NP 2016/2017 General Rate Application
Information - #4
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SECTION 1: INTRODUCTION

1.1 APPLICATION BACKGROUND

1.1.1 Newfoundland Power

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.

Newfoundland Power is dependent upon Newfoundland and Labrador Hydro ("Hydro") for approximately 93% of the electricity which the Company delivers to its customers.

Table 1-1 shows the number of customers served by Newfoundland Power and the annual weather adjusted sales for the period 2010 to 2014F.

Table 1-1
Customers and Sales
2010 to 2014F

	2010	2011	2012F	2013F	2014F
Customers	243,426	247,163	250,737	254,059	257,267
Sales (GWhs)	5,419	5,553	5,681	5,751	5,823

From 2010 to 2014F, the number of customers served by the Company is expected to increase by an average of 1.4% per year. Annual weather adjusted sales are expected to increase by an average of 1.8% per year over this period. Newfoundland Power's outlook for growth in the number of customers and sales reflects both short term factors and longer term economic and demographic trends.

1.1.2 Outlook

Newfoundland Power's outlook reflects a balance of the operational realities associated with the least cost delivery of electrical service to customers and the financial realities associated with earning a fair return on the capital invested in the business.

Success in the continued least cost delivery of safe, reliable electrical service to customers is dependent upon a variety of factors. Among these are operational efficiency, customer responsiveness, and workforce effectiveness.

Newfoundland Power's operations are efficient. Operating costs are stable and reflective of sustainable labour efficiency.

Newfoundland Power continues to be reasonably responsive to customer expectations. Customers increasingly choose to deal with the Company via a variety of electronic means. This adds a degree of complexity and cost to the Company's customer operations.

Continued operational efficiency and customer responsiveness are dependent upon the skills and diligence of the Company's employees and upon Newfoundland Power's application of technology. The essentials of electricity distribution engineering have been established for decades. The systems needed to effectively operate and manage engineered assets, however, are evolving technologically. Newfoundland Power's customer service interface is also increasingly dependent on technology. These developments are not new. But they do take on greater significance in the period of workforce transition into which the Company has entered. More

technologically capable customers have specific, and somewhat different, service expectations. More technologically enabled employees will be required to meet those expectations on a least cost basis.

Newfoundland Power employee retirements have increased and are expected to remain high for the next few years. The level of hiring required in this period is expected to exceed that experienced by the Company for at least two decades. Increased recruitment, training and development efforts will also affect the Company's costs and overall operating efficiency.

Newfoundland Power's electricity system performance continues to be reliable. This is primarily a reflection of stable capital investment in the business.

Newfoundland Power's day to day operations are well managed. But this does not mean that the Company is not exposed to business risk on a day to day basis.

Some aspects of this risk are described in this Application. For example, the Company's service territory has historically experienced some of the most hazardous conditions for electricity system operations. Blizzards and severe ice conditions reflect one seasonal dimension of this. Increased frequency of tropical storms and hurricanes may be another dimension. Incidents of these severe weather conditions have tested the Company's responsiveness a number of times since the last general rate application.

Workforce demographics present another example of these aspects of the Company's business risk. Newfoundland Power is currently managing its workforce demographic transition reasonably; however, this does not mean that the workforce transition currently under way does not present a measure of risk in relation to the Company's future capabilities both to fulfill its obligation to serve its customers and to earn its return.

There are also longer term risks. The population of Newfoundland and Labrador is forecast to continue to decline and it is aging at the fastest rate in Canada. These customer demographic trends have implications for investment and long term cost recovery. The future of electricity supply similarly has potential implications for future cost recovery for Newfoundland Power.

These considerations are important to the investors who fund the capital investment that is critical to the least cost delivery of safe, reliable electrical service to Newfoundland Power's customers. Given the long life of utility assets, amounts invested in the electricity system in 2013 or 2014 will not be recovered for decades. Investors who provide that capital expect, and are entitled to, fair compensation for this investment on a continuing basis.

The automatic adjustment formula which establishes the Company's annual forecast cost of equity (the "Formula") was continued by the Board after Newfoundland Power's last general rate application. Last November, the Formula indicated the cost of equity for Newfoundland Power for 2012 was 7.85%. Currently, the Formula is indicating the cost of equity for Newfoundland Power for 2013 is 7.53%. These returns do not represent fair compensation for the Company's

equity capital. For this reason, in this Application, Newfoundland Power is proposing that the Formula be discontinued.

Financial market conditions have been extraordinary for the past few years. Determination of a fair return in these conditions is challenging. It is a central issue in this Application.

1.2 APPLICATION PROPOSALS

1.2.1 2013 and 2014 Revenue Requirements

In this Application, Newfoundland Power is requesting an average increase in current customer rates of approximately 6.0% effective March 1, 2013. This increase is primarily the result of two changes in the Company's cost of service.

