

P. U. 39(2006)

IN THE MATTER OF the *Public Utilities Act* (the “*Act*”);

and

IN THE MATTER OF an application by Newfoundland Power Inc. (“NP”) for an Order pursuant to Sections 58, 78 and 80 of the *Act*:

- (a) approving a certain amortization and the deferred recovery of certain costs for 2007; and
- (b) approving forecast values for rate base and invested capital for use in the automatic adjustment formula for the calculation of the rate of return on rate base for 2007 pursuant to Order No. P.U. 19(2003).

BEFORE:

Robert Noseworthy
Chair and Chief Executive Officer

Darlene Whalen, P.Eng.
Vice-Chair

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1 **I APPLICATION**

2
3 On September 13, 2006 NP filed an application (the “Application”) with the Board of
4 Commissioners of Public Utilities (the “Board”) requesting an Order of the Board pursuant to
5 Sections 58, 78 and 80 of the *Act*:
6

- 7 1) Approving the amortization of \$2,714,000 of the 2005 Unbilled Revenue as revenue
8 for regulatory purposes;
9 2) Approving the deferred recovery, until a further Order of the Board, of \$5,793,000 in
10 2007 related to the conclusion of the Depreciation True-Up in 2005;
11 3) Approving the deferred recovery, until a further Order of the Board, of the net impact
12 of \$1,147,000 of the forecast 2007 replacement energy cost of \$1,795,000; and
13 4) Approving a 2007 forecast value for rate base of \$785,271,000 and a 2007 forecast
14 value for invested capital of \$787,990,000, subject to a Board Order approving the
15 company’s 2007 Capital Budget Application, to be used in the automatic adjustment
16 formula for calculating NP’s 2007 rate of return on rate base.
17

18 **1. Notice and Hearing**

19
20 Notice of the Application was published in the Telegram on September 21, 2006. On October
21 26, 2006 the Consumer Advocate, Mr. Thomas Johnson, filed a Notice of Intervention with the
22 Board. The Application and supporting documentation was also made available on the Board’s
23 website.
24

25 The Board engaged its financial consultant Grant Thornton LLP to undertake a review of NP’s
26 Application to assess the appropriateness of the information and the proposed treatment as well
27 as the accuracy of the calculations. Grant Thornton filed a report of their findings with the Board
28 on October 24, 2006.
29

30 On October 27, 2006 the Board wrote the parties to advise that, after considering the materials
31 filed, the matter would be considered in the context of a paper hearing. Grant Thornton’s report
32 was provided to the Consumer Advocate and NP for review and comment.
33

34 The Board and the Consumer Advocate issued information requests to NP, which were
35 responded to in full by NP.
36

37 On November 22, 2006 the Consumer Advocate filed a written submission with the Board. NP
38 filed a written submission on November 23, 2006.
39

40 **2. Application Proposals**

41
42 The primary purpose of the Application according to NP is to address certain 2007 costs that are
43 not reflected in customer rates:

- 1 (i) \$2,714,000 attributable to the adoption of the accrual method of revenue recognition for
- 2 income tax purposes effective January 1, 2006 pursuant to a 2005 agreement with the
- 3 Canada Revenue Agency (the "Tax Settlement");
- 4 (ii) \$5,793,000 attributable to the 2005 conclusion of a depreciation true-up approved by the
- 5 Board in Order No. P.U. 19(2003); and
- 6 (iii) \$1,795,000 in forecast replacement energy costs attributable to a proposed 2007
- 7 refurbishment of the Rattling Brook hydroelectric plant.

8
9 NP is proposing to deal with these costs by way of amortization and deferred recovery. In
10 particular NP is proposing to amortize \$2,714,000 of the 2005 unbilled revenue as revenue for
11 regulatory purposes in 2007 to offset the increase in income tax expense attributable to the Tax
12 Settlement. NP is also proposing the deferral of increased costs related to the conclusion of the
13 depreciation true-up and the deferral of forecast 2007 replacement energy costs related to the
14 Rattling Brook project.

