

1 Q. **2013 General Rate Application, Intercompany Charges and Shared Services**

2 What factors, in Hydro's opinion, should the Board consider in determining that
3 there is no subsidization of the non-regulated operations of Nalcor by Hydro's
4 regulated operations?

5

6

7 A. There are a number of factors that the Board should consider in determining that
8 there is no subsidization of the non-regulated operations of the Nalcor Group of
9 Companies by Hydro's regulated operations. These include, in general, the
10 following:

11

12 • Whether there is an appropriate intercompany costing policy in place which
13 both meets the mandate of the Company, as well as the regulatory oversight
14 requirements of the Board;

15

16 • Whether intercompany guidelines, procedures and practices are in place and
17 will accomplish the goals of the intercompany policy;

18

19 • Whether guidelines, procedures and practices are further reflected in proper
20 allocation factors and billing rates, as well as systematic time reporting and
21 comprehensive charging to appropriate entities; and

22

23 • Reviewing periodic reporting of intercompany costs and reviewing
24 intercompany transactions.

1 Independent third party review can give the Board some assurance of the above
2 and, in particular in the case at hand, that there is no subsidization of the non-
3 regulated operations of the Nalcor Group of Companies by Hydro's regulated
4 operations. In this regard, there have been a number of independent reviews of
5 intercompany costing that have been completed since the formation of the Nalcor
6 Group of Companies. In its June 6th, 2012 report, "Nalcor Intercompany Review",
7 Deloitte concluded as follows:

8
9 *Based on our review, the methodologies and practices adopted by Nalcor are*
10 *fair and reasonable and in line with other utilities. Nalcor through its*
11 *philosophy of provision of shared service through all affiliates, with a*
12 *concentration in two main lines of business reflects a commitment to getting*
13 *the full benefits of economies of scale.*

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

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

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

A review conducted by Grant Thornton at the request of the Board, and a report “Review of Intercompany Transactions – 2008 to 2010, Financial Consultants Report” October 9th, 2012 was issued. The scope of the review consisted of the following:

- *Review the intercompany charges / cost allocations for the time period 2008 – 2010.*
- *Review the organizational structure of Nalcor, including the responsibilities of the leadership team and those employees that report to them.*
- *Review the methodology used for intercompany charges / cost allocations since 2008. Test a sample of the calculations based on the methodology to ensure it is applied consistently.*
- *Obtain details of the intercompany transactions to / from Hydro relating to the following subsidiaries:*
 - *Churchill Falls (Labrador) Corporation*
 - *Lower Churchill Development Corporation*
 - *Gull Island Power Company Limited*
- *Obtain details of the cost allocations to / from the regulations of Hydro relating to the non regulatory business units, including:*
 - *Nalcor Energy*
 - *Lower Churchill Project*
 - *Oil and Gas*
 - *Bull Arm Site*
- *Obtain details of the cost allocations to / from the regulated operations of Hydro relating to the non regulatory business units, including:*
 - *Export Sales*
 - *Supply of Power to Iron Ore Company of Canada*

- *Natuashish*
- *Menihek*
- *Review any studies completed by Hydro on its labour costing related to its billing rates.*
- *Provide a comparison, where possible, of how Hydro's billing rates for labour relating to intercompany transactions / cost allocations compares to Newfoundland Power.*

In its conclusion, Grant Thornton did highlight a difference in the corporate structure of Nalcor and Fortis and recommended the Board consider whether a cost recovery basis or market basis is appropriate, however, no other discrepancies were noted. A copy of the Grant Thornton report is attached as PUB-NLH-140, Attachment 1.

Grant Thornton also completes an annual review of Hydro, the scope of which includes a review of both Non-Regulated Activity and Cost Allocations. In its most recent published report "2011 Annual Financial Review of Newfoundland and Labrador", filed in response to CA-NLH-097, the following conclusions were stated:

Non-Regulated Activity

Scope: Review Hydro's non-regulated activity and assess the reasonableness of adjustments in the calculation of regulated earnings and review how costs are allocated between regulated and non-regulated operations.

Conclusion: Based upon our review and analysis, nothing has come to Hydro's attention to indicate that the amounts reported as non-regulated expenses, as summarized above, are unreasonable or not in accordance with Board Orders.

1 Costs Allocations

2 *Scope: Review how costs are allocated between the regulated and non-regulated*
3 *operations including a review of Hydro's labour costing relating to its billing rates.*

4

5 Conclusion: As a result of completing Hydro's procedures, no significant
6 discrepancies were noted with the exception of the executive group as noted
7 above¹. Therefore, Hydro reports that cost allocations for 2011 are in accordance
8 with its methodology.

¹ Grant Thornton noted at page 57 that "The operating bill rate of 57% is applied to the group dollar value to arrive at an operating bill rate for the group. This process is followed to protect the confidentiality of executive leadership salaries. As there are significant differences in executive pay, the variable component percentage varied significantly from the proxy of 57%."



