Q. **Reference: Finance**

Please provide the Deloitte & Touche LLP review of the process and procedures used by Nalcor to recover costs among affiliates as referenced in Introduction Evidence, page 1.22.

A. Please see Hydro’s response to NP-NLH-024 Attachment 1.

Deloitte.

Nalcor Intercompany Review

Final Report

June 6, 2012

Table of contents

1. Executive summary

Deloitte Inc. ("Deloitte") was engaged by Nalcor Energy ("Nalcor") to provide an independent review on the cost allocation policies and procedures used between Nalcor and Newfoundland and Labrador Hydro ("Hydro").

The objectives of this review were to provide confirmation that the allocation methodologies adopted by Nalcor are fair and reasonable and in line with other utilities across Canada.

Nalcor was formed in 2007 to manage and lead the development of the Province's energy resources. Nalcor is the holding company for Newfoundland and Labrador Hydro (Hydro), Nalcor Energy - Oil and Gas Inc. (Oil and Gas), Nalcor Energy - Bull Arm Fabrication Inc. (Bull Arm Fabrication) and Gull Island Power Company Limited (GIPCo). Hydro, a fully owned subsidiary of Nalcor includes regulated and non-regulated activities. Hydro holds a 65.8% interest in Churchill Falls (Labrador) Corporation Limited (Churchill Falls), with Hydro-Québec holding the remainder.

A common or shared services model, allows organizations such as Nalcor and its affiliates to optimize assets and resources to provide efficient or specialized services at potentially lower costs than each individual entity replicating the asset or service. As part of delivering these assets or services, the costs are distributed among the various entities according to services provided.

Nalcor operates a corporate office ("Nalcor Corporate") which offers shared service to all lines of business however shared services are also provided by Hydro for other lines of business. In addition, some shared services are also delivered out of other lines of business as Nalcor has structured its intercompany charging policies such that costs are charged based on work performed regardless of the entity in which the resource resides.

Nalcor's guiding principles for allocating costs are aligned with the following:

- Cost-based
- Fair and reasonable
- Accurate and traceable
- Acceptable in a regulatory context
- Consistent with industry standards

Nalcor has established an Intercompany Transaction Costing Guidelines which is the guiding document outlining the basis and mechanisms for sharing services between entities and non-regulated activities. There are two methodologies used to allocate cost across all Nalcor lines of business. Both the methodologies have been in place prior to the establishment of Nalcor and have been refined over time:

1. Admin Fee methodology (used by Hydro for allocating specific costs)
2. Labour Charge methodology (used by all lines of business)

The Admin Fee methodology is used to allocate the full cost of three Hydro business units which house employees dedicated to shared services as well as certain specified common costs incurred in Hydro for the benefits of all lines of business. This methodology has been revised over time with the most significant change taking place in 2010 such that there is now a greater portion of costs being shared among the lines of business. Using this methodology, all the costs incurred in the specified business units are allocated to other lines of business using pre-determined allocators such as Full Time Equivalents (FTE's), number of users, area (square footage), number of telephones and number of ports.

The Labour Charge methodology is an extension of the policy previously used by Hydro to charge costs to non-regulated activities. This activity was formally outlined in response to the PUB order P.U. 7 (2002-2003) and is now the basis for allocating costs for labour charges throughout Nalcor with the exception of employees included in the Admin Fee calculation. It is used for allocation of employment costs plus an overhead recovery charge. The Labour Charge rate for 2012 was determined at 1.57 of labour costs.

The cost allocations to non-regulated entities through the Admin Fee have been on an upward trend since 2007. The allocations have increased both in absolute dollar value as well as a percentage of the total Operations and Maintenance (O&M) costs. Cost-based is one of the guiding principles for Nalcor's allocation methodology and there was no evidence of any profit being built into the allocations.

As part of this review, Deloitte also conducted an industry scan of similar regulated entities operating within shared services environments. The independent components of the two methodologies adopted by Nalcor align to industry standards.

This review did not "audit" or validate any of the costs or numbers provided to us, or evaluate the O&M costs. However, the organization appears committed to identifying and removing (via allocations) all costs that are not relevant to the regulated operations.

Based on our review, the methodologies and practices adopted by Nalcor are fair and reasonable and in line with other utilities. Nalcor through its philosophy of provision of shared service through all affiliates, with a concentration in two main lines of business reflects a commitment to getting the full benefits of economies of scale.

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2. Scope and approach

Deloitte was engaged by Nalcor to provide an independent review on cost allocation policies and procedures used between Nalcor and Hydro.

2.1 Scope of work

The scope of Deloitte's review included three main activities:

Activity 1: Policy review and opinion

- Review of Nalcor's current intercompany charge policies, practices and basis of cost calculation of markups and confirm alignment with regulatory practices and principles
- Review of the thoroughness to which intercompany costs have been addressed
- Review inter-affiliate agreements for cost allocations

Activity 2: Historical review and opinion

- Review transactions that have occurred from 2007-2012 and outline the effect the expansion of Nalcor has had on the regulated utility over that period

Activity 3: Industry scan and review of best practices

- Conduct an industry scan with three to five similar organizations from across Canada to determine methods for cost allocation. The review will provide a snap shot of cost allocation practices adopted by other organizations to support and validate the practices adopted by Nalcor
- Leverage Global Deloitte best practices and methods for cost allocation and pricing methods and compare to Nalcor's approach for cost allocation

2.2 Approach

Deloitte's approach for the review involved assessing the reasonability of the allocation methodology and the appropriateness and effectiveness of the drivers used for the services provided. The following steps were conducted as part of the review:

- Held discussions with Nalcor management
- Reviewed policies, guidelines, financial statements, annual reports and other relevant Nalcor and Hydro documentation
- Reviewed historical financial data and costing methodology
- Analyzed the historical financial data and the impact of growth of Nalcor into other lines of business
- Conducted industry research and analysis
- Discussed with internal Deloitte Subject Matter Experts (SMEs) on regulatory costing
- Developed this report with the summary of findings, analysis and conclusions

2.2.1 Documents reviewed

For the purposes of this report, the following Nalcor documents were reviewed:

- Intercompany Transaction Costing Guidelines, August 2011 (Appendix A)
- Non-regulated operations, June 2011 (Appendix B)
- Other costs and allocations, August 2011 (Appendix C)
- Intercompany Affiliate agreements – Churchill Falls
- Annual Report - 2010 Business and Financial Report
- Annual Report - 2009 Business and Financial Report

- Annual Report - 2008 Business and Financial Report
- Annual Report - 2007 Business and Financial Report
- Newfoundland and Labrador Hydro 2005 Annual Report
- Nalcor Energy News Release, Dec 11, 2008

2.2.2 Qualification of review

In completing the review, Deloitte relied on data and information provided by Nalcor management and representatives, who retain responsibility for the accuracy of all data provided for analysis. Deloitte did not audit any data gathered, perform a detailed examination of underlying transactions, validate any underlying source records, or verify the accuracy of any data provided for inclusion in the final report or any templates and models prepared during the project. Deloitte has relied solely on the representation of the staff, management and other representatives of Nalcor and Hydro as to the accuracy and completeness of data provided for the review.

As it was not part of the scope of this assignment, we have not modelled the financial impacts of consolidating, or applying only one of the current methodologies, nor have we modelled the impact of using alternative methodologies. In addition, we have relied on Nalcor to provide all financial data and have not been in a position to validate the actual make up of key data used in the current methodologies (including, for example, but not limited to, the makeup of the elements of the bill rate and the fixed overhead charge).

2.3 Key terms and definitions

The following terms and definitions have been used in this document.

Allocator: A basis of allocation to attribute indirect (shared) costs to multiple cost objects (usually based on causality or relative benefit).

Business unit: Business unit is a sub-unit of a section of a department within each legal entity. It is treated as a cost centre to accumulate all costs at the lowest level.

Common services: Services currently based out of Hydro that serve various lines of business and are allocated using pre-determined allocators. Currently, the common service business units include Human Resources (HR), Safety and Health and Information Systems (IS). The other service costs include office space and related costs, telephone and LAN costs.

Cost allocation: The process of assigning/attributing costs to a cost object (i.e., function, product or service).

Cost driver: A cost driver is a measurable event that causes the consumption of resources (costs) by a cost object. Also referred to as activity driver, expense driver and resource driver.

Cost object: Anything for which a separate measurement of costs is desired. For example customers, products, services, contracts, business units, regions or other work units that require a separate cost measurement and to which costs will be traced or allocated.

Direct costs: Costs not shared. Direct costs are related to a particular cost object in a clear one-to-one relationship.

Fixed costs: Fixed costs are costs that do not change based on changes in activity volume, number of transactions or number of cost objects.

Home Based FTE's: Denotes Full Time Equivalent (FTE) employees in the business unit in which they reside before any labour recharges.

Indirect costs: Costs shared by multiple cost objects. Indirect costs should ideally be allocated on the basis of causality or, in the absence of causality, on relative benefit.

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Intercompany transactions: Transactions between different legal entities and lines of business.

Intracompany transactions: Transactions between different business units within the same legal entity or lines of business.

