**Customers and Sales: 2002 to 2008F**

	2002	2003	2004	2005	2006	2007F	2008F
Number of Customers	219,072	221,653	224,464	227,301	229,500	231,715	233,714
Annual Sales (GWh)	4,765	4,882	4,979	5,004	4,995	5,054	5,121

From 2002 through 2008, the number of customers served by Newfoundland Power is increasing by an average of 1.1 percent per year. The annual weather adjusted sales are increasing by an average of 1.2 percent per year over this period.

Newfoundland Power’s outlook for growth in the number of customers and sales reflects both recent trends and longer term demographics.

Newfoundland Power’s primary source of electricity supply is Newfoundland and Labrador Hydro (“Hydro”) which generates approximately 90 percent of the electricity delivered by Newfoundland Power to its customers.

<sup>1</sup> References to years with the notation ‘F’ (i.e. 2008F), are intended to indicate *forecast*.

**1.2 PERFORMANCE****1.2.1 Customer Operations Performance**

Newfoundland Power continues to deliver safe, reliable service in a cost effective manner. Since 2002, both the reliability and quality of service has improved.

Table 2 shows the contribution of Newfoundland Power's costs to the total cost of electricity on a kWh basis for the period 2002 to 2006.

**Table 2**  
**Cost of Electricity: 2002 to 2006**  
**(cents/kWh)**

	2002	2003	2004	2005	2006
Total Cost of Electricity <sup>2</sup>	7.97	8.12	8.60	9.19	9.63
Newfoundland Power's Contribution <sup>3</sup>	3.19	3.07	3.08	3.07	3.05

The contribution of Newfoundland Power's costs to the cost of the electricity provided to customers has remained stable through this period.

The Company's customer operations are well managed. 2008 operating costs are not forecast to increase from 2003 levels.

Improved service and cost control are the foundation of customer operations performance of Newfoundland Power.

<sup>2</sup> Cost of electricity divided by electricity sales. Cost of electricity includes rate stabilization account ("RSA") charges, municipal tax account ("MTA") charges and the Company's revenue from rates.

<sup>3</sup> The contribution margin divided by electricity sales. The contribution margin is the Company's revenue from rates less purchased power expense.

Section 2: *Customer Operations* provides greater detail on the service Newfoundland Power delivers to its customers and the forecast cost of delivery of that service.

#### 1.2.2 Financial Performance

Since 2002, Newfoundland Power has earned a rate of return on rate base that is within the ranges approved by the Board, although since 2005 the rate of return has been close to the lower end of the approved ranges.<sup>4</sup>

Table 3 compares Newfoundland Power's earned rates of return on rate base to the midpoint of the range approved by the Board for ratemaking purposes for the period 2002 to 2006.

Table 3  
Rate of Return on Rate Base: 2002 to 2006  
(percent)

	2002	2003	2004	2005	2006
Approved Midpoint	10.06	8.96	8.91	8.68	8.68
Actual Return	9.94	9.03	8.82	8.53	8.57

Since Newfoundland Power's last general rate application in 2003, its earned returns on equity have been reflective of those used by the Board for ratemaking purposes. However, credit metrics have deteriorated through the period. Part of the erosion of credit metrics is attributable to the reduction in ratemaking rates of return on common equity through the period and part is attributable to reduced recovery of depreciation costs.

Section 3: *Finance* provides greater detail on the past and prospective financial performance of Newfoundland Power.

<sup>4</sup> The range of return on rate base is  $\pm 18$  basis points or  $\pm 0.18$  percent.

### 1.3 ELECTRICITY PRICE

The price of electricity has increased substantially since 2002. The principal driver of electricity price increases in the 5 years ending in 2006 has been the price of No. 6 fuel burned at Hydro's Holyrood thermal generating station ("Holyrood"). In 2002, the average price of fuel burned at Holyrood was approximately \$30 per barrel. By 2006, the price had increased by over 60 percent to \$50 per barrel.

Since 2002, customer rates have increased by over 26 percent.<sup>5</sup>

Table 4 shows electricity price changes for Newfoundland Power customers in the period 2002 to April 2007.