Grant Thornton

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Board of Commissioners of Public Utilities Newfoundland and Labrador Hydro

Review of Intercompany Transactions – 2008 to 2010
Financial Consultants Report

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Introduction and Scope

Nalcor Energy ("Nalcor") was created in late 2007 as part of the Government of Newfoundland and Labrador's Energy Plan to manage its energy resources. As part of a corporate restructure in 2008 Nalcor became the parent company of Newfoundland and Labrador Hydro ("Hydro") ("the Company"), Nalcor Energy – Oil and Gas Inc. ("Oil and Gas") and Nalcor Energy - Bull Arm Fabrication Inc. ("Bull Arm"). In 2010, Gull Island Power Corporation ("GIPCo") became its fourth wholly owned subsidiary as part of a further corporate restructure. In addition, Hydro holds investments in two entities: 65.8% of Churchill Falls (Labrador) Corporation ("CF (L) Co") and 51% of Lower Churchill Development Corporation ("LCDC"). Churchill Falls holds a 33.3% investment in Twin Falls Power Corporation ("Twin Falls"). Appendix A presents the current organizational structure of Nalcor Energy:

Along with the reorganization, certain activities and oversight roles were transferred to Nalcor. As a consequence, various services are shared for key functions across the various lines of business of Nalcor. The Board of Commissioners of Public Utilities ("the Board") has requested that we undertake a review of intercompany transactions over the period 2008 to 2010 in order to determine how intercompany charges/cost are allocated between shared services.

The scope of our review consisted of the following:

- Review the intercompany charges/cost allocations for the time period 2008 – 2010.
- Review of organizational structure of Nalcor, including the responsibilities of the leadership team and those employees that report to them.
- Review the methodology used for intercompany charges/cost allocations since 2008. Test a sample of the calculations based on the methodology to ensure it is applied consistently.
- Obtain details of the intercompany transactions to/ from Hydro relating to the following subsidiaries:
 - Churchill Falls (Labrador) Corporation
 - Lower Churchill Development Corporation
 - Gull Island Power Company Limited
- Obtain details of the cost allocations to/ from the regulated operations of Hydro relating to the other divisions/business units of Nalcor Energy, including:
 - Nalcor Energy
 - Lower Churchill Project
 - Oil and Gas
 - Bull Arm Site
- Obtain details of the cost allocations to/ from the regulated operations of Hydro relating to the non regulatory business units, including:
 - Export Sales
 - Supply of Power to Iron Ore Company of Canada
 - Natuashish
 - Menihek
- Review any studies completed by Hydro on its labour costing relating to its billing rates.
- Provide a comparison, where possible, of how Hydro's billing rates for labour relating to intercompany transactions/cost allocations compares to Newfoundland Power.
- Prepare a report of our observations and findings.

- 1 The procedures undertaken in the course of our financial review did not constitute an audit of the
- 2 Company's financial information, and consequently we have not expressed an audit opinion on the
- 3 financial information provided by the Company.
- 4

Summary of Intercompany Transactions – 2008 to 2010

The following table provides a summary and comparison of the regulated and non regulated intercompany transactions to and from Nalcor from 2008 to 2010:

Intercompany Transactions (Nalcor)	Actual 2010	Actual 2009	Actual 2008	Variance 2010-2009
<u>Charges from Nalcor to Hydro</u>				
Regulated - Salaries and overtime	\$ 1,668,877	\$ 1,123,812	\$ 1,296,307	\$ 545,065
Non regulated - Salaries and overtime	218,863	20,690	-	198,173
Total	\$ 1,887,740	\$ 1,144,502	\$ 1,296,307	\$ 743,238
Year over year percentage change	65%	-12%		
<u>Charges to Nalcor from Hydro</u>				
Regulated - Salaries and overtime	\$ 465,062	\$ 310,623	\$ 66,392	\$ 154,439
Non regulated - Salaries and overtime	5,118	10,252	-	(5,134)
Total	\$ 470,180	\$ 320,875	\$ 66,392	\$ 149,305
Year over year percentage change	47%	383%		

The increase in salaries and overtime charged from Nalcor to regulated operations in 2010 compared to 2009 of \$545,065 is the result of the following items:

- An increase of \$146,499 is the result of the transfer of managers to Nalcor. According to the Company, Nalcor has adopted a matrix organizational structure whereby certain functions and personnel provide service across lines of business and having managers reside in Nalcor fits with this structure. Managers are able to track and code their time in accordance with work activities to ensure that costs are charged to the appropriate line of business. The labour cost recoveries are based on salary rates plus benefits/ leaves plus an amount to recover office related costs associated with an employee. Labour cost allocations are discussed in more detail further in our report;
- An increase of \$130,880 is due to hiring additional staff dedicated to regulated Hydro but having the positions reside in Nalcor. According to Hydro, there is now a dedicated controller and dedicated analyst for regulated Hydro that is based in Nalcor but their time is charged to Hydro. Both are Nalcor positions with one hired in Nalcor in May 2009 and the other in early 2010;
- An increase of \$127,638 is primarily relating to an increase in billing rates in the executives' salaries charged to regulated Hydro;
- An increase of \$36,196 is due to the number of internal audits scheduled by the internal audit department. According to Hydro, since audits are assigned by the level of risk, fluctuations from year to year are expected depending on the audits undertaken each year for the various lines of business; and,

- 1 • An increase of \$24,352 is due to an increase in financial/ budget analysts. According to Hydro,
2 this was a result of increased analysis and sensitivities required on the long-term models for
3 generation expansion and the long term financial plan for Hydro.
4
- 5 The increase in salaries and overtime charged to Nalcor from Hydro regulated operations in 2010
6 compared to 2009 of \$154,439 relates primarily to the following:
- 7 • \$69,172 is due to an increase in Hydro finance staff working on Nalcor activities;
8 • \$15,580 is due to an increase in work performed by Hydro staff on activities that were
9 considered new business activities in Nalcor;
10 • \$15,945 is due to an increase in charges by Hydro staff on branding activities for Nalcor; and
11 • \$44,007 is the result of an increase in Hydro staff working on Exploits related activity in
12 connection with the assets previously owned by Abitibi Bowater in Grand Falls-Windsor.
13