Intercompany Transaction Costing Guidelines: Framework document that governs intercompany transaction processing used by the Nalcor lines of business.

Net labour costs: - Total salaries and benefits plus operating labour charges in, less operating labour charges out. For the purposes of this document, net labour costs only refer to operating labour costs.

Salaries and benefits: Includes the salaries costs for permanent and temporary personnel plus fringe benefits, group insurance and employee future benefits.

Shared services: Shared services are provisions of services from office functions such as HR, Finance, Procurement, Information Systems (IS) and other services, of one or more business units to other business units or lines of business in the organization.

Users: Numbers of users for cost allocation purposes is calculated using simple average of home based FTE's and contractors, Lotus Notes users, JDE users and number of personal computers.

Variable cost: Costs that change in proportion to change in business volume.

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3. Nalcor and Hydro background

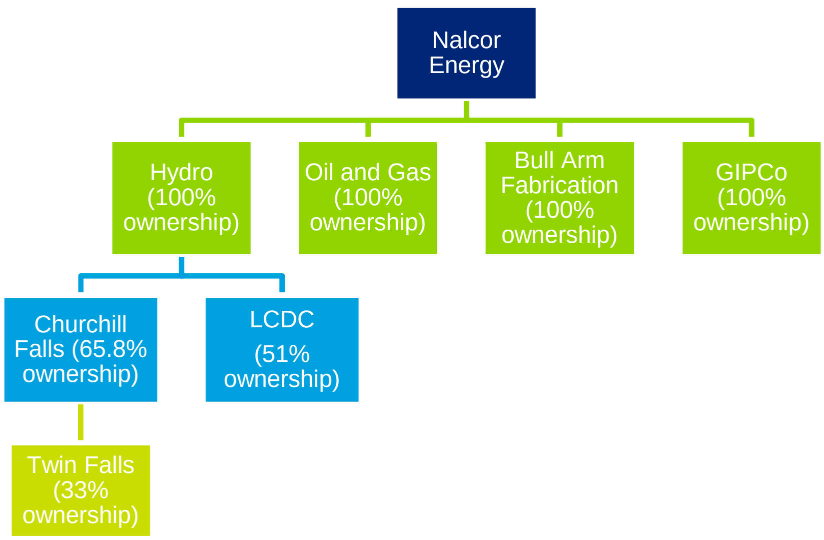
Nalcor Energy (Nalcor) is a crown corporation of the Government of Newfoundland and Labrador, established as part of one of the key initiatives of Newfoundland and Labrador's Energy Plan. The Province's 2007 Energy Plan outlines the setup of the new Energy Corporation:

"This Energy Corporation will be wholly owned by the province and will be the parent company of Newfoundland and Labrador Hydro (NLH), Churchill Falls Labrador (CF(L)Co) Corporation, other subsidiaries currently owned by NLH and new entities created to manage the province's investments in the energy sector. This will provide a structure that permits both regulated and non-regulated activities to exist and grow within separate legal entities."

In 2008, the Nalcor brand identity and corporate structure was established. Although, Nalcor entered into new lines of business, Hydro support staff and executives continued to operate under Hydro while supporting other lines of business.

Nalcor is the Government of Newfoundland and Labrador's holding company for the Province's energy assets and its business includes the development, generation, transmission and sale of electricity; the exploration, development, production and sale of oil and gas; industrial fabrication and energy marketing. Nalcor currently is the holding company for Newfoundland and Labrador Hydro (Hydro), Nalcor Energy - Oil and Gas Inc. (Oil and Gas), Nalcor Energy Bull Arm Fabrication Inc. (Bull Arm Fabrication) and Gull Island Power Company Limited (GIPCo). The following is Nalcor's legal entity structure:

Figure 1: Nalcor Legal Entity Structure



Nalcor, through its subsidiary, Hydro, holds a 65.8% interest in Churchill Falls (Labrador) Corporation Limited (Churchill Falls), with Hydro-Québec holding the remainder. Lower Churchill Development Corporation (LCDC) and GIPCo are both inactive subsidiaries.

Nalcor operates five lines of business:

Regulated:

- Regulated Hydro

Non-regulated:

- Churchill Falls
- Lower Churchill Project
- Oil and Gas
- Bull Arm Fabrication

In addition, Nalcor is also involved in other non-regulated energy activities and opportunities, including energy marketing, non-regulated electricity generation, wind energy and research and development.

3.1 Newfoundland and Labrador Hydro (Hydro)

As the Province's main electricity provider, Hydro is focused on providing a safe, reliable and least cost electricity supply to meet current electricity needs and accommodate future growth. Hydro's primary business is to generate and deliver electricity in Newfoundland and Labrador to utility, industrial, residential and commercial customers.

Currently, Hydro's operations include both regulated and non-regulated activities.

3.1.1 Regulated operations

Regulated Hydro activities include generation, transmission and distribution of electricity to customers throughout Newfoundland and Labrador. Hydro is regulated by the Newfoundland and Labrador Board of Commissioners of Public Utilities (PUB). Base electricity rates are set through periodic general rate applications using a cost of service (COS) methodology whereby Hydro is entitled to recover, through customer rates, all reasonable and prudent costs incurred in providing electricity service to its customers including a return on rate base.

3.1.2 Non-regulated operations

Non-regulated activities include the sale of recall energy to external markets and sales to the mining companies in Labrador West. The following activities and costs within Hydro are determined to be non-regulated:

- All activities associated with Churchill Falls
- All activities related to Export sales, Natuashish, Star Lake, Ramea, and Conservation and Demand Management (Labrador)
- Other specific non-regulated costs and dividends

Additional details on the non-regulated operations can be found in Appendix B.

3.2 Emergence of shared services

The creation of Nalcor and expansion into lines of business other than electricity has resulted in changes to the organizational structure such that there are now resources residing in multiple lines of business providing services to all other lines of business (both regulated and non-regulated entities). This has given rise to the need to allocate various shared costs via intercompany transactions.

For the purposes of this document, the central or "corporate" lines of business providing and receiving services is referred to as 'Nalcor Corporate' while the term 'Nalcor' is used when referring to the overall holding company encompassing all lines of business.

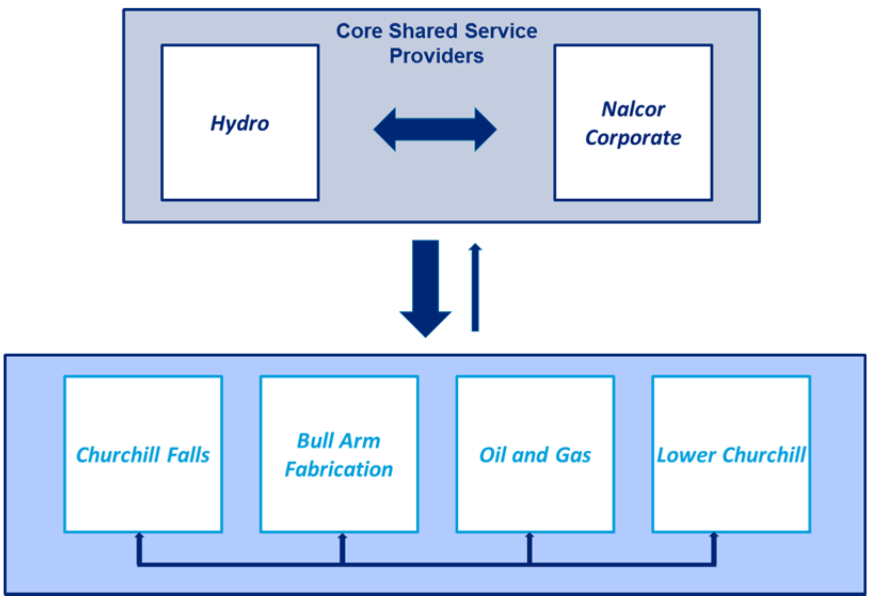
Prior to the establishment of Nalcor, several executive and corporate staff functions such as human resources, information systems, legal, finance, etc., were primarily responsible only for Hydro and its affiliates; however these functions now share the mandate to provide their expertise and services for other lines of business and the costs for shared staff are also distributed across all business units. As such Nalcor operates using a matrix organizational operating model whereby any employee may support any line of business as required.

Nalcor has opted for a shared services model to leverage the existing resources to support all lines of business. The shared services approach is intended to optimize management and cost efficiencies for Nalcor and its affiliates. This model is commonly used by other utilities in North America.

Between 2008 to 2010, over 30 executive and administrative staff within Hydro providing support services for all lines of business were transferred from Hydro to Nalcor Corporate. As a result, both Hydro and Nalcor Corporate are now the core shared service providers, providing the bulk of all shared services to the lines of business (including each other) but costs can come from any line of business based on work activity.

The following chart depicts the current flow of services.

Figure 2: Nalcor Shared Services Flow



The following table shows the number of employees in the two core shared services entities (Nalcor Corporate and Hydro) by division, at the end of December 2011.