15
16 In the Application NP stated that the proposals will, if approved by the Board, enable NP to defer
17 a rate increase in 2007 which it says would otherwise be necessary to address these costs.
18 According to NP this would in turn position NP to file its next general rate application in 2007 to
19 set rates for 2008, following Newfoundland and Labrador Hydro's general rate application which
20 is currently before the Board.

21 22 **II BOARD DECISIONS**

23 24 **1. Amortization of the 2005 Unbilled Revenue for 2007 Income Tax Costs**

25
26 NP proposes to amortize in 2007 approximately \$2.7 million of the 2005 unbilled revenue as
27 revenue for regulatory purposes to offset the increase in income tax expense attributable to the
28 Tax Settlement. Grant Thornton reviewed NP's proposal and calculations and reported that the
29 proposal is consistent with that approved by the Board in Order No. P.U. 40(2005). The
30 Consumer Advocate accepts this calculation as accurate but argues that an amount should be
31 deducted from this amount to reflect the fact that the actual 2006 tax costs associated with the
32 Tax Settlement were less than forecasted and approved in Order No. P.U. 40(2005).

33
34 In Order No. P.U. 40(2005) the Board approved the adoption of the accrual method of revenue
35 recognition for regulatory purposes. This approval was granted in the context of the Tax
36 Settlement where the same change was made for tax purposes. As a result of this change,
37 revenue that accrued in the last part of December 2005, which under the billed method would not
38 have been included in revenues for 2005, is recorded as income for that year as unbilled revenue.
39 NP estimated the amount of the unbilled revenue as of December 31, 2005 to be \$24,262,000
40 (referred to as the Forecast Unbilled Revenue for 2005). Order No. P.U. 40(2005) was issued
41 based on this forecasted amount, which was the best information available at the time.

42
43 In 2006, after the issuance of Order No. P.U. 40(2005), NP was able to calculate the actual
44 unbilled revenue for 2005 based on actual billing cycle data. The actual amount of unbilled

1 revenue was \$22,539,020 (Actual Unbilled Revenue for 2005), less than the Forecast Unbilled
2 Revenue for 2005 of \$24,262,000.

3 NP is required by virtue of the Tax Settlement to amortize for tax purposes the Actual Unbilled
4 Revenue for 2005 of \$22,539,020 in equal amounts over the three years 2006, 2007, 2008.
5 Compliance with this settlement agreement resulted in actual 2006 income tax costs arising from
6 the amortization of Actual Unbilled Revenue for 2005 of \$2,714,000. The amount approved by
7 the Board in Order No. P.U. 40(2005) to be amortized in 2006 related to the Tax Settlement was
8 \$2,921,000 (\$3,086,000 less \$165,000 unrelated to the 2005 unbilled revenue) which was based
9 on the Forecast Unbilled Revenue for 2005. Therefore the actual tax paid by NP in 2006 was
10 \$207,000 less than was forecasted and accepted in Order No. P.U. 40(2005).

11
12 In this Application the Consumer Advocate submitted that the Board should reduce the amount
13 proposed by NP to be recognized in 2007 by this \$207,000. While agreeing with the calculation
14 of \$2,714,000 as the tax costs associated with the Tax Settlement for 2007, the Consumer
15 Advocate submitted that the amount that should be recognized for regulatory purposes in 2007 is
16 \$2,507,000 (\$2,714,000 less \$207,000). The Consumer Advocate argued that the amount of
17 \$2,507,000 is sufficient to provide an exact offset for the cumulative tax effect of the recognition
18 of the unbilled revenue to date.

