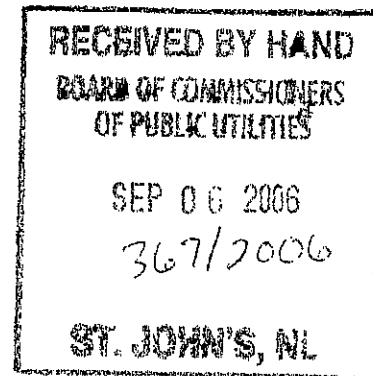


Board of Commissioners of Public Utilities
120 Torbay Road
P.O. Box 21040
St. John's, NL A1A 5B2



Re: Newfoundland and Labrador Hydro Inc. - Request for Deferral of Expenses associated with the Repair of the Unit 2 Boiler at the Holyrood Thermal Generating Station as a Major Extraordinary Repair

The Board has requested that we review this application and provide our comments. Our review of the application focused on: i) whether the recommendations in a 1991 KPMG report and the resulting recommendation of the Board relating to accounting treatment for extraordinary repairs remain appropriate today, and ii) whether the proposed amortization period of five years in total is appropriate.

We have reviewed Hydro's application, the 1991 KPMG report and the Board's recommendation contained in its April 13, 1992 report to the Minister of Mines and Energy and offer the following comments for your consideration.

Treatment of Extraordinary Repair Costs

The 1991 KPMG report recommends that when extraordinary repairs are applied to part of a complete retirement unit it is preferable to expense the repair costs in the year in which they occur or over an extended period of time. The recommendation further states that the deferral of costs and recovery/amortization over a specified amortization period should only occur if the

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recognition in a single year would cause "rate shock" or a "shock" in Hydro's earnings. Hydro has considered the nature of the repairs and the associated work to be carried out in relation to the Unit 2 boiler and has determined that the repairs are not of a capital nature since it does not meet the asset replacement or asset betterment criteria and consequently have referenced the above recommendation in its proposed treatment of the estimated \$2.2 million costs of the repairs.

With regard to the treatment of the costs of this repair as a major extraordinary repair we offer the following comments:

- We concur with Hydro that the costs of this repair are not capital in nature and therefore are considered operating expenses for accounting purposes.
- Generally accepted accounting principles (GAAP) would require that these operating costs be recognized as expenses in the fiscal year in which they are incurred unless an alternative accounting treatment is approved by the Board.
- We concur with Hydro that recognition of the estimated costs of the repair in accordance with GAAP would have a significant negative impact on Hydro's earnings for 2006. The total cost of repairs to the Unit 2 boiler of \$2.2 million represents 71% of the forecast net loss for 2006 of \$3.1 million. To expense the entire repair cost in the year it occurred would result in a forecast overall net loss to Hydro for 2006 of \$5.4 million.
- In the past the Board has given regulatory approval for the deferral and amortization of significant or extraordinary costs incurred by a utility. Examples of this would include the treatment of pension and retirement costs associated with early retirement programs at Newfoundland Power Inc and the deferral of costs related to Hydro's Asbestos Abatement Plan as approved in P.U. 2 (2005).

Based upon our review of this situation and application by Hydro, we conclude that providing for an alternate accounting treatment for costs associated with the repair of the Unit 2 Boiler at the Holyrood Generating Station is appropriate from a regulatory perspective.

With regard to the \$500,000 minimum threshold for consideration of extraordinary repairs at Hydro as recommended by the Board in its 1992 report to the Minister of Mines and Energy, we suggest that the Board consider revisiting this at a future hearing including whether the establishment of a threshold is necessary at all. Clearly, in this specific circumstance, the \$2.2 million estimated cost for repairs is significant and certainly exceeds the recommended threshold of \$500,000.

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Period of amortization of costs

Hydro is proposing that the costs associated with the repair of the Unit 2 boiler be amortized over a five-year period beginning in September 2006 (based on anticipated completion in August 2006). The effect of this proposed amortization approach on the return on rate base and revenue requirement is set out in Table 1 and Table 2 respectively of their application. The proposed annual amortization starts at \$148,000 in 2006, rises to \$445,000 for years 2007 to 2010 and declines to \$295,000 in 2011. The effect on the return on rate base due to the increase in deferred charges assuming a rate of 7.47% as approved in the 2004 cost of service averaged approximately \$89,000 a year. The impact on the revenue requirement averages \$533,000 a year with lowest impact in 2006 of \$226,000. The total impact on the revenue requirement over the five years is \$2,666,000 which includes financing costs of \$443,000.

We have reviewed Hydro's proposed amortization period and considered the impact of using alternate periods. In the past, in considering deferral and amortization of costs, the Board has generally considered amortization periods of 3-5 years to be appropriate. It is important to note that the annual amortization of the repair costs will have no impact on customer rates until Hydro's 2006 general rate application (GRA) is heard by the Board and an order has been issued. In the absence of a GRA, the impact of the amortization period is to smooth the impact of the repairs on Hydro's earnings. In this context, we do not take any issue with the amortization period proposed by Hydro.

If you have any questions or require further clarification regarding the comments provided above please contact me.

Yours truly,

Grant Thornton LLP

Bill Brushett, FCA
Partner

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