Figure 3: Employees Providing Core Shared Services

Division	Nalcor Corporate	Hydro	Total
Executive Leadership & Associates	21	2	**23**
Human Resources & Organizational Effectiveness (HROE)	7	63	**70**
Finance/CFO	26	90	**116**
Project Execution & Technical Services (PETS)	15	91	**106**
Total	**69**	**246**	**315**

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The shared service in the two core groups are provided as follows:

- The employees in Nalcor Corporate are involved in providing shared services to all lines of business as required and their costs are allocated using the time records based ”Labour Charge” (see section 4.3.2)
- In Hydro, there are two main employee groups providing services as follows:
  - Employees in common service departments providing shared services to all lines of business. Their time is allocated via an Administration Fee, using allocators other than time records (described in more detail in section 4.3.1)
  - The other employees are similar to the Nalcor Corporate group and may provide services to other lines of business as required. Their costs are allocated using the time records based ”Labour Charge” (see section 4.3.2)

The following are the support departments within both the Hydro and Nalcor Corporate groups that generally share services with other lines of business:

Executive Leadership & Associates
- Communication
- Internal Audit
- Leadership Team
- Legal

HROE
- Human Resources (HR)
- Environmental Services
- Labour Relations
- Safety and Health

Finance
- Information Systems (IS)
- Treasury
- Financial Planning
- Risk Insurance
- Controller’s Office
- Supply Chain Management

Project Engineering and Technical Services (PETS)
- Engineering Services

In addition Hydro Place, the head office building primarily used by Hydro prior to 2007, is now the main corporate office for Nalcor and its affiliates and houses all lines of business. As a result, costs primarily absorbed by Hydro prior to the formation of Nalcor Energy are now distributed across all lines of business including Nalcor Corporate.

4. Nalcor cost allocation principles and methodology

4.1 Cost allocation principles

Nalcor's intercompany cost recoveries practices are outlined in the Intercompany Transaction Costing Guidelines, dated August 2011, and are governed by the following five guiding principles:

- Cost-based
- Fair and reasonable
- Accurate and traceable
- Acceptable in a regulatory context
- Consistent with industry standards

Cost-based: Intercompany charges among lines of business are cost-based only.

Fair and reasonable: The result of allocations should fairly and reasonably reflect the cost of providing the service. The allocation of a cost should reflect a causal relationship between the provision of the service and the cost.

Accurate and traceable: The allocated charges should reflect the cost of the provision of services among entities with a reasonable degree of accuracy. Where there is cost sharing, the allocators should be an accurate reflection of the cost driver. Labour should be charged as per time sheet recording based on work activity.

Acceptable in a regulatory context: The methodology should be acceptable under regulatory framework which demands a certain amount of rigour in development and design, taking into account the fact that results of the methodology may affect large groups of stakeholders, including end consumers of electricity in Newfoundland and Labrador.

Consistent with industry standards: The methodology should be consistent with published industry standards and practices, where applicable, as well as best practices among entities in other Canadian jurisdictions.

4.2 Inter-affiliate agreements for cost allocations

Nalcor's Intercompany Transaction Costing Guidelines is the policy that governs all intercompany and intracompany transactions for all lines of business. This policy is attached in Appendix A.

The transactions have been formally outlined in inter-affiliate agreements for all entities and these agreements outline the determination and payment of costs associated with the provision of corporate and support services, including but not limited to, management, general accounting, treasury, purchasing, legal, information systems and technology, human resources, safety and health, engineering, project execution and administration.

The agreements outline the transaction flow that occurs between entities and acts as a formal mechanism for charging the costs between entities. To date, the agreements between Churchill Falls (Labrador) Corporation Ltd. (Churchill Falls) and Hydro, and Churchill Falls and Nalcor have been executed. The remaining agreements are similar and are currently in draft status.

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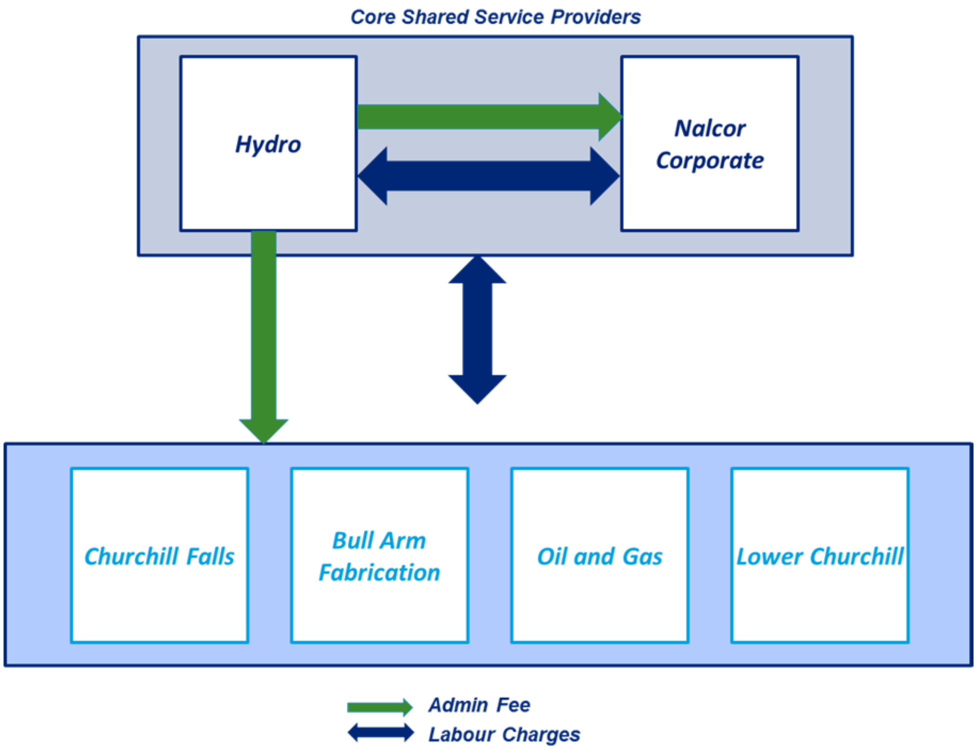
4.3 Cost allocation methodology

Nalcor and its affiliates use a matrix organization and operating model where any employee could provide services for any lines of business, as required. However, most of the intercompany transactions arise from Nalcor Corporate and Hydro as they provide the bulk of the shared services to all lines of business, including each other.

The following chart depicts the allocation of costs of shared service provided by the two core service providers.

Figure 4: Nalcor Shared Services Cost Allocation



It should be noted where other lines of business do provide their shared service, they use the labour charge process as described below. Labour Charge coming from lines of business other than Nalcor Corporate is less than 1% of the total labour charges incurred by Hydro.

Nalcor adopts two allocation methodologies for allocating and recovering all intercompany costs. Hydro uses both methodologies while Nalcor Corporate uses only one of the methodologies for allocating all shared service costs.

4.3.1 Administration (“Admin”) fee (Hydro only)

Certain departments in Hydro are designated as “common service departments” and provide shared services to all lines of business (refer to Figure 5). The costs associated with common service departments (employment and other costs) are allocated via an Administration Fee (Admin Fee) to other lines of business (in line with Nalcor’s Intercompany Transaction Costing Guidelines).

The following are the Hydro "common service departments" and the costs and allocation basis employed within the Admin Fee methodology:

Figure 5: Common Service Departments

	Common Service Departments		
	Safety and Health	**Human Resources**	**Information Systems**
Services included	Administration and management of safety and health related initiatives for all staff	Payroll, recruitment, employee benefit programs, pensions, training, rewards & recognition program and maintenance of the corporate human resources database.	Management and deployment of Information Technology Strategy including support, maintenance of IT infrastructure as well as responding to user queries including helpdesk services, interest and depreciation costs.
Key costs included	• Salaries & fringe benefits, • System equipment maintenance • Office supplies & expenses • Professional services • Travel	• Salaries & fringe benefits, • System equipment maintenance • Office supplies & expenses • Professional services • Miscellaneous expenses	• Salaries & fringe benefits • System equipment maintenance • Office supplies & expenses • Professional services (including software maintenance) • Miscellaneous expenses • Equipment rental • Travel • Depreciation • Interest
Computation basis	Total costs of business unit 2007	Total costs of business unit 2022	Total costs of business unit 2068 and depreciation on IS assets
Allocators used	FTE	FTE	User

The following are the Hydro "other service costs" and the allocation basis employed within the Admin Fee methodology:

Figure 6: Other Service Costs

	Other Service costs		
	Telephone costs	**LAN costs**	**Facilities and related costs**
Services and costs included	Trunk lines lease and telephones	Network management, internet service and maintenance related costs	Cleaning, snow clearing, heat and light, reception, mailroom services, interest and depreciation costs.
Key costs included	• Telephone costs only (based on GL Account)	• LAN costs only (based on GL Account)	• Salaries & fringe benefits • System equipment maintenance • Office supplies & expenses • Professional services • Depreciation • Interest
Allocators used	# of telephones	# of ports	Area (Sq. foot)

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The Admin Fee is reviewed and adjusted annually to reflect actual costs incurred. The following table represents the cost allocators used in the Admin Fee calculation and the proportion distributed to each line of business for 2012 budget calculation.