19
20 The Consumer Advocate stressed that he was not recommending that the Board make a
21 retroactive adjustment to last year's decision. Each year's accounting adjustment should reflect
22 the amount needed to offset dollar for dollar the tax effect of recognizing the 2005 Unbilled
23 Revenue as required by the Tax Settlement. This same principle should be applied in 2008.
24 Referring to page 14 of Order No. P.U. 40(2005), wherein the Board stated "*The Board will*
25 *accept NP's proposal to recognize \$3,086,000 of the 2005 Unbilled Revenue in 2006 to offset the*
26 *income tax effects associated with the tax settlement.*", the Consumer Advocate suggested that
27 the intent of the Board was to hold the company whole with respect to income tax effects. The
28 intent was not to allow NP to gain and customers lose, or vice versa, due to any variance between
29 the forecast and actual 2005 Unbilled Revenue. He stated:

30
31 *"While it may be the case, as Newfoundland Power suggests in CA 7.0 NP, that it would not be*
32 *appropriate to make a retroactive adjustment to Order No. P.U. 40(2005) to reduce the amount*
33 *of 2005 Unbilled Revenue recognized in 2006, the Board's discretion in establishing an*
34 *appropriate amount of 2005 Unbilled Revenue to recognize in 2007 is fettered only by*
35 *considerations of the fair treatment of both Newfoundland Power and its customers. The*
36 *Consumer Advocate submits that fairness to both parties can be achieved by ensuring that the*
37 *cumulative amount of 2005 Unbilled Revenue for tax purposes is precisely equal to the actual*
38 *effect over the three-year recognition period."*

39
40 In response to the Consumer Advocate's submission NP confirmed that the \$207,000 difference
41 is the result of actual electricity deliveries in December 2005 that were billed in January 2006
42 being less than forecast. NP submitted that, in accordance with established regulatory principles
43 and practice and as provided for in the *Act*, forecasts of revenues and costs are used in its
44 applications to the Board. NP stated that the Consumer Advocate's proposal would effectively

1 be an ex-post facto reconciliation of a forecast based Board determination to an actual result.
2 According to NP this is contrary to the principles of regulatory certainty and predictability and
3 would, in effect, amount to retroactive regulation.
4

5 The Board notes that Order No. P.U. 40(2005) addressed the issue of the recognition of a
6 significant forecast accounting accrual at the end of 2005 arising from the adoption of the accrual
7 method of revenue recognition. The amount of this accrual was estimated by NP based on the
8 best information available at the time. Grant Thornton reviewed NP's methodology and
9 calculations and found the forecast to be reasonable and without errors. A three-day hearing was
10 held with the participation of NP and the Consumer Advocate, who presented an expert witness.
11 No issues were raised during the hearing with respect to the amount of the Forecast Unbilled
12 Revenue for 2005. In Order No. P.U. 40(2005) the Board accepted NP's methodology and
13 calculations and, in order to deal with the tax impacts, approved the amortization of a specific
14 amount. The amount of the 2005 unbilled revenue liability was recognized by NP on its 2005
15 balance sheet as a regulatory liability (Note 2 to the Financial Statements wherein the 2005
16 unbilled revenue liability is recognized as \$23.6 million, which is the adjusted unbilled revenue
17 number to reflect weather normalization). The approval by the Board of the amortization of a
18 portion of the 2005 unbilled revenue balance is also identified in NP's 2005 financial statements
19 (Note 3).
20

21 The Board sets electricity rates on a prospective basis using forecast costs for a test year or years.
22 This is consistent with accepted regulatory principles and established practice and in line with
23 the Board's mandating legislation. Section 3(a)(ii) of the *EPCA* directs the Board to establish
24 rates wherever practicable based on forecast costs for the supply of power for 1 or more years.
25 Section 80(4) permits the Board to use estimates of the rate base and the revenues and expenses
26 of a public utility when setting rates. The prospective nature of rate setting was also recognized
27 by the Supreme Court in the Stated Case.
28