1 The following table provides a summary and comparison of the regulated intercompany transactions
2 to and from other Nalcor entities or lines of business from 2008 to 2010:
3

Intercompany Transactions (Other - Regulated)	Actual 2010	Actual 2009	Actual 2008	Variance 2010-2009
Charges to Churchill Falls - Operating Projects from Hydro (Notes 1 and 2)				
Salaries	\$ 313,972	\$ 249,219	\$ 74,191	\$ 64,753
Overtime	93,908	91,885	39,170	2,023
	<u>\$ 407,880</u>	<u>\$ 341,104</u>	<u>\$ 113,361</u>	<u>\$ 66,776</u>
Year over year percentage change	19.6%	200.9%		
Charges from Churchill Falls - Operating Projects to Hydro				
Salaries	\$ -	\$ -	\$ 1,292	\$ -
Year over year percentage change	-	-100.0%		
Charges to Oil and Gas from Hydro (Notes 1 and 3)				
Salaries	\$ 125,254	\$ 33,895	\$ 12,226	\$ 91,359
Overtime	4,744	7,043	797	(2,299)
	<u>\$ 129,998</u>	<u>\$ 40,938</u>	<u>\$ 13,023</u>	<u>\$ 89,060</u>
Year over year percentage change	217.5%	214.4%		

Note 1: When Hydro employees perform services for CF (L) Co. or other Nalcor entities, the costs are captured in a cost recovery business unit that is a non regulated business unit and billed out to the appropriate entity. The result is that the costs are moved from regulated Hydro to the non regulated billing business unit and then recovered from CF (L) Co. or other Nalcor entity.

Note 2: Churchill Falls - Operating Projects includes the Lower Churchill Project. Prior to 2009, Lower Churchill Project was a non-regulated business unit in Hydro. It was transferred to Nalcor Energy during 2009.

Note 3: Charges to Oil and Gas are recorded in the entity 'Nalcor Energy - Oil and Gas Inc.'.

4
5 The increase in salaries and overtime charged to oil and gas from regulated operations in 2010
6 compared to 2009 of \$89,060 relates primarily to an increase in supply chain management salaries of
7 \$69,373 and controllers department salaries of \$25,511. According to Hydro, these increases were
8 necessary to meet the requirements of the Oil and Gas line of business.
9

1 The following table provides a summary and comparison of the regulated intercompany transactions to
2 and from other Nalcor entities or lines of business from 2008 to 2010
3

Intercompany Transactions (Other - Regulated) Continued	Actual 2010	Actual 2009	Actual 2008	Variance 2010-2009
Charges to CF (L) Co from Hydro (Note 1)				
Salaries	\$ 647,262	\$ 640,960	\$ 633,276	\$ 6,302
Overtime	33,438	40,829	37,327	(7,391)
Travel	17,806	11,224	10,237	6,582
Other	509	2,830	416	(2,321)
	<u>\$ 699,015</u>	<u>\$ 695,843</u>	<u>\$ 681,256</u>	<u>\$ 3,172</u>
Year over year percentage change	0.5%	2.1%		
Charges from CF (L) Co to Hydro				
Salaries	\$ 16,553	\$ 28,294	\$ 11,813	\$ (11,741)
Overtime	9,457	17,043	11,130	(7,586)
	<u>\$ 26,010</u>	<u>\$ 45,337</u>	<u>\$ 22,943</u>	<u>\$ (19,327)</u>
Year over year percentage change	-42.6%	97.6%		
Charges to Bull Arm from Hydro (Notes 1 and 2)				
Salaries	\$ 46,547	\$ 61,597	\$ 26,135	\$ (15,050)
Overtime	3,102	13,056	336	(9,954)
	<u>\$ 49,649</u>	<u>\$ 74,653</u>	<u>\$ 26,471</u>	<u>\$ (25,004)</u>
Year over year percentage change	-33.5%	182.0%		
Charges from Bull Arm to Hydro (Note 2)				
Salaries	\$ -	\$ 760	\$ -	\$ (760)
Overtime	-	1,887	-	(1,887)
	<u>\$ -</u>	<u>\$ 2,647</u>	<u>\$ -</u>	<u>\$ (2,647)</u>

Note 1: When Hydro employees perform services for CF (L) Co. or other Nalcor entities, the costs are captured in a cost recovery business unit that is a non regulated business unit and billed out to the appropriate entity. The result is that the costs are moved from regulated Hydro to the non regulated billing business unit and then recovered from CF (L) Co. or other Nalcor entity.

Note 2: Charges from and to Bull Arm are recorded in the entity 'Nalcor Energy - Bull Arm Fabrication Inc.'

- 1 The following table provides a summary of non-regulated intercompany salary and overtime
2 transactions from 2008 to 2010 from Hydro regulated operations and other Nalcor entities:

**By Non-Regulated Business Unit
(labour charges)**

	Actual 2010	Actual 2009	Actual 2008	Variance 2010-2009
Regulated Hydro to Non-Regulated				
Natuashish	\$ 119,480	\$ 213,392	\$ 174,528	\$ (93,912)
Natuashish Operating Projects	-	40,554	-	(40,554)
Energy Conservation Labrador	6,662	-	-	6,662
Export Sales Operations	117,994	59,530	-	58,464
IOC Sales Operations	7,137	4,404	-	2,733
Menihek	211,775	129,670	375,732	82,105
Other non-regulated costs	1,364	35,169	115,988	(33,805)
	<u>\$ 464,412</u>	<u>\$ 482,719</u>	<u>\$ 666,248</u>	<u>\$ (18,307)</u>
Other Nalcor Entities to Non-regulated				
Natuashish	\$ 3,088	\$ 2,962	\$ 130	\$ 126
Export Sales Operations	170,523	15,274	-	155,249
Menihek	-	6,723	-	(6,723)
Other non-regulated costs	25,367	-	-	25,367
	<u>\$ 198,978</u>	<u>\$ 24,959</u>	<u>\$ 130</u>	<u>\$ 174,019</u>