Figure 7: Admin Fee Allocators

Cost Type	Cost Allocators	Total Metric	Hydro	Nalcor Corporate	Lower Churchill Project	Oil and Gas	Bull Arm Fabrication	Churchill Falls
HR and Safety and Health costs	FTEs	**1,402**	61%	12%	4%	1%	0%	22%
Information Systems	Users	**1,339**	64%	9%	6%	1%	0%	20%
Telephones	Number of telephones	**680**	72%	13%	11%	3%	1%	0%
LAN Costs	Number of ports	**1,241**	85%	8%	6%	1%	0%	0%
Facilities & related costs	Area at Hydro Place (Square Foot)	**152,501**	56%	15%	23%	5%	1%	0%

Note: Allocators are as of July 31, 2011

Although Nalcor has five lines of business (six including Corporate), Hydro has the highest number of employees and space usage and therefore a large proportion of the common services cost remain with Hydro. Note that Energy Marketing, Menihek and Exploits related allocator values and costs have been included with Nalcor Corporate costs in the above table.

4.3.2 Labour Charge

The Labour Charge out policy is an extension of the policy previously used by Hydro to charge costs to non-regulated activities. This activity was formally outlined in response to the PUB order P.U. 7 (2002-2003) and is now the basis for allocating costs for labour charges throughout Nalcor.

The costs of employees who do not reside in the “common service departments” are allocated to the lines of business using a Labour Charge. The Labour Charge is based directly on time and the calculation has two main components:

- Bill rate
- Fixed overhead charges

4.3.2.1 Bill rate

Bill rate is the factor applied to hourly wages and is intended to cover costs associated with employees as follows:

Bill Rate = (Base Salary + Employee Benefits + Bonus + Payroll taxes + Labrador travel benefits)/ Average Total Available Working Hours.

In the case of overtime, the bill rate is not applied and overtime is billed as incurred in accordance with the standard overtime policy.

The bill rates are reviewed annually and updated accordingly.

4.3.2.2 Fixed overhead charges

In addition to the bill rate, a fixed overhead charge is also applied to each hour of regular labour billed. The fixed charges are intended to recover overhead costs (non-salary and benefit costs) directly associated with employees.

The following costs are included in the fixed overhead charge calculation:

- Recovery of the Admin fee charged to the line of business; and
- Other employee related expenses such as telephone and fax, books and subscriptions, membership and dues, conferences, training and other employee expenses.

The fixed charge rate is reviewed annually and updated accordingly by Nalcor for all lines of business. The rate for 2012 as per forecast is $13.10 per hour to a maximum of $98 per day. While most employees (in all lines of business) who provide shared services are located in Hydro Place, this rate is also used as a proxy for employees working from other locations.

5. Cost allocations review – 2007 – 2012

A high-level review was conducted for the various cost allocations and the impact of the creation of Nalcor (2007) on Hydro's costs. For the purposes of cost allocation comparison, the financial data from 2007 to 2011 was based on 'Actuals' and 2012 data was based on budget.

5.1 Impact of the establishment of Nalcor on Hydro common services costs

With the emergence of Nalcor and the expansion of the other lines of business, a significant amount of fixed costs traditionally borne by Hydro are now allocated to other affiliates Hydro serves. As the organization has added subsidiaries, the economies of scale have become evident as the cost of these departments and other common costs which include certain fixed and semi fixed costs (such as systems costs, facilities costs, depreciation and interest) as well as certain overhead costs (such as reception costs, general office costs, maintenance cost etc.) have been shared over an increasing number of entities.

The shared services costs used for comparison only include activities and costs for the following four departments in Hydro: HROE, Finance, Executive and PETS. The following table lists the total shared services related Operations and Maintenance (O&M) costs and the corresponding recoveries through the Admin Fee and Labour Charge.

Figure 8: Shared Services Recoveries

	Actual 2007	Actual 2008	Actual 2009	Actual 2010	Actual 2011	Budget 2012
			Amounts (in Million $)			
Admin Fee (out)	(1.5)	(1.8)	(2.2)	(3.1)	(3.6)	(5.8)
Labour Charge (in)	0.0	1.3	1.1	1.6	2.2	2.5
Labour Charge (out)	(1.5)	(0.9)	(1.4)	(1.7)	(1.9)	(1.1)
Shared Services net recoveries	**(2.9)**	**(1.4)**	**(2.5)**	**(3.1)**	**(3.4)**	**(4.4)**

As illustrated in the table above, the net recoveries have increased from $2.9 million in 2007 to $4.4 million budgeted in 2012. In 2008, approximately 25 positions in the Shared Services departments were moved from Hydro to Nalcor Corporate thereby contributing additional savings to Hydro's total O&M costs and reflected in the increase in the Labour Charge (in) of $1.3 million from other lines of business.

Both methodologies for Admin Fee and Labour Charge have been in use by Hydro prior to the formation of Nalcor and were in place at the inception of Nalcor in 2007 (although the only affiliate of Hydro at the time was Churchill Falls). As Nalcor established the different lines of business and Hydro employees supported them, the methodologies were extended to include all the lines of business.

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5.2 Admin Fee

The Admin Fee methodology has been continually refined since the establishment of other non-regulated activity, first in Hydro and then with the setup of Nalcor. In 2010, the methodology was further refined to include the total costs of three dedicated business units that provide services to all lines of business. In this way, the Admin Fee has increased steadily from $1.5 million in 2007 to $3.4 million in 2011 and is forecasted to further increase to $5.8 million in 2012.

Figure 9: Shared Services O&M Costs and Recoveries

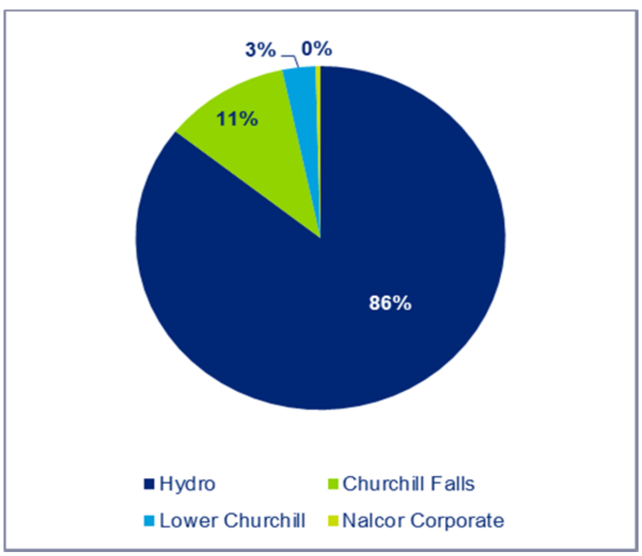
	Actual 2007	Actual 2008	Actual 2009	Actual 2010	Actual 2011	Budget 2012
			Amounts (in Million $)			
Total Costs	9.1	8.9	9.1	9.9	11.7	15.0
Admin Fee (Recovery)	1.5	1.8	2.2	3.1	3.4	5.8
Net costs	**7.6**	**7.1**	**6.9**	**6.8**	**8.9**	**9.2**

Note: For 2007 to 2009 the O&M costs for the departments that are now common service departments are provided for comparison purposes.

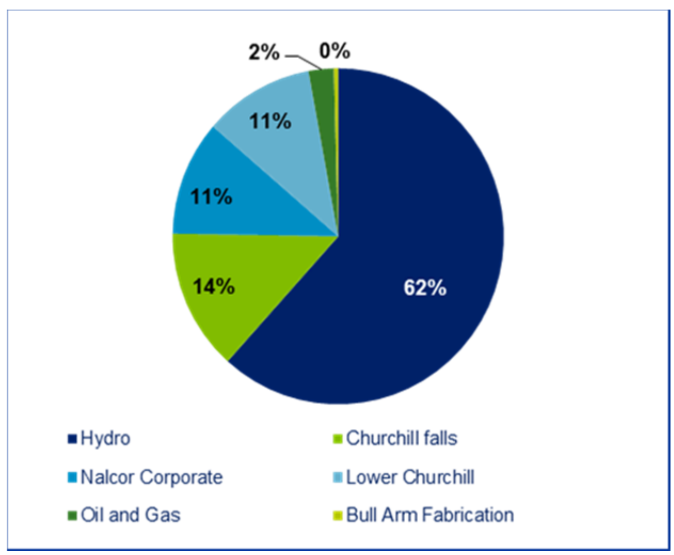
As depicted in the charts below, from an overall percentage value perspective, Hydro was retaining 88% of the total costs for shared services in 2007 and only 12% costs were allocated to other entities. However, there has been noticeable increase in costs shared by other entities thereby reducing Hydro's share of common services costs to 62% in 2012.

Figure 10: Shared Services Costs Percentage Distribution – 2007 vs 2012

Shared Services Costs Percentage Distribution 2007



Shared Services Costs Percentage Distribution 2012



Of the $15 million common service costs, as per 2012 forecasts, approximately $9.3 million will be retained by Hydro as their share of the common service costs and $5.8 million will be allocated to other lines of business as illustrated in Figure 11 below.