29 The Board acknowledges the Consumer Advocate's submission that the actual tax effect for
30 2006 was lower than approved in Order No. P.U. 40(2005). This was confirmed by NP in its
31 response to CA 5.0 in which NP stated "*Income taxes of \$2,714,000 related to the actual 2005*
32 *Unbilled Revenue amount of \$22,539,000 used for income tax purposes is \$207,000 less than the*
33 *forecast income tax effect of \$2,921,000 that was based on the forecast 2005 Unbilled Revenue*
34 *provided in the 2006 Accounting Policy Application.*" However the Board does not accept the
35 suggestion by the Consumer Advocate that the income tax effect for 2007 should be reduced by
36 \$207,000 to account for the difference between the forecast and actual tax impacts. Order No.
37 P.U. 40(2005) was clear and unambiguous as to the amortization of a portion of the Forecast
38 Unbilled Revenue for 2005 to offset the 2006 income tax costs. The Consumer Advocate was
39 unsuccessful in his application for leave to appeal the Order. Consistent with regulatory practice
40 and in the absence of special circumstances, the Board does not look back to the actual results
41 and make adjustments to ongoing costs to reflect the differences between forecast and actual.
42 The Board finds that such an adjustment would be retroactive in nature and is inappropriate in
43 the circumstances in the absence of language in the original Order to ground such an adjustment.

1 Consistent with regulatory practice and in the interests of a predictable and fair regulatory
2 framework that accepts the necessity and practicality of prospective regulation the Board will not
3 make the offset proposed by the Consumer Advocate.
4

5 NP is requesting amortization of income tax costs \$2,714,000 for 2007 associated with the Tax
6 Settlement. This amount is calculated based on the actual 2005 Unbilled Revenue of
7 \$22,539,020 and represents the best estimate of income tax effects for 2007 attributable to the
8 Tax Settlement. As set out above, the calculation of the amount proposed to be amortized in
9 2007 has been accepted by the Consumer Advocate and Grant Thornton has concluded that it is
10 consistent with Order No. P.U. 40(2005). Therefore the Board finds that the proposed
11 amortization is reasonable and appropriate in the circumstances.
12

13 **The Board will accept NP's proposal to recognize \$2,714,000 of the 2005 Unbilled Revenue**
14 **in 2007 to offset the income tax effects associated with the Tax Settlement.**
15

16 **2. 2007 Depreciation True-Up Deferral**
17

18 In Order No. P.U. 19(2003) the Board approved the amortization of accumulated depreciation
19 reserve variance or "true-up" of \$17.2 million over a three-year period beginning in 2003. This
20 resulted in an annual amortization of \$5,793,000 which was used to offset depreciation expense
21 in each of the three years 2003, 2004 and 2005. This annual amortization concluded in 2005
22 and, as a result, NP has incurred additional depreciation expense commencing in 2006 of
23 \$5,793,000 equal to the annual true-up adjustment. In its Application NP is proposing that this
24 increased expense be deferred to be recovered in future rates.
25

26 In Order No. P.U. 40(2005) the Board ordered NP to defer recovery, until a further Order of the
27 Board, of the increased depreciation expense of \$5,793,000 related to the amortization of the
28 depreciation true-up. This deferred recovery is recorded as an expense reduction on NP's 2006
29 statement of income, effectively offsetting the increase in 2006 expense that is attributable to the
30 conclusion of the depreciation true-up. NP provided a pro forma impact of the deferred recovery
31 of increased depreciation expense in its Application (pg. 8) which shows that the proposed
32 deferral only offsets the increased depreciation expense related to the conclusion of the
33 depreciation true-up and not increased depreciation expense related to increased plant
34 investment.
35

36 As noted by Grant Thornton in its report, the treatment proposed by NP in this Application for
37 the 2007 increased depreciation expense is consistent with that approved by the Board for the
38 2006 increased depreciation expense. The Consumer Advocate did not object to this proposed
39 treatment. The Board will accept NP's proposal to defer \$5,793,000 of increased depreciation
40 expense in 2007 resulting from the conclusion of the depreciation true-up in 2005. NP is
41 currently completing an updated depreciation study and the deferred 2006 and 2007 costs related
42 to the conclusion of the depreciation true-up will be reviewed and tested by the Board as part of
43 NP's general rate application to set rates for 2008.