- 3
4 The decreased charge to Natuashish from regulated operations in 2010 compared to 2009 relates
5 primarily to more staff based in the Natuashish business unit in 2010 resulting in a reduction in labor
6 charged in from regulated during 2010.
7
8 According to Hydro, work on Natuashish Operating Projects and Menihek can vary depending on
9 maintenance projects.
10
11 The increased charge to export sales operations from regulated operations in 2010 compared to 2009
12 primarily relates to a rates analyst dedicated to energy marketing from regulated operations.
13
14 The decreased charge to other non-regulated costs from regulated operations in 2010 compared to
15 2009 is primarily due to costs recorded in Nalcor in 2010 but recorded in the non-regulated costs
16 business unit in 2009. The 2009 costs primarily related to charges from a senior legal counsel, a
17 manager of Health and Safety, and a supervisor in Treasury.
18

Labour Cost Allocations

We reviewed Hydro's methodology for the years 2008 to 2010 relating to the procedures the Company had in place to allocate labour costs between regulated and non-regulated operations, and between Nalcor companies given the corporate restructuring in 2008.

In 2008, the *Intercompany Salaries* account was added as a result of the expansion of Nalcor and the restructuring of some employees into Nalcor from Hydro. The account is used to record salary costs for employees working within different companies and business units. During 2009 the Company started the process of reviewing all bill rates as it was recognized that some inconsistencies existed in the calculation of rates being used.

According to the Company, it is critical that Nalcor's:

- billing rates are accurate, and
- the labour pool is charging time to correct entities.

We address each of these matters below.

Labour Cost Studies and Billing Rates

Hydro's billing rates are determined on a cost recovery basis designed to cover salary, benefits and vacation and do not incorporate any profit margin (with the exception of external billing rates). Hydro's billing rates were developed to include a base wage amount (hourly wage), a variable component and a fixed charge. The billing rate is derived from a base wage amount and a variable component. The fixed charge is a separate charge based on each hour billed.

Variable component

The following costs were included in the analysis to determine the variable component:

Benefits

- Fringe benefit costs, e.g. CPP, Public Service Pension Plan.
- Insurances, e.g. life, medical, dental.
- Company costs, e.g. WHSCC, Employee future benefits.
- Miscellaneous, e.g. Statutory allowances, all shift differential pays, standby allowance.

Leaves

- Annual leave, medical, sick leave.

In 2009, 2010 and 2011, Hydro completed a review of its labour costing relating to its billing rates. The review prepared by Hydro was based on Hydro's average costs over a rolling three year period from 2006 to 2008 in 2009, from 2007 to 2009 in 2010 and from 2008 to 2010 in 2011 and incorporated all costs of an employee, including salaries, fringe benefits, leaves/vacation and employee related expenses. The analysis completed by the Company determined an average variable component over each of the three year periods of approximately 57% of base wage (actual was 58.5% for 2007, 57.9% for 2008, 55.6% for 2009 and 59.0% for 2010).

Of the 57% variable component, 35% was attributable to the cost of benefits and the remaining 22% was cost of leaves.

Effective October 1, 2009 new billing rates were implemented for all employees based on the labour cost study proxy amount of 57%. The proxy amount was applied to a band (or group) of pay scales for both non-union and union employees, resulting in an average bill rate for each group for the period October to December 2009. Effective January 2010 the 57% proxy was applied to the top of the scale of each band for non-union employees and applied to the hourly rate for union employees.

In completing our procedures, we reviewed the analyses prepared by Hydro related to the variable component of the billing rates for accuracy, and agreed the analysis to general ledger accounts where appropriate. We did not note any discrepancies.

Fixed Charge

Effective October 1, 2009 the Company included a fixed charge for time charged to entities. The fixed charge was determined to be \$80 per day for all employees, or \$10.67 hour based on a 7.5 hour day. The fixed charge component included the following costs in its analysis:

- *Hydro Place costs* e.g. heat & light, insurance, maintenance, reception, depreciation and interest.
- *Common Services* e.g. IT services such as software, servers & help desk, HR services such as payroll, recruitment, health, safety.
- *Employee related costs* e.g. telephone & fax, books & subscriptions, training.

The proportionate of total costs relative to the \$80 per day fixed charge was 40% for Hydro place, 39% for common services and 21% for employee related costs. The fixed charge provides a mechanism to recover each employee's common service and employee related costs based on hours worked on a different line of business from the entity the employee is employed. Common service cost allocations to the various lines of business of Nalcor are addressed further in our report.

The fixed charge for Hydro is recorded in business unit # 2003 NLH Controller Dept under Account #7141 'Fixed charge / (Recovery)', and is grouped under cost recoveries and includes both charges to and from inter-companies. The following table provides a summary of the fixed charge recovery for 2008 to 2010:

	Actual 2010	Actual 2009	Actual 2008	Variance 2010-2009
Fixed Charge / (Recovery)	\$ (215,636)	\$ (1,702)	\$ -	\$ (213,934)

This indicates there was more intercompany Hydro staff hours (at \$10.67 per hour) charged to Nalcor entities/lines of business in 2010 than Nalcor entities staff hours charged to Hydro.

