Reference: Volume 2, Review of General Expenses Capitalized

Q. Volume 2, Review of General Expenses Capitalized, page 11. NP states: ***"Conceptually, there is no material difference to total capital expenditures whether pension costs are capitalized by way of a labour loader or through GEC. Both approaches ultimately allocate pension costs to capital projects based on the Company's overall labour allocations."***

The Board approved pension costs as a component of GEC on an incremental basis in Order No. P.U. 3(1995-96). If there is no material overall impact on the amount of pension capitalized using either method, is there any other reason to change the current methodology now and increase revenue requirement by $1.4 million in 2023F, with the exception that the use of the labour loader is more common practice. What would the impact be on revenue requirement, rates and rate base if this policy wasn't changed at this time?

A. **A. The Review**

In February 2021, the Board requested that Newfoundland Power include with its next general rate application ("GRA") a review of its methodology and cost ratios used to determine General Expenses Capitalized ("GEC").

The Board requested that the review address why the Company includes pension costs in GEC and how capitalizing pension costs by way of a labour loader would impact revenue requirement and customer rates.

The request followed the results of the utility survey filed with the *Review of Capitalization Policies and Guidelines* which showed that only 1 of the 11 utilities surveyed indicated the use of a capitalized overhead calculation to allocate pension costs to capital projects.

As a result of the *Review of General Expenses Capitalized* (the "GEC Review"), Newfoundland Power proposes to remove pension costs from its GEC calculation and directly charge pension costs to capital projects by way of a labour loader, effective January 1, 2023.

B. Benefits of a Labour Loader

There are a number of benefits of using a labour loader when compared to the GEC allocation method to capitalize pension costs.

(i) It is consistent with generally accepted accounting principles in the United States ("U.S. GAAP") without requiring Board approval.

Pension costs can be directly charged to capital projects in accordance with *Accounting Standard Codification (“ASC”) 360 Property, Plant, and Equipment* (“ASC 360”). Regardless of whether Newfoundland Power was a regulated entity, it could capitalize pension costs.

In Newfoundland Power’s view, *ASC 980 Regulated Operations* (“ASC 980”), which permits the creation of assets and liabilities to reflect the economic impact of rate-regulated activities, is best used in instances where U.S. GAAP would not otherwise recognize the economic result of a regulatory decision.[1] For example, *ASC 980* could be used to capitalize a cost that has an enduring benefit to customers that *ASC 360* would require to be expensed.[2]

All general expenses included in the Company’s GEC calculation require the application of *ASC 980* to be capitalized, with the exception of pension costs which can be capitalized under *ASC 360.*

(ii) It is consistent with the Company’s treatment of Other Post-Employment Benefits (“OPEB”).

The Company has historically allocated OPEB costs to capital projects via a labour loader. The process is simple and has allowed for automatic cost tracking and reporting. Pension and OPEB costs are typically assessed together. Having both cost types allocated in the same manner would provide for efficiencies in assessing Newfoundland Power’s core employee future benefits.

(iii) It is consistent with sound public utility practice.

Ten of the 11 utilities surveyed do not include pension costs in their respective capitalized overhead calculations. Pension amounts would be directly charged to capital projects.

Directly charging pension costs to capital projects is therefore consistent with public utility practice as required by section 4 of the *Electrical Power Control Act, 1994.*

[1] *ASC 980 Regulated Operations* provides guidance on accounting and financial reporting for entities with regulated operations. Regulators may approve allowable costs for ratemaking purposes in a different period than the costs would be charged to expense by an unregulated entity.

[2] For example, in Order No. P.U. 12 (2021) the Board approved the capitalization of general expenses associated with the implementation of a Customer Information System.

(iv) It provides for accurate accounting of pension costs.

Pension costs are a material amount, particularly in relation to the total GEC amount. For example, the 2020 GEC amount included pension costs of $3.2 million, almost 50% of the total 2020 GEC amount of $6.6 million.

The use of a labour loader would accurately record pension costs to capital projects. A labour loader follows the labour that is directly charged to a capital project, whereas the GEC calculation uses a flat rate to allocate the total GEC amount across capital projects. The GEC calculation is also limited to capital and operating allocations.[3]

For income tax purposes, a labour loader would treat the RRSP component of costs like other employee benefits and be recorded in the proper capital cost allowance accounts.

More accurate accounting would also result in lasting benefits in determining capital project estimates and tracking employee costs. Like OPEB costs, pension costs are associated with the labour required to complete capital projects. The use of a labour loader will allow pension costs to form part of capital job estimates rather than be part of the separate GEC capital project.

(v) It provides for reduced administration.

Understanding the full cost of a project or a customer job includes understanding pension costs. Currently, calculations are completed outside of labour cost reports to incorporate pension costs. For example, pension costs must be added when completing customer job estimates and billings as well as for contribution in aid of construction estimates.

The use of a labour loader would allow regional employees across the Company to better understand the impact of pension costs on both internal costs as well as when completing job estimates.

C. Revenue Requirement Impacts

The allocation of pension costs to capital projects by way of a labour loader would increase the 2023 revenue requirement by approximately $1.4 million. The estimated customer rate impact of this proposal is an increase of 0.2%. There is no impact on rate base.

[3] The use of a labour loader would allow pension costs to follow the base labour which can be recorded to a number of accounts, such as capital, operating, retirement and recoverable accounts.

The income tax effects associated with the proposed change in capitalizing pension costs would reverse over time and reduce revenue requirements in subsequent years. Ultimately, there would be no impact on total revenue requirement collected through customer rates over the lives of the related capital assets.

In Newfoundland Power's view, employing a deferral account would be a reasonable option to reduce the impact on 2023 revenue requirement. For example, a cost deferral could offset the $1.4 million impact and be amortized over a 34-month period, similar to the Company's other cost deferrals included in the *2022/2023 General Rate Application*.

This option would reduce the 2023 revenue requirement impact to $0.5 million and the customer rate impact to 0.07%.

See response to Request for Information PUB-NP-060 for further information on using a deferral account to lessen the impact of the change in pension capitalization on 2023 revenue requirement.

D. Conclusion

Newfoundland Power has completed its review of pension cost capitalization.

The review showed that it is standard utility practice to directly charge pension costs to capital projects by way of a labour loader. There are also a number of other benefits associated with the method including consistency with the Company's treatment of OPEB costs, more accurate cost accounting and reduced administration.

Consistent with the results of the review, it is appropriate to remove pension costs from the Company's GEC calculation and directly charge pension costs to capital projects by way of a labour loader, as proposed, effective January 1, 2023.