

Q. 2013-2014 General Rate Application, Company Evidence

Volume 2, Report 5, Cost of Service Study - Why does Newfoundland Power use actual costs and revenue for 2011 in the completion of the Cost of Service Study filed in support of its Application rather than forecast costs and revenues for the test years 2013 and 2014? Include in the answer information on the practices of other Canadian distribution utilities in this regard.

A. A. Introduction:

Newfoundland Power has always used an historical cost of service study to evaluate customer rates. The 2011 Cost of Service Study provided in support of the Application provides fair and reasonable results for the Company to use in evaluation of customer rates.

An embedded cost of service study, or cost allocation study, provides an approximation of the cost of serving a customer class. There are many judgements involved in the process of classifying and allocating costs. The objective in cost allocation is to have a method that reflects cost causation and is appropriate to determine if there is equitable sharing of costs among the rate classes. Because there many judgements involved and proposed rates apply to a future period which can never be perfectly forecast, an acceptable range of cost recovery has been used by utilities to determine if there is undue cross-subsidization among rate classes.

B. Forecast vs. Historical:

Based upon response from 5 Canadian electrical distribution utilities, three allocate forecast test year costs in their cost of service study and two don't.¹

The historical cost of service studies are sometimes updated to reflect material changes in cost components from the historical year to the test year to ensure study results are reasonable on a forward looking basis. Newfoundland Power employs this practice when appropriate and refers to the result as a pro-forma cost of service study.²

¹ Newfoundland Power received responses from electrical distribution utilities in Alberta, British Columbia, Ontario, Quebec and Prince Edward Island. Some of the distribution utilities that responded to the survey requested confidentiality for their responses.

² For example, in the 2008 General Rate Application filed in 2007, the Company filed a pro-forma cost of service study. This study was based on 2005 results but updated to include the impacts of the January 2007 wholesale and customer rate changes, and the results of the 2006 Depreciation Study. See 2008 General Rate Application, Volume 2, Supporting Materials, Tab 10, page 1. For the 2011 Cost of Service Study, the energy requirements for Street and Area Lighting were reduced from the energy usage reported for 2011 to reflect an update to the fixture ballast energy requirements. This adjustment was made to better reflect the test year cost of serving Street and Area Lighting. See Volume 2, Exhibits and Supporting Materials, Tab 5, Cost of Service Study, page 1, footnote 1.

1 Historical cost of service studies are sometimes normalized to adjust for abnormal events.
2 Newfoundland Power's cost of service study reflects normalized revenues and
3 normalized purchased power costs. This approach avoids year to year variability in cost
4 of service results due to abnormal weather conditions and enhances the robustness of the
5 results when considering the reasonableness of the revenue to cost ratios.³
6

7 The use of a forecast cost of service study is practical for use when the test year revenue
8 requirement is determined through a separate proceeding prior to the filing of the cost of
9 service and rate design proposals.⁴ However, in regulatory proceedings where both rate
10 proposals and revenue requirement proposals are presented coincidentally, regulatory
11 efficiency can be hindered by having to update the cost of service study each time the
12 costs are updated.⁵
13

14 Proposed forecast test year costs filed with the utility's application have not been tested
15 by the Board and can materially differ from the approved forecast test year costs. The
16 use of proposed forecast test year costs can create uncertainty concerning differing results
17 between the proposed forecast cost of service study and the approved forecast cost of
18 service study.
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20 **C. Summary:**

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22 Newfoundland Power uses an historical cost of service study to evaluate customer rates.
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24 The use of a forecast cost of service study would generally not provide material
25 improvement in either the Board's process of reviewing Newfoundland Power's rate
26 applications or the reasonableness of the rate proposals submitted by Newfoundland
27 Power.

³ For example, in a warmer than normal year, purchased power costs would comprise a lower portion of total costs and in a colder than normal year purchased power costs would comprise a larger portion of total costs. As purchased power costs are the largest cost item, a high degree of variability in purchased power costs from year to year could cause material variability in revenue to cost ratios.

⁴ In Alberta, rate applications are split between revenue requirement in phase 1 and rate design in phase 2.

⁵ This occurs at Newfoundland Hydro general rate applications in which the allocated costs by class are used to determine the revenue requirement for each class.