1 **The Board will allow NP to defer recovery, by use of a deferral account, of the increased**
2 **depreciation expense for 2007 of \$5,793,000 related to the conclusion of the amortization of**
3 **the depreciation true-up.**

4
5 **3. 2007 Replacement Energy Cost Deferral**
6

7 In its Application NP is proposing to defer forecast energy replacement costs for 2007 associated
8 with the refurbishment of the Rattling Brook hydroelectric plant. This capital project was
9 approved by the Board in Order No. P.U. 30(2006) as part of NP's proposed 2007 capital budget.
10 During the construction period NP will have to purchase replacement energy from Hydro to
11 replace the normal production of the Rattling Brook plant while it is out of service. NP has
12 forecast the spill associated with this project would result in a loss of 38.2 GWh of energy
13 production in 2007.
14

15 NP estimates the cost of this replacement energy for 2007 to be \$1,795,000. This has been
16 calculated using NP's purchase power cost from Hydro at 4.7 cents per kWh (38,200,000 kWh x
17 \$.047/kWh). With the tax effect included the net cost to NP will be \$1,147,000, which is not
18 reflected in existing customer rates.
19

20 The Consumer Advocate submitted that the Board should direct NP to save approximately 5% of
21 its forecast 2007 Hydro Plant Operating Costs (\$2,288,000) or \$100,000 as an offset to the cost
22 of replacement power, and to reflect this reduction when it seeks approval of the Board to
23 recover this deferred energy replacement costs.
24

25 In its submission NP stated that no reduction in forecast 2007 hydro plant operating costs can be
26 expected to offset the forecast cost of replacement energy resulting from the Rattling Brook
27 project. NP identified four reasons for this: i) the manner in which NP operates its 23 hydro
28 plants; ii) the highly fixed behaviour of operating costs associated with NP's hydro plants; iii)
29 NP's operating cost experience with hydro plant refurbishments in recent years; and iv) the 2007
30 expected operating costs associated with the Rattling Brook hydro plant. NP submitted that there
31 is no evidence to support the Consumer Advocate's suggestion that a reduction (or offset) can be
32 expected or is even achievable and that, in fact, the evidence before the Board contradicts this.
33

34 The Board notes NP's position that there will be no material change in hydro plant operating
35 costs as a result of the Rattling Brook refurbishment project being undertaken in 2007. The
36 Consumer Advocate is essentially arguing that the downtime of the Rattling Brook plant in 2007
37 should result in some operational savings. However, there is no basis or evidence before the
38 Board to justify a reduction in NP's forecast 2007 Hydro Plant Operating Costs, and specifically
39 no evidence to persuade the Board to order an arbitrary reduction of 5% or \$100,000. The Board
40 does not accept the Consumer Advocate's argument that the rationale applied by the Board of
41 ordering a "productivity allowance" adjustment in previous general rate applications would merit
42 the same kind of treatment regarding a single project expenditure such as the Rattling Brook
43 refurbishment. The Board acknowledges that NP will have to incur additional costs to purchase
44 energy from Hydro due to the unavailability of the Rattling Brook Hydro Plant for a period in
45 2007. These 2007 forecast costs are not reflected in current customer rates and, in the absence of

1 acceptable evidence supporting a specific adjustment, are costs that the Board will permit NP to
2 recover.