In 2007 the primary allocation was to Churchill Falls. In 2008 and 2009, there were additional costs allocated as the non-regulated activities and staff increased. From 2009 to 2010, there was a notable increase of $0.9 million that resulted due to the change in the Admin fee methodology described above. In 2011, there is a forecasted increase of $0.5 million from 2010 and is due to a general increase in costs. For 2012, the Admin fee recovery is budgeted to increase by $1.2 million from $3.6 million in 2011 to $5.8

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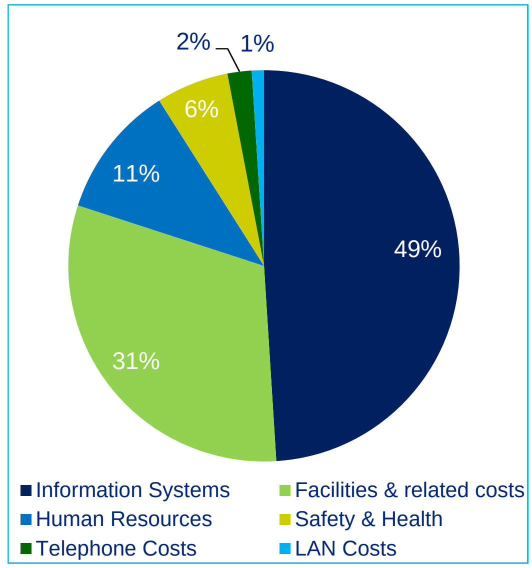
million in 2012. The primary reason for the budgeted increase in 2012 is the inclusion of addition common costs such as depreciation and interest costs related to IS and Hydro Place.

The 2012 forecasted common services costs are outlined below.

Figure 11: Common Services Costs by Cost Categories

Common Service Costs	Allocation basis	Total ($ Million)
Information Systems	User	7.31
Facilities & related costs	Area (square foot)	4.67
Human Resources	FTE	1.65
Safety & Health	FTE	0.98
Telephone	# of telephones	0.23
LAN Costs	# of ports	0.18
Total costs		**$15.02**



The total common services cost for 2012 is forecasted at $15 million of which 80% is constituted by Information Systems and Facilities and related costs. To evaluate the reasonableness of the allocators used, it is important to understand the costs included in each of the six cost components and relationship to the allocators.

The Admin Fee calculation adopted by Hydro used a hybrid approach to different "categories" of cost. Based on our understanding from Nalcor, most of the expenses listed above cannot be allocated specifically to the lines of business. The following are some observations drawn from our analysis of the Admin Fee.

Information Systems (IS):

Approximately half of the total Admin Fee costs come from IS and it is an accumulated cost for the entire Business Unit. As such, the expenses included are of varied nature including fixed and variable costs, direct and indirect costs.

Based on our understanding from Nalcor, all systems are common systems used by all lines of business and therefore the allocator is based on a simple average of total FTE's, number of users for JDE, Lotus Notes and number of personal computers.

Human Resources (HR)

Payroll and recruitment are the primary activities of this group in addition to other HR related activities. All costs are being allocated based on a proxy for the likely usage of the service being the number of FTE of the potential recipients. Employment costs followed by professional services and miscellaneous expenses form most of the costs in HR.

Safety and Health

Similar to HR, all costs for the Safety and Health business unit are allocated based on FTE basis. The total costs for the business unit includes both employment and other general costs.

Facilities and related costs

A significant amount of costs (over 30% of other service costs) are grouped together as Facilities and related costs and are allocated on the basis of a single allocator (square footage – of the building used by the Line of Business). A large component of the costs relates to systems and equipment maintenance, depreciation, interest and office supplies which generally require different treatment depending on the nature and driver of the expense. However, according to Nalcor all costs included in this group relate to the operation and maintenance of the building facilities and as such square footage is an appropriate allocator.

Telephone and LAN costs

Telephone and LAN costs are isolated and allocated on the basis of specific volumetrics. The costs are not material and the allocators are reasonable.

5.3 Operating Labour Charge

Labour Charge is an important element in the discussion of the shared services context of Nalcor and Hydro. Since 2008 there has been an increase in charges from Nalcor and other lines of business to Hydro. As well, there is a recovery of costs from Hydro to the other lines of business based on work activity. Prior to the establishment of Nalcor and consistent with the expansion of Hydro's mandate as outlined in the Hydro Act, there has been an increase in staff and activities that are non-regulated.

As can be seen from the table below, the net labour costs to Hydro have increased by $2.4 million from 2007 to 2012 although the labour charged out of Hydro remained at a consistent level from 2007 to 2012. The labour charge (out) represents cost recoveries to Hydro for services performed related to non-regulated activities.

Figure 12: Net labour costs from 2007 to 2012

	Actual 2007	Actual 2008	Actual 2009	Actual 2010	Actual 2011	Budget 2012
			Amounts (in Million $)			
Labour Charge (in)	0.0	1.3	1.1	1.7	2.3	2.5
Labour Charge (out)	(1.5)	(1.0)	(1.6)	(1.9)	(2.1)	(1.6)
Net labour	**(1.5)**	**0.3**	**(0.5)**	**(0.2)**	**0.2**	**0.9**

Since the beginning of 2008, approximately 25 employees from the Executive and Finance departments were transferred from Hydro to Nalcor Corporate; and these staff now provide services to all lines of business through the matrix organizational structure. Salary and benefits costs for the original staff who were transferred are now captured in Nalcor and the cost of the services they provide on behalf of Hydro are now reflected as intercompany labour in. In order to evaluate the impact of the intercompany labour in, it is necessary to include the savings from the transferred staff.

Following are the savings estimated by Nalcor:

Figure 13: Estimated savings due to staff transfers from Hydro

	2008	2009	2010	2011	2012
			Amounts (in Million $)		
Salaries and benefits	2.4	2.6	2.6	2.6	2.7
Interco Labour in	1.1	0.9	1.1	0.7	0.9
Savings	**1.3**	**1.7**	**1.5**	**1.9**	**1.8**

Salary and benefits represent the net estimated costs that Hydro would have incurred if Nalcor did not exist assuming that the same level of recharges from Hydro had occurred. Over this period, there is a cumulative savings in Hydro related to the original employees transferred of $8.3 million. Given that there

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have been additional transfers since 2008, there are likely additional savings that have not been quantified.

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6. Industry scan and best practices

As part of this analysis, two external components were taken into consideration. The first component is an articulation of key regulatory principles related to shared services. The second is an industry scan which provides a summary of four entities that represent a varying degree of geography, structure, size and scale of operations.

6.1 Best practices and principles

Based on our experience, research and analysis, the best practices and principles adopted by several utility companies can be summarized in the following three categories:

- Regulatory principles
- Regulatory precedent
- Costing principles

6.1.1 Regulatory principles

Regulators must review and set rates in accordance with their empowering legislation. Regulators frequently refer to established regulatory principles to guide their judgment. In the context of the current evaluation, these key principles include:

Just and reasonable

The primary regulatory principle, and the one most likely to be incorporated into regulatory legislation, is that rates should be "just and reasonable". "Just and reasonable" applies to both customers and regulated entities. It requires a weighting of the legitimate interests of both parties.

Cost of service standard

At the heart of rate regulation is the "cost of service standard", sometimes referred to as the "revenue requirement standard." Under this standard, a regulated entity is permitted to set rates that allow the opportunity to recover its costs for regulated operations, including a fair rate of return on its investment devoted to regulated operations – no more, no less.

The 'cost of service' standard reflects the need for fairness and the necessity to offer adequate incentives for providing regulated services.

Prudence standard

The prudence standard modifies the "cost of service" standard. Under this standard, customers should be charged only for prudently incurred costs. This recognizes a regulated entity's responsibility to manage itself in a prudent manner and provide regulated services at the most efficient cost.

Prudence is established by determining what a reasonable person would have done in a similar situation. This should not be done in hindsight. A regulated entity's management can be expected to rely only on information reasonably available to it when it makes its decision.

It is generally assumed management has acted prudently unless evidence exists to the contrary.

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6.1.2 Regulatory precedent

Regulators are often guided by their previous decisions, along with those of other regulators. In this regard, this sub-section provides an overview of how Canadian regulators have dealt with issues related to corporate cost allocations.

Affiliate transactions

Regulators normally allow affiliates to provide services to regulated utilities and vice versa. Some regulators have explicitly recognized the benefits of such transactions to the utility and ratepayers.

Regulators generally require a utility to pursue the best interests of the utility and its ratepayers in all transactions with affiliates, although they may not make an explicit statement to this effect. This is consistent with the cost of service and prudence standards; although a utility should be given an opportunity to recover the costs of providing regulated operations, that opportunity should be limited to prudent costs.

Basis for affiliate charges

It is almost universally accepted that the preferred basis for inter-corporate charges is market price. This may reflect the view that affiliates should be treated as separate organizations. In this context, market price is what parties operating at arm’s length would tend to agree upon. It is also consistent with prudent management; market price is the highest price a utility would expect to pay and the lowest price it would expect to receive.

Unfortunately the market price for most corporate services is difficult to establish, at least on a supportable basis. Even where comparable services can be acquired from alternative suppliers, it can be difficult to establish the prices charged. Also adjusting for differences between the services provided to the utility and the benchmark prices can require a great deal of effort, and more importantly, a significant amount of subjective judgement.