Charges for external billings do incorporate a profit margin. According to Hydro, in 2010 external billings are based on markup of 57% on wage rates (CF (L) Co is 80%), fixed charge of \$80/day and a 25% profit margin. In addition, current agreements will be grandfathered (i.e. where contracts have defined rates or arrangements were made prior to the policy in April 2010, the old rates would apply) and variances from the application of this policy will require the approval of the Head of Line of Business and CFO (or designate) approval.

Charging to Correct Entities

In order to ensure labour costing is charged to correct entities, Nalcor implemented a new mandatory timesheet policy for all employees. The previous policy on timesheets varied across business units and was not mandatory for employees. As part of its implementation plan, timesheet preparation guidelines were provided to staff and a policy / guideline developed. According to Hydro, the time sheet policy / guidelines are as follows:

All Nalcor employees (except CF (L) Co employees) are to prepare weekly time sheets and code all paid hours (i.e. 37.5 or 40 per week) to a work order or to leave. Mandatory and prompt time sheet reporting for all Hydro Place employees was implemented effective Monday, April 19, 2010 (March 2011 outside Hydro Place). Previously, many employees were required to record exceptional time only (leaves, overtime and charge-out hours). On a go forward basis all employees are required to record all time to a work order or as leave. Employees are responsible to record the 37.5 or 40 hour work week, plus any additional overtime and/or premiums. Time sheets are to be completed and submitted no later than the following week.

We selected a sample of employees from the detailed intercompany salary accounts in 2009 and 2010 including samples for charges from Nalcor Energy to Hydro and to various business units from Hydro. The selection of samples included both executive and non-executive employees.

Our procedures included:

- Agreeing hours charged to timecards.
- Agreeing the billing rate to schedule of billing rates provided by Hydro.
- Recalculation of the billing charge in the general ledger as based on the billing rate and hours.
- Assess the reasonableness of the new billing rate(s) applied in comparison to the proxy 57% variable component.

For the 2009 testing, the proxy percentage from the base rate was not expected to be precisely 57% as billing rates were applied to pay scale groups and not to each staff members' individual hourly rate. As a result, there was a range of percentages depending on where the employee was paid within the pay scale. However, a proxy amount of approximately 57% was expected and we noted no exceptions in our testing except within certain executive billing rates which is discussed further below.

For the 2010 testing, the proxy percentage from the base rate was not expected to be precisely 57% for non-union employees as billing rates were applied to the top of the scale. As a result, the variable component was skewed depending on where the non-union employee was paid within the pay scale. However, we did not note any discrepancies in the Company's methodology with all non-executive employees sampled within the expected range of 57% variable component.

For the executive, we noted certain executive billing rates where there were variations from the expected 57% variable component. According to Hydro, the executive leadership team pay scales fall into 1 of 4 groups for billing purposes based upon their actual salary. Depending upon the executive position the incumbent is filling, they would be in one of those pay grades, and there would be a corresponding bill rate calculated by dividing the pay grade by 1950 hours times 1.57. This process is followed to protect the confidentiality of executive leadership salaries. As there are significant differences in executive pay, the variable component percentage varied significantly from the proxy of 57%.

Common Service Costs Allocation

As previously indicated in the report, certain departments based in Hydro provide common services to various lines of business of Nalcor. Hydro recovers costs incurred related to these common services through an administration fee. According to Hydro, the first time there was an allocation of costs from regulated Hydro operations to another line of business other than to CF (L) Co. was in 2006 when the “New Business” department was set up in Hydro.

The following table provides a summary of the intercompany administration fee and cost recoveries charged in Hydro to Nalcor various lines of business and CF (L) Co. for 2008 to 2010:

Cost Recoveries	Actual 2010	Actual 2009	Actual 2008	2010-2009
<u>Intercompany Administration Fee</u>				
Regulated recovery	\$ (1,537,108)	\$ (995,887)	\$ (106,204)	\$ (541,221)
Non-regulated expense	7,669	25,658	9,540	(17,989)
	<u>\$ (1,529,439)</u>	<u>\$ (970,229)</u>	<u>\$ (96,664)</u>	<u>\$ (559,210)</u>
<u>Cost recovery</u>				
CF (L) Co.	<u>\$ (1,550,963)</u>	<u>\$ (1,170,616)</u>	<u>\$ (1,156,340)</u>	<u>\$ (380,347)</u>

The primary reason for the increase in the intercompany administration fee and CF (L) Co. cost recovery in 2010 relates to the change in the intercompany allocation methodology introduced in the fall of 2009 whereby certain business units were designated as “common service” business units. The costs of specified business units (e.g. Human Resources, Safety and Health and Information Systems) are allocated across the lines of business / business activity. (Prior to this, a fixed cost allocation and labor related costs only based on time spent working for a particular entity were charged whereas under the current methodology all costs incurred in these business units are recovered). According to the Company, this distinction was made based on the fact that the function of these business units was considered to benefit all lines of business and it is not practical to allocate time via time recording e.g. help desk phone calls. The implication of such a change is that all costs of these common service business units are now shared across the lines of business based on an appropriate allocator such as FTEs. This change in methodology was also applied to CF (L) Co. cost recoveries for 2010 pursuant to a services agreement discussed in more detail further in our report. Prior to the change in the methodology in 2009, there were estimates of costs of providing services for Human Resources, Safety and Health and accounting allocated per FTE or number of users in the lines of business.

The labour costs relating to the staff that work in the common service business units are not charged to the other entities/lines of business since these costs are included in the administration fee calculation.

Note 1: The total 2010 cost recovery from CF (L) Co. also includes other cost recoveries of \$110,228 in addition to the administration common cost allocation of \$1,440,735.

Note 2: According to the Company, 2009 Hydro regulated common costs allocation is not available as 2010 was the first year there were designated common service business units.

