Q. Does the company accept that if assets are not forecast to be used and useful they should be removed from rate base and any losses borne by its shareholder?

A. ***Introduction***

Except for cases of imprudent or unreasonable management decision making, Newfoundland Power does not agree with the proposition contained in this question. In the Newfoundland and Labrador context, the proposition is inconsistent with (i) good utility practice relating to system maintenance and (ii) sound public utility accounting practice.

Newfoundland Power's electrical distribution and transmission systems contain millions of components such as insulators, cut outs, fuses, and transformers. The condition and performance of these components is subject to a range of stresses which affect their service lives. The replacement of components due to environmental stress or technological obsolescence is common place.

Each year, asset retirements associated with the replacement of components (whether replacement is before or after the expected average service life of the asset) are reflected in Newfoundland Power's accounts. In addition, actual component replacements are included in the development of depreciation rates that permit the appropriate level of overall recovery of prudent investment in utility assets. The replacement of a component does not, however, give rise to a "loss" or "gain" to be borne by either shareholders or customers.

Managing Least Cost Reliable Operations

Newfoundland Power's inspection and maintenance programs are aimed at identifying deteriorated electrical equipment in a systematic way. This practically results in some assets being retired before reaching their expected service life. However, there is little question that these programs are consistent with good utility practices.

The Board's consultants, The Liberty Consulting Group, recently concluded a comprehensive review of Newfoundland Power's reliability management. In its *Report on Island Interconnected System to Interconnection with Muskrat Falls addressing Newfoundland Power,* December 17, 2014, amongst other things, the consultants observed:

> *"3.2 Newfoundland Power uses an effective combination of periodic O & M inspection and maintenance programs and capital transmission, distribution, and annual capital substation and capital rebuild and modernization projects to address condition, reliability, and operating issues with its transmission, distribution, and substation assets…*
>
> *3.4 Newfoundland Power's transmission line and pole inspection and corrective maintenance practices are consistent with good utility practices…*

3.5 Newfoundland Power's distribution feeder and pole inspections and corrective maintenance practices are generally consistent with good utility practices…

3.6 Newfoundland Power's substation inspection, corrective maintenance, and preventative maintenance practices are consistent with good utility practices…

3.8 Newfoundland Power's T&D System Rebuild and Modernization Strategies are generally consistent with system needs."

Newfoundland Power's reliability management is consistent with good utility practice and the needs of the Company's electrical system. It is also consistent with the delivery of least cost reliable electrical service to Newfoundland Power's customers.

The Company's reliability management includes the replacement of electrical system components which are deteriorated or defective and thereby more prone to failure. Some of these components will not have reached their expected service life when they are retired.

Accounting for Asset Retirement

Newfoundland Power's accounting practice is to retire electric plant when it is no longer used and useful in the provision of service to customers. For utilities such as Newfoundland Power which use U.S. generally accepted accounting principles ("U.S. GAAP") and group depreciation methods, this results in equal deductions from the Company's electric plant in service and accumulated depreciation accounts.

The use of group depreciation methods for utilities with millions of units of property (as opposed to unit depreciation) is cost effective and consistent with sound public utility practice. The Board has consistently approved Newfoundland Power's use of group depreciation methods.[1]

[1] See, for example, Order No. P.U. 13 (2013) where the Board approved Newfoundland Power's continued use of the equal life group depreciation procedure. The issue there was not the continued appropriateness of group depreciation methodology. The issue was whether Newfoundland Power should discontinue use of equal life *group depreciation* in favor of average life *group depreciation.*

Under group depreciation methods, the expected service life of an asset *group* is estimated based upon actuarial data and actual field experience, including retirements. This provides the best basis for estimating the expected average service life of the asset group for the purposes of determining investment recovery via annual depreciation accruals.[2]

Conclusion

Sound reliability management includes the replacement of electrical system components that are prone to failure whether those assets have reached their expected service life or not. The notion that retirement of assets before their expected service life automatically gives rise to "losses" to be borne by shareholder is, in Newfoundland Power's view, inconsistent with good utility practice.

The proposition that assets retired from rate base before reaching their expected service life result in a "loss" or a "gain" is not consistent with group depreciation methods. Group depreciation methods are consistent with sound public utility practice.

[2] The expected average service life of an asset or group of assets is not static. It can be affected by a variety of factors including historical data, field experience, technological obsolescence and management plans for utility operations. The dynamic nature of service life estimation justifies the regular periodic study, and regulatory consideration, of depreciation rates.