Where market price cannot be established, regulators usually require cost-based prices. These cost-based prices should reflect fully distributed costs, including a fair return.

Minding the investment/stand-alone standard

If the activities of the parent allow for savings relative to a stand-alone situation and the parent incurs costs associated with those activities, an appropriate allocation of the costs of the activity would be a prudently incurred cost of providing regulated operations.

6.1.3 Costing principles

Where a market price cannot be established, regulators often direct utilities to employ cost-based prices for intercorporate transactions. There is an economic justification for this approach because, in a competitive market, the prices for goods and services will tend to reflect the costs of providing them where costs include a fair return. However, this raises the issue of how costs should be calculated to establish the cost of intercorporate services.

Allocating costs on the basis of causality

To the extent possible, costs should be allocated to cost objects on the basis of causality. A “cost object” is the “thing that is being costed”.

A causal relationship is established where a cost is incurred because of the existence of a cost object and would not be incurred without it. Unfortunately, there is not always a direct causal relationship between costs and specific cost objects. In some cases, the causal relationship can only be established in relation to a group of cost objects (e.g., group of business units). In these cases, costs should be allocated on the basis of beneficiality – i.e., relative benefits received.

Stable over time

The cost allocation methods should be clearly documented and sustainable over a period of time. The allocators should be easily adaptable to future changes in the business for consistent cost allocations.

Cost effective and manageable

While it is important to arrive at the most accurate cost allocations, there has to be a reasonable cost benefit to the exercise. The costs must not overcome benefits and be a burden on the organization to track them. The value of costs to be allocated needs to be more than the cost to track them. The cost allocation exercise should be relatively simple, cost effective and easily understood.

6.2 Industry scan

As a part of our assessment of Nalcor's cost allocation methodology, we conducted a review of the costing practices of other regulated Canadian energy utilities. We requested four different utility companies within Canada to participate in the review. The four entities represent a varying degree of geography, structure, size and scale of operations. The participants requested their responses remain confidential; therefore, no comments or responses of any specific utility have been identified in this report.

The following summarizes our findings in comparison of Hydro to other utilities.

Figure 14: Industry Scan Comparison of Hydro to other Utilities

	Nalcor	Utility A	Utility B	Utility C	Utility D
Number of Employees	1000-2500	1000-2500	2500-5000	<1000	1000-2500
Regulated and non-regulated business	Yes	Yes, non-regulated is negligible	Yes, non-regulated is negligible	Only regulated business	Yes
Key services shared	Corporate functions – Exec team, HROE, Finance, PETS	All Corporate functions – Finance, IS, HR, Enterprise Risk, Security, Insurance	All Corporate functions – HR, IS Finance, Legal, Security	Insurance, Risk Management	All Corporate functions – Finance, HR, IS, Security, Procurement, Legal
Shared services entities	Holding company and Regulated entity	Holding company and Regulated entity	Holding company	Holding company	Holding company
Service level agreements with business units for shared services	Yes, some are in draft	Yes	Yes	Yes, only for insurance provision	Yes
Information Systems	Project based expenses capitalized to the line of business; operating expenses allocated based on average number of users	Project based expenses capitalized or direct billed to the lines of business; all other costs recovered based on Service level agreements	Project based expenses capitalized or direct billed to the lines of business; all other costs recovered based on Service level agreements	N/A	Based on Service Level Agreements
Finance	Time entry	AP - Number of invoices Others – Time	Composite formula; drivers include - Capital	N/A	Composite formula

Allocation methods adopted

Allocation methods adopted

	Nalcor	Utility A	Utility B	Utility C	Utility D
		surveys	exps, Oper Maint (expense), Total assets, Total capital, Total revenue		
Payroll	FTE	FTE	FTE	N/A	FTE
Office space	Area (square foot)	Area (square foot) adopted currently but moving to fair market value model	Rent – Area (square foot); other – composite formulas	N/A	N/A
Other costs	HR – FTE; Safety and Health – FTE; Telephone costs - # of telephones; LAN costs - # of ports	Computers, phones, etc. - # of employees; Mgt fee – not allocated to regulated entity	Procurement – based on # of PO's; other costs – composite formulas	Insurance – assets, risk, property type, liability	Corporate costs –service based cost methodology
Labour rate	Labour calculated at Bill rate + Fixed Overhead calculation. Approx. – 1.57	Labour charged at 1.5 times hourly rate to recover fixed overhead costs	Labour charged at hourly rate + fixed % of hourly rate	Labour charged at hourly rate + % of hourly rate to recover fixed overhead costs	N/A
Calculation of time as a driver	Actual time records used	Quarterly estimates based on divisional forecasts	Time Surveys deployed annually	N/A	Time Surveys deployed annually
Profit component	No	No	No	No	No
Current policies accepted with regulatory bodies	N/A	Yes	Yes	Yes	Yes
Code of Conduct for inter-affiliate charges	No	Yes	Yes	Yes	Yes

As evident from the table above, Nalcor's practices and policies for cost allocation for shared services costs are in line with other utilities that were interviewed for the purposes of this review. Like other utility companies, Nalcor's cost allocation policies are aligned to only recovering costs without any intended profit component.

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7. Conclusion

Based on our review, the methodologies and practices adopted by Nalcor are fair and reasonable and in line with other utilities. Nalcor through its philosophy of provision of shared service through all affiliates, with a concentration in two main lines of business reflects a commitment to getting the full benefits of economies of scale.

The cost allocations to non-regulated entities through the Admin Fee have been on an upward trend since 2007. The allocations have increased both in absolute dollar value as well as a percentage of the total Operations and Maintenance (O&M) costs. Cost-based is one of the guiding principles for Nalcor's allocation methodology and there was no evidence of any profit being built into the allocations.

This review did not "audit" or validate any of the cost or numbers provided to us, or evaluate the O&M costs. However, the organization appears committed to identifying and removing (via allocations) all costs that are not relevant to the regulated operations.

As part of this review, Deloitte also conducted an industry scan of similar regulated entities operating within shared services environments. The independent components of the two methodologies adopted by Nalcor align to industry standards.

As Nalcor continues to evolve its services, there may be opportunities to implement alternative allocation models to attribute costs to other drivers as well as reduce calculation efforts in determining allocations.

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Appendix A – Intercompany transaction costing guidelines

Intercompany Transaction Costing Guidelines

Table of Contents

Table of Contents (cont'd.)

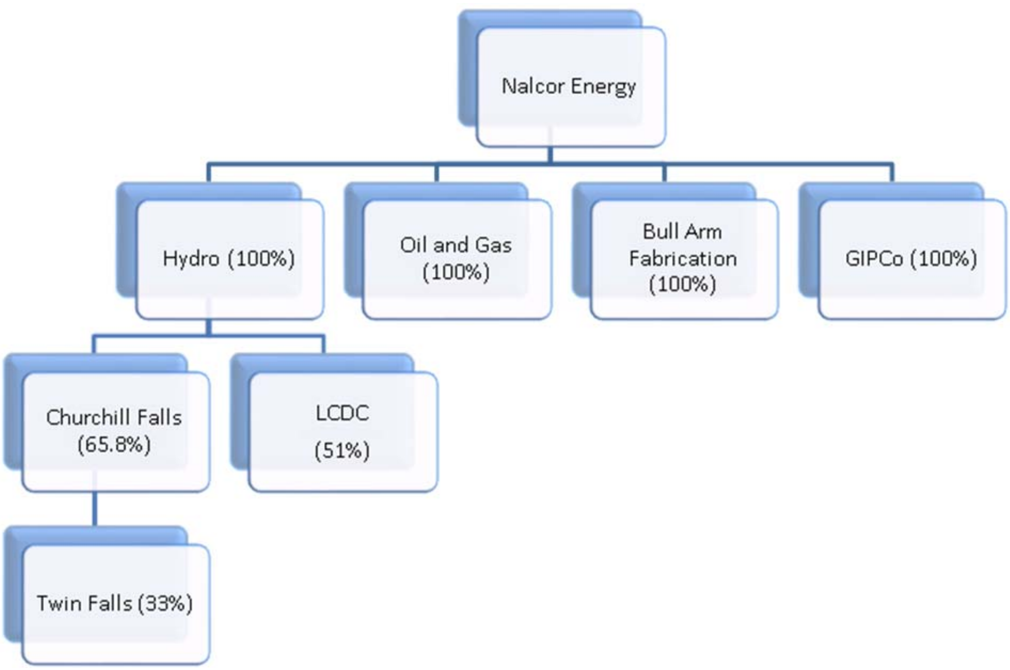
1.0 PURPOSE

This document is intended to outline the guidelines for charging costs across the lines of business within Nalcor Energy (Nalcor or the company).

2.0 INTRODUCTION

Nalcor is a Crown corporation that was established in 2007 as part of one of the key initiatives of Newfoundland and Labrador's Energy Plan. The company, which is wholly owned by the Government of Newfoundland and Labrador, was established to take a lead role in the development of the province's energy resources. The Nalcor legal entity structure is outlined below:

Figure 1



Nalcor's business includes the development, generation, transmission and distribution of electricity; the exploration, development, production and sale of oil and gas; industrial fabrication and energy marketing. These intercompany transaction costing guidelines apply to both intra-company and intercompany transactions. That is, the guidelines are applied to transactions between regulated and non-regulated Hydro, as well as to transactions between Nalcor and CF(L)Co, for instance.