3 **The Board will accept NP's proposal to defer recovery of the replacement energy costs for**
4 **2007 associated with the refurbishment of the Rattling Brook Hydro Plant.**

5

6 **4. Forecast Rate Base and Invested Capital**

7

8 In its Application NP is requesting approval of a forecast average rate base for 2007 of
9 \$785,271,000 and a forecast average invested capital for 2007 of \$787,990,000. Both these
10 forecasts are subject to the approval of NP's 2007 Capital Budget Application and also subject to
11 acceptance by the Board of the proposals contained in this Application. NP is proposing that the
12 forecast 2007 values for rate base and invested capital be used in the Automatic Adjustment
13 Formula for the calculation of NP's rate of return on rate base for 2007.

14

15 The Board approved NP's 2007 Capital Budget application in Order No. P.U. 30(2006), issued
16 on September 29, 2006. As outlined elsewhere in this Decision, the Board will also approve
17 NP's proposals in this Application with respect to amortization and deferral of certain costs.
18 NP's forecast 2007 average rate base and invested capital incorporates these proposals.

19

20 According to Grant Thornton's report (pg. 4) approval of the proposals contained in this
21 application would result in an increase in the 2007 average rate base of \$4,827,000. The average
22 deferred charges would increase by \$3,470,000 and the average 2005 Unbilled Revenue would
23 be reduced by \$1,357,000. Grant Thornton reviewed NP's calculations of the forecast average
24 rate base and concluded that the 2007 forecast average rate base of \$785,271,000 is calculated
25 correctly and in accordance with Order Nos. P.U. 36(1998-99), P.U. 19(2003) and P.U.
26 40(2005).

27

28 With respect to invested capital Grant Thornton stated that approval of this Application will
29 increase the forecast average invested capital by \$4,827,000 in comparison to average invested
30 capital without these proposals. Grant Thornton also reviewed NP's calculations and confirmed
31 that NP's calculation of the 2007 forecast average invested capital of \$787,990,000 is calculated
32 correctly and in accordance with Order Nos. P.U. 36(1998-99), P.U. 19(2003), and P.U.
33 40(2005).

34

35 The Consumer Advocate did not raise any issues with respect to NP's calculations of the 2007
36 forecast average rate base and forecast average invested capital.

37

38 In the context of NP's 2007 capital budget Order [P.U. 39(2006)] and the Board's approval of
39 NP's proposals in this Application, the Board is satisfied that NP's calculations for the 2007
40 forecast average rate base and 2007 forecast average invested capital are accurate.

41

42 **The Board will approve the forecast average rate base for 2007 of \$785,271,000 and the**
43 **forecast average invested capital for 2007 of \$787,990,000 for use in the Automatic**
44 **Adjustment Formula for the calculation of NP's rate of return on rate base for 2007.**

1 **III ORDER**

2
3 **IT IS THEREFORE ORDERED THAT:**

- 4
- 5 1. NP’s proposal to amortize \$2,714,000 of the 2005 Unbilled Revenue as revenue for
6 regulatory purposes in 2007 is approved.
- 7
- 8 2. NP’s proposal to defer recovery, until a further Order of the Board, of the amount of
9 \$5,793,000 in 2007 related to the conclusion of the Depreciation True-Up in 2005 is
10 approved.
- 11
- 12 3. NP’s proposal to defer recovery, until a further Order of the Board, of the amount of
13 \$1,147,000 related to replacement energy costs associated with the Rattling Brook project
14 is approved.
- 15
- 16 4. Pursuant to s. 80 of the *Act*, the forecast 2007 values for rate base of \$785,271,000 and
17 invested capital of \$787,990,000 for use in the Automatic Adjustment Formula to
18 calculate NP’s rate of return on rate base for 2007 is approved.
- 19
- 20 5. NP shall pay the expenses of the Board arising from this Application, including the
21 expenses of the Consumer Advocate.

Dated at St. John’s, Newfoundland and Labrador this 5th day of December 2006.

Robert Noseworthy
Chair and Chief Executive Officer

Darlene Whalen, P.Eng.
Vice-Chair

G. Cheryl Blundon
Board Secretary