The first relates to Newfoundland Power's energy supply costs. A general rate application requires forecast electricity supply costs to be reconciled with forecast revenue from rates for the test period. The effect of rebalancing 2013 and 2014 supply costs with revenue from rates accounts for an approximate 2.6% increase from current customer rates. Between test periods, increases in supply costs related to increases in customer electricity usage are recovered through the energy supply cost variance mechanism originally approved by the Board after the Company's 2008 general rate application.

The second relates to Newfoundland Power's future return on equity. In this Application, the Company has filed expert evidence indicating that a fair return on equity for Newfoundland Power in 2013 and 2014 is 10.4% to 10.5%. This is higher than the ratemaking return on equity

approved by the Board for 2012 of 8.8%. Increasing Newfoundland Power's ratemaking return on equity for 2013 and 2014 accounts for an approximate 1.8% increase from current customer rates.

The remaining 1.6% increase from current customer rates results from a mixture of cost changes. These include the rebalancing of 2013 and 2014 employee future benefits costs to customer rates (changes in these costs are currently recovered on an annual basis through the Rate Stabilization Adjustment (the "RSA")) and increased depreciation costs resulting from the Company's continuing investment in the electricity system. This 1.6% increase also includes the effects of cost related proposals contained in this Application relating to conservation cost recovery and accounting for weather normalization impacts, both of which reduce 2013 and 2014 revenue requirements. Newfoundland Power's overall operating costs associated with the delivery of service to customers continue to grow, but at a rate that is less than inflation.

1.2.2 Customer Rates

While this Application proposes an *average* increase in customer rates of 6.0%, the proposed rate increases are not uniform. This Application proposes a number of changes to customer rates and rate structures as a result of the Retail Rate Review, which was commenced by agreement following the Company's 2008 general rate application.

Newfoundland Power is proposing to merge its existing Rates 2.1 and 2.2 which apply to small general service customers with loads of 100 kW or less. The new merged Rate 2.1 will be fairer

to customers. Revenue from each of these rates is materially higher than the Company's cost to serve these customers.

On average, customers served under the merged Rate 2.1 will receive rate increases of approximately 0.6%. Primarily as a result of the proposed changes to the Company's small general service customer rates, the proposed increase for the Company's residential customers is 7.2%. For the remainder of the Company's customer rates, the proposed increase is 6.0%. These proposals are aimed at ensuring greater fairness in recovery of Newfoundland Power's cost of service from all customer classes.

For Rates 2.3 and 2.4, which apply to larger general service customers, the Company is also proposing changes to the energy block sizes and basic customer charges. For Newfoundland Power's residential customers, the basic customer charge is proposed to remain unchanged for customers served at 200 amps or less. A separate basic customer charge is proposed for customers served at over 200 amps.

Finally, a number of changes to components of various rates are proposed, including changes in (i) the difference between winter and non-winter demand charges for general service customers; (ii) payment discounts for all residential and general service customers; and (iii) the treatment of the maximum monthly charge in future RSA adjustments.

1.2.3 Other Proposals

In 2008, Newfoundland Power and Hydro agreed to the first joint provincial energy conservation plan. Under this plan, Newfoundland Power expects to deliver gross customer energy savings of approximately 28 GWh per year by the end of 2012. These savings are enduring in nature and will avoid fuel costs at Hydro's Holyrood thermal generating station ("Holyrood") every year. Hydro and Newfoundland Power recently agreed to a second joint provincial energy conservation plan which is directed at increasing the level of customer energy savings. In this Application, Newfoundland Power is proposing to defer and amortize customer energy conservation program costs over a 7 year period commencing in 2013. This proposal is aimed at better matching the long term benefits of Newfoundland Power's customer energy conservation programming with the costs of that programming.

In this Application, Newfoundland Power is also seeking approval of (i) revised depreciation rates which reflect the results of its most recent study; (ii) the recognition of pension expense in accordance with U.S. GAAP; and (iii) the credit to, or recovery from, customers of annual Weather Normalization Reserve balances through the RSA. All of these approvals are proposed to be effective in 2013.

SECTION 2: CUSTOMER OPERATIONS

2.1 OVERVIEW

Newfoundland Power's customer operations are primarily focused upon stable electricity system reliability; reasonable response to evolving customer service preferences; and maintenance of sustainable levels of operating efficiency. This has resulted in reasonable continuing levels of customer satisfaction with the service the Company delivers.

To be responsive to customers' desire to lower their electricity bills, Newfoundland Power introduced a broader customer energy conservation portfolio in 2009. Commencing in 2013, the Company plans to expand this portfolio. This will increase the Company's costs but result in lower customer electricity bills and additional avoided Holyrood production costs of approximately $9.4 million annually by year end 2014.

Newfoundland Power's workforce management is consistent with continuity in the provision of safe, reliable service to customers. Increased recruitment and training requirements add costs; however, overall labour costs are consistent with least cost service delivery over both the short and long term.

Newfoundland Power's forecast 2013 and 2014 operating and capital costs are appropriate for the purpose of establishing customer rates. These costs are required for the management and operation of the electricity system at the lowest possible cost consistent with the provision of safe, reliable service to Newfoundland Power's customers.