The guidelines are based on the principle of cost based recovery. There is no profit component and, where practicable, employees track time worked to specific lines of business using a weekly time sheet. Costs associated with the operations of certain departments that provide common services available for the consumption of all lines of business are allocated through the Administration Fee as outlined in this document.

3.0 CORPORATE SERVICES

Certain departments provide corporate services (or shared services) to other lines of business within Nalcor. These services include management, general accounting, treasury, purchasing, legal, information systems and technology, human resources, safety and health, engineering and project execution and administration. e Transactions associated with these services are governed by these guidelines. Intercompany transactions operate on the premise that all transactions are billed at cost. The costing framework covers transactions from corporate or shared services groups as well as common services that are allocated through an dministration fee process.

There are two main types of costs which are charged :

- Type 1 - Common Service Costs (via Administration Fee); and
- Type 2 - Costs related to the provision of Corporate Services.

3.1 Type 1 – Common Service Costs

Certain departments, which are based within Hydro, provide common services to various lines of business. Hydro recovers costs through an administration fee as described below.

Table 1

Common Service Departments	Allocation Basis
Human Resources	FTE
Safety and Health	FTE
Information Systems (IS)	Average Users
Office space and related costs	Square footage
Telephone and Local Area Network (LAN) costs	Average Users

3.1.1 Human Resources

Human Resources is responsible for the administration and coordination of all employee related services including payroll, recruitment, employee benefit programs, pensions, training and the rewards and recognition program as well as the maintenance of the human resources database. Human Resources also administers the performance appraisal system, salary surveys and maintains organization charts. Operating costs incurred in providing Human Resources services are allocated to the lines of business on a full time equivalent (FTE) basis

3.1.2 Safety and Health

The Safety and Health department provides Occupational Health services including coordinating corporate efforts with regard to employee safety as well as wellness, disability and sick leave management, and medical screening. Operating costs incurred in providing safety and health services are allocated to the lines of business on an FTE basis.

3.1.3 Information Systems (IS)

IS provides assistance and support in the areas of Software Applications, Planning and Integration and Business Solutions. This department is also responsible for the maintenance and administration of the company wide computer infrastructure and network and provides technical support. Operating costs incurred in providing IS services are allocated to the lines of business on an average user basis. Depreciation expense and a return on rate base at the weighted average cost of capital (WACC) for costs capitalized such as servers andsoftware are allocated to each line of business on an average user basis. Costs that are incurred solely for a particular line of business, rather than shared among the lines of business are charged to that line of business and are excluded from the determination of shared costs.

3.1.4 Office Space

Each line of business occupying floor space at Hydro Place is charged a rental charge for floor space. The square footage rental rate reflects the average annual capital and operating cost for Hydro Place as determined by the following formula:

$$\frac{\text{Hydro Place operating costs + return on rate base + annual depreciation}}{\text{Hydro Place total square footage}}$$

The cost based rate includes the following expenses for Hydro Place:

- Annual depreciation for all common assets
    - Common assets include:
        - Furniture for offices, cubicles and common areas;
        - Fitness equipment;
        - Cafeteria equipment;
        - Printers and fax machines;
        - Mailroom equipment;
        - Network services equipment;
- System Equipment Maintenance expenses and operating projects;
- Expenses relating to salaries, fringe benefits, group insurance and employee future benefits for Office Services, Building Maintenance and Transportation;
- Heat and Light;
- Office Supplies;

- Postage;
- Safety Supplies;
- Consulting expenses for projects at Hydro Place;
- Security Card Maintenance Contract; and
- Return on rate base at WACC for all common assets.

3.1.5 Telephone Infrastructure (PBX) Costs

All lines of business will be charged their share of Telephone Infrastructure (PBX) Costs including long distance charges. The Local Area Network (LAN) costs provided by Network Services are divided by the total number of LAN ports to derive a cost per user. The telephone costs provided by Network Services are divided by the number of telephone, fax, and modem lines to derive a cost per telephone per user. The average number of users for each line of business will be the allocator.

3.2 Type 2 – Corporate Costs

Corporate costs incurred within various lines of business are charged to the appropriate line of business as described below.

3.2.1 Employee Labour Costs

All employees of Nalcor are required to charge time by completing time sheets which allocate labour to work orders based on activity.. The guiding principle is that where an employee spends time on specific tasks and work activities for another entity or line of business, time is to be charged at cost. Cost, or the bill rate, is defined as labour costs, fringe benefits (including time off) and other direct costs. See Appendix A for a detailed listing of the components of the bill rate.

The operating bill rates are reviewed annually and updated accordingly.

3.2.2 Overtime

Overtime will be charged according to policy and no further mark up or fixed charge is applied.

3.2.3 Time Sheets

All employees are required to complete weekly time sheets on a timely basis. All work hours must be coded to work orders in order to adequately track hours to the appropriate business unit. Time is coded in 30 minute increments.

3.2.4 Corporate Services Functions

Some of the functions and departments that share services across entities are as follows:

a) Leadership Team

Executive management provides strategic oversight and general management.

b) Legal

General Counsel's responsibilities include the provision of legal and corporate secretary services.

c) Internal Audit

The Internal Audit Department provides auditing services as determined in an annual audit plan as part of the annual update of the Five Year Internal Audit Plan.

d) Project Engineering and Technical Services

This division provides services in all engineering disciplines and covers such items as:

a) design, construction and project management;
b) engineering studies, technical specifications and construction coordination;
c) tender preparation and analysis including interaction with consultants; and
d) review and resolution of maintenance problems.

e) Environmental Services

The Environmental Services Department's activities include auditing for compliance with government regulations and corporate policy, obtaining permits and approvals for proposed programs and advising on environmental matters.

f) Labour Relations

Labour Relations provides services relating to the negotiation and administration of collective agreements, the resolution of grievances and all union/management communications.

g) Financial Planning

Investment Evaluation provides services to facilitate the production, review and distribution of annual long-term financial plans. As well, they provide long-term financial planning and analyses for various activities and scenarios.

h) Risk and Insurance

Risk and Insurance provides services related to the placement, policy and claims administration, risk control and risk financing of the corporate insurance program.

i) Finance

The Finance Department provides accounting and treasury services including external financial reporting.

j) Supply Chain Management

The Supply Chain Management department coordinates all efforts related to the procurement process activities including tendering, purchasing and contract administration.

3.2.5 Fixed Charge

In addition to labour costs, a fixed rate will be applied to each hour of regular labour charged to lines of business . The fixed charge accounts for the additional cost, beyond basic salary and benefit costs, of having an employee available to provide service. The fixed charge recovers costs originally charged in the Administration Fee as well as other employee related costs, including:..

- Telephone and fax;
- Books and subscriptions;
- Memberships and dues;
- Conferences;
- Training; and
- Employee expenses (e.g. over time meal allowance).

While most employees who provide intercompany services are located in Hydro Place, this rate will also be used as a proxy for employees working from other locations

The fixed charge rate is reviewed annually and updated accordingly.

3.2.6 Materials Costs

Materials issued from inventory will be charged at cost to the applicable line of business.

3.2.7 Vehicle Costs

Vehicles utilized across lines of business will be charged a rental rate which is based upon the type of vehicle utilized. The rental charge is calculated by multiplying the usage time by the daily or hourly rental rate for the applicable vehicle. The rental rates are updated annually.

3.2.8 Computers

Computers are charged directly to the applicable line of business.

3.2.9 Cost of Equipment

Equipment will be charged to each line of business at a cost based rate as determined and maintained by the Capital Assets Accounting department.

4.0 BILLING AND COLLECTION

Invoices for the recovery of intercompany transactions are to be issued on a monthly basis. Billings to and from related entities shall be undertaken within 30 days of the service, resource or asset being provided. Receivables between related companies are paid upon invoice receipt from a related entity. If the invoice is not paid in full within 30 days from the date of invoice, Treasury and Risk Management will calculate an intercompany interest charge. The amount of the charge will be such that there is no net financing impact on the company to which the balance is owed. Finance charges are calculated by applying a rate to the intercompany balance(s) that is equal to the cost of short-term financing for the company to which the balance is owed. If the company to which the balance is owed is Hydro, then the rate applied to such balances is the last approved Weighted Average Cost of Capital (WACC), which is currently 7.53% (2006 GRA).