The following table provides a breakdown of costs by department /costs for 2010 and 2009:

Note 1: Nalcor Entities is comprised of Nalcor entities as described in the previous table.

7
8 The 2009 accounting costs related to an allocation of costs for payables processing to non-regulated
9 lines of business. In 2010, employees began coding their time by entity in accordance with the
10 mandatory time sheet policy.

According to Hydro, the department/cost included in the determination of the administrative fee charged, along with the allocation basis, is summarized in the following table:

Department/ Costs	Allocation Basis
Human Resources	FTE
Safety and Health	FTE
Information Systems	# of Users
Office space and related costs	Square footage
Telephone and LAN costs	# of Users

We address each of the departments/costs allocations in turn.

Human Resources

The Human Resources department is responsible for the administration and coordination of all employee related services. Operating costs incurred in providing Human Resources services are allocated to the lines of business based on a per full time equivalent ("FTE") basis. According to Hydro, payroll taxes are excluded from the allocation and are included as part of the bill rate to ensure Hydro recovers the payroll tax associated with a Hydro employee doing work for another line of business. In 2010 the cost per FTE allocated to lines of business for Human Resources was \$1,163 per FTE.

Safety and Health

The Safety and Health department is responsible for occupational health services including coordinating corporate efforts with regard to employee safety, 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 a per FTE basis. In 2010 the cost per FTE allocated to lines of business for Safety and Health was \$654 per FTE.

Information Systems

The Information Systems ("IS") department is responsible for providing assistance and support in the areas of Software Applications, Planning and Integration and Business Solutions, maintenance and administration of the corporate wide computer infrastructure and network and provides technical support. Operating costs incurred in providing IS services are allocated to the lines of business on a per user basis. Depreciation expense and a return on rate base at the weighted average cost of capital ("WACC") for costs capitalized such as servers, iSeries server and software are allocated to each line of business on an average user basis. Software charges specific to Hydro are removed from the total amount of costs allocated. In 2010 the cost per user allocated to lines of business for IS was \$3,644 per user.

1 Office Space

2
3 Each line of business occupying floor space at Hydro Place is charged a rental charge. The square
4 footage rental rate reflects the average annual capital and operating cost for Hydro Place as determined
5 by the following formula:

6
7
$$\text{Rental Rate} = \text{Hydro Place operating costs} + \text{return on rate base} + \text{annual depreciation} /$$

8
$$(\text{divided by}) \text{Hydro Place total square footage.}$$

9

10 According to Hydro, the cost based rate includes the following expenses for Hydro Place:

- 11 • Annual depreciation for all common assets.
12 • Network services equipment.
13 • System Equipment Maintenance.
14 • Expenses relating to salaries, fringe benefits, group insurance and employee future benefits for
15 Office Services, Building Maintenance and Transportation.
16 • Heat & Light.
17 • Office Supplies.
18 • Postage.
19 • Safety Supplies.
20 • Any consulting expenses related to Hydro Place maintenance.
21 • Security Card Maintenance Contract.
22 • Return on Rate base at WACC for all common assets.

23
24 A cost based rate was first implemented by Hydro in 2011 at a cost per square footage rental rate of
25 \$26.56. Prior to 2011, the office space rent was allocated based on market rates per square footage.
26

27 Telephone Infrastructure (PBX) Costs

28
29 All lines of business are charged a share of Telephone Infrastructure (PBX) costs including long
30 distance charges. The Local Area Network (LAN) costs provided by Network Services are divided by
31 the total number of LAN ports to derive a cost per user. The telephone costs provided by Network
32 Services are divided by the number of telephone, fax, and modem lines to derive a cost per telephone
33 per user. The average number of users is the factor used for the allocated costs per line of business.
34

35 In 2010 the cost per user allocated to lines of business for telephone costs was \$298 per user and for
36 LAN costs was \$198 per user.
37

38 The 2010 allocations for Human Resource, Safety and Health, and Information Systems are based on
39 actual costs and would therefore be 'trued up' at year end. However, the PBX and LAN allocations are
40 based on budget costs and there is no 'true up' adjustment on these allocations to reflect actual costs.
41 The office space rental charge would be based on a cost recovery rate set for the year.
42

43 In completing our procedures, we requested the Company's supporting calculation of its intercompany
44 administration fees charged to each line of business for 2010. Our procedures included a recalculation
45 of administration fee charged to each line of business based on the allocation basis included in the table
46 above and agreed the costs included in the allocation base to the Company's general ledger where
47 appropriate. We did not note any discrepancies.
48

Non-Regulated Costs Allocation

All non-regulated operations are reported in separate business units, and if applicable, work orders are used in order to enable tracking of costs. Intercompany salary and benefits charged to and from Nalcor Energy and its subsidiaries are captured in the JD Edwards integrated suite of applications and a Lotus Notes Time Reporting application. These costs are recharged through the cost account '6014 - intercompany salaries' in the appropriate business units, consistent with Nalcor's intercompany transaction costing methodology as discussed above.

The following is a summary of non-regulated activities/costs /business units of the Company:

Subsidiaries

- Churchill Falls (Labrador) Corporation - BU#1958. Services from Hydro to CF (L) Co are rendered according to a services agreement dated January 1, 2010. According to the services agreement, all costs are charged according to Hydro's bill rates, fixed charge rate and an allocation of its intercompany administration fee on an appropriate basis. This is consistent with Nalcor's intercompany transaction costing methodology as discussed above. In addition, prior to December 15 each calendar year, Hydro will provide a list of services to be provided, as well as an estimate of costs to be recovered through monthly billing. Billings are adjusted after actual costs for the year have been determined to the satisfaction of both parties.
- Lower Churchill Development Corporation Limited –BU#1953. This corporation is mainly inactive and there were no charges to or from Hydro in 2008, 2009 or 2010.
- Gull Island Power Company Limited – BU# 1954. The corporation is mainly inactive. As discussed above, GIPco was transferred to Nalcor in 2010 as part of a corporate restructure. There were no charges to or from Hydro in 2008, 2009 or 2010.