**Table 4**  
**Rate Changes: 2002 to 2007**  
**(percent)**

	2002	2003	2004	2005	2006	2007	Total <sup>6</sup>
Newfoundland Power <sup>7</sup>	-0.6	-0.2	-	-0.5	-	-0.5	-1.8
Newfoundland Hydro <sup>8</sup>	3.7	-	5.3	-	-	3.1	12.6
RSP/RSA/MTA <sup>9</sup>	-0.1	2.0	4.5	5.2	4.8	-2.5	14.5

<sup>5</sup> On a compounded basis.

<sup>6</sup> The total reflects the *compounded* change in rates from 2002 to 2007.

<sup>7</sup> Rate changes for 2002, 2005 and 2007 were the result of the operation of the automatic adjustment formula which sets Newfoundland Power's annual return on rate base. The rate change for 2003 resulted from Order No. P.U. 19 (2003).

<sup>8</sup> These rate changes resulted from Orders on Hydro general rate applications and include the effects of rebasing fuel costs from the RSP/RSA fuel rider into Hydro base rates (see Order Nos. P.U. 9 (2002-2003), P.U. 19 (2004) Amended and P.U. 8 (2007)).

<sup>9</sup> These rate changes result from operation of Hydro's rate stabilization plan ("RSP") and Newfoundland Power's RSA which principally operate to ensure timely recovery of the cost of Holyrood fuel. For 2003, 2005 and 2006, the rate changes reflected changes in fuel costs or fuel forecasts in accordance with the Board's Orders. For 2004, the rate change reflects the recovery of Hydro's pre-2004 legacy Holyrood fuel costs of approximately \$115 million (see Order No. P.U. 19 (2004) Amended). For 2007, the rate change was the result of a one-time adjustment to reflect reduced Holyrood fuel usage caused by higher hydroelectric production (see Order No. P.U. 8 (2007)) but does not reflect an expected 2.9 percent rate reduction on July 1, 2007 as a result of the operation of RSP/RSA. Adjustments associated with the MTA have a minimal impact on rate changes over the 2002 to 2007 period.

1 Electricity prices are expected to continue to be highly influenced by the cost of fuel burned at  
2 Holyrood.

3

4 As of 2007, marginal wholesale supply costs for Newfoundland Power will meet or exceed the  
5 revenue Newfoundland Power can expect to receive for those sales. This reflects the relatively  
6 high cost of Holyrood fuel and changes in the wholesale rate design. This development, where  
7 Newfoundland Power's costs exceed revenues on a marginal basis, can be expected to impact the  
8 regulation of the Company.

9

#### 10 1.4 REGULATION

11 Newfoundland Power is regulated under the provisions of the *Public Utilities Act* (the "Act") and  
12 the *Electrical Power Control Act, 1994* (the "EPCA"). The Board's statutory power and  
13 responsibilities under the Act and the EPCA are required to be discharged in a transparent  
14 manner consistent with generally accepted sound public utility practice.

15

16 Prior to this Application, Newfoundland Power last filed general rate applications with the Board  
17 in 1998 and 2002. These filing intervals have been reflective of both the stability in  
18 Newfoundland Power's overall cost structure and the Board's use of regulatory mechanisms such  
19 as the automatic adjustment formula to set Newfoundland Power's annual return on rate base.

20

21 The stability in Newfoundland Power's overall cost structure has been the result of purposeful  
22 management of the balance between customer expectations and the cost of the Company's  
23 reasonable fulfillment of those expectations. The Board's use of regulatory mechanisms has

1 complemented Newfoundland Power's cost stability and provided for transparent least cost  
2 regulation in the circumstances that presented themselves over the past decade.

3  
4 The variability of the price of fuel burned at Holyrood is expected to continue to be a primary  
5 near-term determinant of the price customers will pay for electricity. Over the longer term,  
6 supply costs can be expected to exert a generally upward pressure on price. This simply reflects  
7 the economic reality that future generation costs are expected to exceed embedded generation  
8 costs. These dynamics are, in varying degrees, affecting electricity customers throughout  
9 Canada.