APPENDIX A
OPERATING BILL RATE COMPONENTS

Components of the operating bill rate are as follows:

Salary Cost Components:

- Salaries & Temporary Salaries including the payroll code for Easeback/Return to Work
- Other Salary Costs - Retroactive Pay

Mark UP Components:

- Fringe Benefit Costs
    - Canada Pension Plan
    - Employment Insurance
    - Public Service Pension Plan
    - Group Money Purchase Plan
    - Prior Service Matched PSPP
    - Workplace Health Safety and Compensation premiums

- Insurances
    - Life Insurances
    - A D&D Insurance
    - Medical Insurance
    - Dental Insurance

- Company Costs
    - Employee Future Benefits expense
    - Payroll Taxes
    - Other Salary Costs - Bonus, Performance Contracts& Signing Bonus

- Leave
    - Training hours
    - Short term Sick Leave
    - Long Term Sick Leave
    - Medical Travel
    - Medical Appointments
    - Annual Leave
    - Floaters
    - Family Leave
    - Compassion Leave
    - Jury Duty
    - Statutory Holiday
    - Union Leave
    - Banked overtime

Appendix B – Non-regulated operations

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Non-Regulated Operations

Newfoundland and Labrador Hydro

Table of Contents

PURPOSE OF DOCUMENT

The purpose of this document is to outline the non-regulated operations within Newfoundland and Labrador Hydro (Hydro). Activities conducted by Hydro staff on behalf of other Nalcor lines of business are non-regulated and are recorded in a business unit designated as a cost recovery business unit as outlined in Section 8 below.

DEFINITION

Non-Regulated Costs Definition:

All costs associated with any asset which is not used and useful in the generation, transmission and distribution of electrical power and energy by Hydro within the Province of Newfoundland and Labrador; activities exempted by specific legislation; and costs specifically identified by the Board of Commissioners of Public Utilities) as being non-recoverable from rate payers.

LIST OF NON-REGULATED ACTIVITIES

To date, the following activities/costs have been determined to be non-regulated:

1. All activities associated with the following subsidiary companies:
    a) Churchill Falls (Labrador) Corporation Limited (Churchill Falls)
    b) Lower Churchill Development Corporation Limited (LCDC)
2. Supply of power to the Iron Ore Company of Canada (IOC)
3. Export Sales
4. Natuashish
5. Star Lake
6. Ramea Wind-Hydrogen project

7. Conservation and Demand Management - Labrador

8. Cost Recovery Business Units

9. Other Specific Non-Regulated Costs

10. Dividends

1. SUBSIDIARY COMPANIES

a) Churchill Falls

The services provided to Churchill Falls by Hydro are provided in accordance with the CF(L)Co – NLH Services Agreement dated January 1, 2010. The Agreement provides for the provision of services by Hydro to Churchill Falls and outlines the manner in which those services will be charged and paid by Churchill Falls. The agreement is outlined in Appendix A. Any employee providing services to this entity will charge their time in accordance with Nalcor's Intercompany Transaction Costing Guidelines as outlined in Exhibit 7.

b) LCDC

Although this corporation is primarily inactive[1], minimal costs such as external audit fees are being incurred and Business Unit (BU) 1953 is used to capture these costs. Any employee providing services to this entity will charge their time in accordance with Nalcor's Intercompany Transaction Costing Guidelines as outlined in Exhibit 7.

2. SUPPLY OF POWER TO THE IRON ORE COMPANY OF CANADA (IOC)

Power and energy sales to IOC is a non-regulated activity. IOC is a customer on the Labrador Interconnected system and consequently, the costs associated with this customer is derived from the Cost of Service model. Rates charged to this customer are based on a negotiated contract and are not regulated.

[1] This company is not participating in Nalcor's ongoing Lower Churchill project.

All revenues and expenses associated with this activity are captured in BU 1952 and are excluded from the determination of regulated net income. Any employee providing services to this activity will charge their time in accordance with Nalcor's Intercompany Transaction Costing Guidelines as outlined in Exhibit 7.

3. EXPORT SALES

Hydro meets the power and energy requirements for the Labrador Interconnected System primarily through an agreement with Churchill Falls. Under that agreement, Hydro purchases recall power and energy up to a maximum of 300 MW and 2,362 GWh annually. Power and energy surplus to meeting the needs of the Labrador Interconnected system is sold by Hydro to external markets.

All revenues and expenses associated with this activity are captured in BU 1950 and are excluded from the determination of regulated income. Any employee providing services to this activity will charge their time in accordance with Nalcor's Intercompany Transaction Costing Guidelines as outlined in Exhibit 7.

4. NATUASHISH

Hydro has been operating and maintaining the plant in the community of Natuashish on behalf of the Federal Government on a cost recovery basis. All costs are charged at bill rates plus overheads to ensure full cost recovery.

All revenues and expenses associated with this activity are captured in BU 1405 and are excluded from the determination of regulated income. Any employee providing services to this activity will charge their time in accordance with Nalcor's Intercompany Transaction Costing Guidelines as outlined in Exhibit 7.

5. STAR LAKE

Hydro is operating the Star Lake plant on behalf of Nalcor who is acting as an agent for the Government of Newfoundland and Labrador (Province).

All revenues and expenses associated with this activity are captured in BU 1970 and are excluded from the determination of regulated income. Any employee providing services to this activity will charge their time in accordance with Nalcor's Intercompany Transaction Costing Guidelines as outlined in Exhibit 7.

6. RAMEA PROJECT

In accordance with Board Order No. P.U. 31 (2007), no costs associated with the construction of a wind-hydrogen diesel generation project at Ramea will be borne by rate payers in the implementation, operation or abandonment of the facility. All expenses associated with this activity are captured in BU 1406 and are excluded from the determination of regulated income. Any employee providing services to this activity will charge their time in accordance with Nalcor's Intercompany Transaction Costing Guidelines as outlined in Exhibit 7.

7. CONSERVATION DEMAND MANAGEMENT

In accordance with P.U. 7 (2008), Hydro and Newfoundland Power will undertake energy conservation initiatives. All expenses associated with this activity in Labrador West are captured in BU 1949 and are excluded from the determination of regulated income. Employees providing services to this activity will charge their time in accordance with Nalcor's Intercompany Transaction Costing Guidelines as outlined in Exhibit 7.

8. COST RECOVERY BUSINESS UNITS

Hydro maintains a number of cost recovery business units to capture costs incurred by Hydro personnel on behalf of other lines of business. These costs are billed on a monthly basis to the lines of business and are excluded from the determination of regulated income. Any employee providing services to these business units will charge their time in accordance with Nalcor's Intercompany Transaction Costing Guidelines as outlined in Exhibit 7.

9. OTHER SPECIFIC NON-REGULATED COSTS

From time to time, costs related to the Hydro legal entity are incurred but are not charged to regulated customers. These costs are recorded in BU 1955 and include the following:

a) <u>Contributions and Donations</u>

Expenditures for charitable donations, community and charitable advertisements, street light subsidy and scholarships are not considered to be regulated expenses.

b) <u>Advertising</u>

Regulated advertising expenses are limited to matters relating to conservation, safety and consumer information. Advertising for corporate image building is not a regulated expense.

c) <u>Companion Travel Costs</u>

On occasion, management approves the cost of a Hydro employee's companion attending a corporate function. These costs are not considered regulated expenses.

d) <u>Bad Debt Expense</u>

Bad debt expenses incurred for uncommon reasons may be designated as non-recoverable and are excluded from the determination of regulated income.

10. DIVIDENDS

On a monthly basis, net cash associated with non-regulated activities, with the exception of items in Sections 6 through 9 of this policy, are paid to Nalcor as a dividend. Any residual amounts that are not subject to the dividend policy are retained within the Hydro legal entity but are reported as non-regulated costs.

Appendix C - Other costs and allocations

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Item	Allocation Method
Advertising expenses administered by Nalcor	Allocated
Audit expenses	Direct billed
Bonus, performance contracts and signing bonuses	Bill rate
Branding costs administered by Nalcor	Not charged
Capital costs of Hydro Place emergency diesel power system	Admin Fee
Capital costs of Printers and fax machines	Admin Fee
Cell phone expenses	Direct billed
Consultant costs associated with building	Admin Fee
Corporate memberships	Allocated
Cost of postage machines	Admin Fee
Directors expenses	Not charged
Directors fees	Direct billed
Equipment for fitness centre and cafeteria	Admin Fee
Freight and courier expenses	Direct billed
Group insurance – Administration costs	Admin Fee
Group insurance – premiums	Direct billed
Heat & light expenses	Admin Fee
Insurance expenses	Direct billed or allocated as per industry standard
Local Area Network (LAN) expenses	Admin Fee
Long distance expenses	Admin Fee
Nalcor annual report and annual general meeting expenses	Allocated across lines of business
Office equipment and maintenance expenses	Admin Fee

Item	Allocation Method
Operating costs of Fitness centre, cafeteria, Day care – operating costs	Not allocated
Operating costs of Hydro Place emergency diesel power system	Not allocated
Postage expenses	Admin Fee
Print forms and supplies	Admin Fee
Purchase of miscellaneous office furniture	Admin Fee
Rewards and recognition expenses	Admin Fee
Routers, Multiplexor (MUX), Switches acquisition costs	Admin Fee
Safety supply expenses	Admin Fee
Security system acquisition costs	Admin Fee
Security system maintenance expenses	Admin Fee
Telephone expenses	Admin Fee
Telephone, LAN and wireless network acquisition costs	Admin Fee
Treasury related fees	Direct billed
Wellness Program expenses	Admin Fee
Wireless network expenses	Not allocated

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