Business units in Hydro

- Export Sales – BU# 1950. Hydro purchases recall power and energy through an agreement with Churchill Falls. Surplus power is sold by Hydro to external markets. Systems Operations allocates the power purchase costs. All revenue and expenses are captured in Business Unit (BU) 1950 and excluded from regulated income.
- Supply of Power to the Iron Ore Company of Canada (IOC) – BU#1952. The portion of costs associated with IOC is derived from the Cost-of-Service on the Labrador Interconnected system. Rates charged are based on a negotiated contract which is not approved by the Board. All revenues and expenses are captured in BU 1952 and excluded from regulated income. Any employee providing services to this activity will charge their time in accordance with Nalcor's intercompany transaction costing methodology as discussed above.
- Natuashish – BU#1405. This business unit was established to track costs associated with 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. Any employee providing services to this activity will charge their time in accordance with Nalcor's intercompany transaction costing methodology as discussed above.

- 1 • Menihék – BU#1960. This business unit was established to capture revenues and costs associated
2 with the power purchase agreement with Hydro-Quebec to supply electricity to three communities
3 in Quebec, relating to Hydro's Menihék Generating station.
4
- 5 • Star Lake – BU#1970. Hydro operates this plant on behalf of Nalcor who is acting as agent of the
6 province. All revenues and expenses associated with this activity are captured in BU 1970 and
7 excluded from regulated expenses. Any employee providing services to this activity will charge
8 their time in accordance with Nalcor's intercompany transaction costing methodology as discussed
9 above.
10
- 11 • Ramea Project – BU#1406. In accordance with PU 31(2007) no costs associated with the project
12 at Ramea will be borne by ratepayers. All revenues and expenses associated with this activity are
13 captured in BU 1406 and excluded from regulated income. Any employee providing services to
14 this activity will charge their time in accordance with Nalcor's intercompany transaction costing
15 methodology as discussed above.
16
- 17 • Conservation Demand Management – BU#1949. In accordance with PU 7(2008) Hydro will
18 undertake energy conservation initiatives. All revenues and expenses associated with this activity
19 are captured in BU 1949 and excluded from regulated income. Any employee providing services to
20 this activity will charge their time in accordance with Nalcor's intercompany transaction costing
21 methodology as discussed above.
22
- 23 • Cost Recovery Business Units. Hydro maintains a number of cost recovery business units to
24 capture costs incurred by Hydro personnel on behalf of other lines of business, e.g. Oil and Gas,
25 Bull Arm etc. All costs associated with these activities are billed monthly to the lines of business
26 and excluded from regulated income. Any employee providing services to this activity will charge
27 their time in accordance with Nalcor's intercompany transaction costing methodology as discussed
28 above.
29
- 30 • Other Specific Non-Regulated Costs – BU#1955. This business unit has been established to
31 capture various non-regulated costs, including:
32 • Contributions and Donations.
33 • Advertising for corporate image building.
34 • Companion travel costs.
35 • Big Brook and Barr'd Harbour – these communities on the Northern Peninsula receive
36 electricity under a special arrangement approved in the early 1970's. Hydro supplies, operates
37 and maintains generation equipment but does not collect any revenue. These activities are
38 deemed non-regulated.
39 • Bad debt expenses incurred for specific reasons that are designated non-recoverable are
40 excluded from the determination of regulated income.
41

Other Intercompany Matters

Capital work order / projects

Individuals working on capital projects charge their time directly to the projects on time sheets using specific work order numbers assigned to each capital asset. For each regular labour charge, an intercompany fixed charge of \$10.67 per hour is calculated related to the capital project, consistent with the fixed charge discussed previously. The fixed charge is not applied to overtime hours. The \$10.67 is only applied to intercompany labour for capital projects and is therefore not applied for hours worked on capital projects by individuals residing within the same company/line of business as the project.

Insurance

Expenses relating to insurance are allocated between BU's 1183 (Hydro); 3005 (Nalcor); 2504(CF(L)Co); 6201(Oil & Gas); and 4500(Bull Arm). According to Hydro, the criterion is consistent with industry practice, and is identified as follows:

- Property & Equipment: by location, occupancy and construction type;
- Casualty (General liability, Umbrella, and Excess Liability): by revenues, payroll stats and employee counts;
- Aviation: non-owned: number of hours flown; owned: age of aircraft and experience of pilots;
- Crime: # of employees who handle dollars on companies behalf and documented security systems;
- Automobile: vehicle types, location, radius of operation as maintained by administrators of fleet;
- Travel Accident: classification of employee and number of hours travelled;
- Marine: number of dockings, number of vessels; number of barrels discharged; and
- Directors and Officers: indemnification provisions of the by-laws, charters of articles of incorporation, F/S.

According to Hydro, all insurance policies are at the Nalcor level due to better rates through economies of scale. Each policy is renewed annually and is subject to the impact of any documented claims history. In many instances, Hydro does incur a large percent of the total policy cost simply due to the nature of the operations, number of employees, etc.

According to Hydro, there are certain fees also associated with insurance (i.e. broker's fees), which are allocated 56% to Hydro and 44% to CF(L)Co based on proportionate share of the total corporate Nalcor premiums, and to other companies as appropriate based on usage.