10  
11 Supply cost dynamics in which wholesale supply costs exceed revenue on a marginal basis, can  
12 be expected to potentially affect regulation of Newfoundland Power in at least two ways. First,  
13 the interval between general rate applications could be reduced. Under the current wholesale  
14 supply rate, even modest growth in customer load will reduce the amount of contribution  
15 available to cover Newfoundland Power's costs other than supply costs. This, in turn, may  
16 require Newfoundland Power to file more frequent general rate applications than over the past  
17 decade simply to recover the cost associated with supplying modest customer growth. Second,  
18 the high price of fuel can be expected to increase the regulatory focus on customer rate design  
19 and, in particular, the economic efficiency of customer rate design. This increased focus can be  
20 expected to occupy more of the regulatory agenda in the near term than it has in the recent past.

1 In this Application, Newfoundland Power has proposed changes to regulatory mechanisms which  
2 will permit continued transparent least cost regulation in the context of current supply cost  
3 dynamics.

4  
5 Recent developments of a process nature are expected to impact the regulation of Newfoundland  
6 Power. In 2006, Hydro's general rate application was substantially resolved by means of a series  
7 of negotiated agreements between Hydro and its stakeholders. The advent of more negotiated  
8 and mediative processes to resolve regulatory issues in this province is consistent with regulatory  
9 development across Canada. Reasonable resolution of issues through such processes can deliver  
10 tangible benefits to customers by lowering overall regulatory costs.

11

## 12 **1.5 APPLICATION OVERVIEW**

### 13 **1.5.1 2008 Revenue Requirements**

14 In this Application, Newfoundland Power is requesting an average increase in current customer  
15 rates of approximately 5.3 percent in 2008. This increase results from three primary changes in  
16 Newfoundland Power's costs.

17

18 Depreciation cost recovery accounts for an approximate 1.9 percent increase in 2008 revenues.

19 This increase is principally due to the 2005 conclusion of the reserve variance true-up.

20

21 In order to sustain creditworthiness and financial integrity, the Company is targeting a 2008  
22 return on equity of 10.25 percent. The 2007 return on equity for ratemaking purposes is 8.60

1 percent. An approximate 1.9 percent revenue increase in 2008 is attributable to improving the  
2 Company's 2008 return on rate base to reflect a return on common equity of 10.25 percent.

3

4 The Board has directed the Company to file a report with this Application to address the use of  
5 the accrual method for recognizing other employee future benefits. The Company has completed  
6 this review and proposes to recognize other employee future benefits on an accrual basis  
7 commencing in 2008. Implementing the Company's proposals related to employee future  
8 benefits accounts for an approximate 1.5 percent increase in 2008 revenue.

9

10 In addition to these three costs, other proposals made in this Application, such as those relating  
11 to the amortization of revenue and cost deferrals and outstanding reserve balances, also affect  
12 2008 revenue requirements.

13

#### 14 **1.5.2 Other Proposals**

15 To ensure the continued fairness of electricity pricing, the Company is proposing to vary rate  
16 increases by customer class. For Domestic customers, this will result in an increase of  
17 approximately 1 percent higher than average. For General Service customers, this will result in  
18 increases which will be generally lower than average.

19

20 This Application includes proposals relating to existing regulatory mechanisms. Newfoundland  
21 Power has proposed a continuation of a demand management incentive substantially in its  
22 current form.<sup>10</sup> Changes to the RSA are proposed to permit the Company to recover the fuel

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<sup>10</sup> The existing Purchased Power Unit Cost Variance Reserve provides an incentive to minimize customers' peak demand.



- 1 related costs associated with customer growth on an ongoing basis. Changes to the automatic  
2 adjustment formula are proposed to reflect changes in rate base calculation, estimation of a risk  
3 free rate and Newfoundland Power's proposal for 2008 return on equity.  
4
- 5 Finally, the evidence filed in support of this Application is consistent with the Board's directions  
6 regarding calculation of Newfoundland Power's rate base. It also outlines the Company's  
7 response to Board directions regarding inter-corporate relationships.