Labour charges for insurance / risk management staff are charged through time sheets in accordance with Nalcor's intercompany transaction costing methodology as discussed above.

External contractors

According to Hydro, contractors providing common services are asked to code work activities separately and bill accordingly. Alternatively, a breakdown can be provided to facilitate cost allocation.

Comparison of Hydro's Labour Billing Rates with Newfoundland Power

In P.U.19 (2003), the Board of Commissioners of Public Utilities ordered Newfoundland Power ("NP") to undertake a review and update of its operating practices and procedures relating to inter-corporate transactions with its parent company, Fortis Inc and/or any of its subsidiary companies. On March 31, 2004, NP filed the "Report on Inter-Corporate Charges" in compliance with P.U. 19 (2003). The report included the formal inter-corporate transactions policy and pricing guidelines that reflected NP's practices. We have used this report in completing the comparison with Hydro in the area of labour billing rates.

Before comparing labour billing rate practices of both utilities it is important to outline the structure of executive and senior management of both.

One important difference to be noted between Newfoundland Power and Hydro is that NP has its own executive and leadership team separate from Fortis Inc, and each department within NP has its own management team, who are all employed by NP. Therefore, the daily operations of the utility are primarily managed and carried out by employees of NP.

However, with Hydro, the executive and leadership teams are primarily employees of Nalcor, with the exception of the Vice President of Regulatory Operations who is employed by Hydro. Also, there are a number of managers that have responsibilities relating to the daily operations of Hydro who are employed by Nalcor. There are examples in Hydro's operations where the manager of a particular department is employed by Nalcor and the majority of the employees in that department that report to the manager are employed by Hydro. Therefore the inter-corporate transactions relating to labour costs between Hydro and Nalcor would be occurring on a daily basis whereas most of the labour costs between NP and Fortis would be on an exception basis.

As previously indicated in this report, the labour billing rates of Nalcor, Hydro and its other lines of business are designed to operate as a full cost recovery, with the exception of billings to external parties. As noted, it is now mandatory for all employees (with the exception of "common services" departments) to complete daily time sheets on a weekly basis indicating on which entity/line of business they spent time working. The billing rates to the particular line of business are based on the employee's base hourly wage plus a 57% mark up to cover benefits, etc., plus a fixed charge of \$80 per day to cover common costs. This fixed charge is designed to recover a portion of the common shared service costs that are allocated to each line of business that was described previously in the report.

Prior to the 2003 General Rate Application ("GRA"), the costs of NP employees, including members of the executive, for time worked for Fortis and its subsidiaries were recovered on the basis of detailed time records. Where no market rate was ascertainable, the charges were based on fully distributed costs which included the employee's hourly labour rate loaded for benefits as a percentage of costs. Benefits are defined to include vacation, statutory holidays, CPP, EI, workers compensation, payroll tax, health insurance and pension costs. However, as a result the 2003 GRA, the Board ordered as follows:

"As part of the review of operating practices and procedures relating to inter-corporate transactions NP will be required to investigate the utilization of market rates for executive and management time charges. In lieu of market rates, NP shall propose an appropriate markup on its cost-based rates as a proxy for market in the event that utilization of market rates is not practical."

1 As a result of its review, NP proposed an inter-corporate charge out rate for the time of executives and
2 managers that included a markup rate of 20%, as a proxy for market, on the individual executive's or
3 manager's salary and benefits. This proposed market rate was accepted by the Board.
4
5 NP employees' time spent on work for Fortis and related companies, is supported by daily timesheets.
6 However, where a fair market rate is determinable, the inter-corporate charge is based on the fair
7 market rate. For example, NP charges its staff time to provide engineering services to Fortis and its
8 related companies based on a fair market rate. As indicated above, where no market rate is
9 ascertainable, the charges are based on fully distributed costs plus the 20% markup rate. This
10 represents the most significant difference between Hydro and NP in the determination of labour rates
11 charged to related entities.

Conclusion

In preparing this report, we reviewed the intercompany transactions over the period 2008-2010 between the regulated business units within Hydro and the other Nalcor entities and lines of business. We also reviewed the processes and policies introduced by Hydro to determine how intercompany charges/costs are allocated between shared services to the various entities/lines of business, and we also compared the methodology that is used to calculate the labour billing rates that are charged between the various lines of business within the Nalcor group to the methodology used by Newfoundland Power in its intercompany labour charges.

Based on our review, the intercompany charges (including labour billing rates) to/from the various lines of business and the regulated business units of Hydro are primarily calculated using a cost recovery methodology. It is important to note that there is a significant difference between the corporate structure of the Nalcor entities and the Fortis group of companies. As previously noted, the executive and leadership teams of Hydro are primarily Nalcor employees whereas each Fortis company, including Newfoundland Power, has its own leadership team. Also, as noted earlier in the report, Nalcor has adopted an organizational structure whereby certain functions and personnel provide service across various lines of business. The Company has indicated that having the managers in these positions reside in Nalcor fits with this structure. With this type of corporate structure, it would seem more likely that intercompany labour charges would occur on a daily basis between Hydro and Nalcor.

Based on past orders issued by the Board with respect to Newfoundland Power's intercompany charges, we recommend that the Board consider whether it is appropriate for primarily all of the intercompany charges within Hydro to be determined on a cost recovery basis or whether any of the charges should be based on market information. It is our understanding that Hydro will be addressing the subject of intercompany charges in its next general rate application.

1 **Appendix A – Nalcor Energy Organization Chart**

Nalcor Energy

