Board of Commissioners of Public Utilities
Newfoundland Power Inc.
2008 General Rate Application
Financial Consultants Supplementary Report

Grant Thornton

Contents

Introduction and scope

On October 11, 2007, Newfoundland Power Inc. ("the Company") ("Newfoundland Power") submitted a revised filing to the Board with respect to its 2008 General Rate Application. This revised filing incorporated the terms of the *Settlement Agreement for the Proposed Resolution of Certain Issues Arising from the Application* negotiated between Newfoundland Power and the Consumer Advocate and dated October 12, 2007 ("the Settlement Agreement").

In addition to the items negotiated in the Settlement Agreement, the revised filing was also updated for changes in the 2008 forecast of costs and sales based on Newfoundland Power's most current forward-looking information.

Section 2 of the Company's Amended Application sets out revisions made to the 2008 test year cost and sales forecasts. These revisions consist of the following:

- revisions to the Company's 2008 operating costs related to increased financing charges partially offset by decreased insurance costs and increased revenue associated with wheeling charges paid by Newfoundland & Labrador Hydro; and

- revisions to the Company' 2008 customer, energy and demand forecast to incorporate the Company's most recent forecast assumptions.

Section 3 of the Company's Amended Application sets out the elements of the Settlement Agreement impacting 2008 test year revenue requirement. These elements include the following:

- the continued recognition of the Company's other post employment benefits ("OPEBs") on a cash basis and the adoption of accrual accounting for income tax associated with pension costs. The Company's original application proposed the adoption of the accrual method of accounting for OPEBs and the adoption of the accrual method of accounting for income tax related to all employee future benefits.

- an agreed rate of return on common equity of 8.95% for ratemaking purposes in 2008. The Company's original application proposed a rate of return on common equity of 10.25%; and

- a reduction in the amortization period for certain regulatory deferrals and reserves from 5 years to 3 years commencing in 2008, including the 2005 Unbilled Revenue Reserve, Municipal Tax Liability, Deferred Depreciation Costs, Deferred Replacement Energy Costs, and the balance in the Purchased Power Unit Cost Variance Reserve. This change resulted in a $1,043,000 (or 0.2%)

reduction in revenue requirement from that originally proposed by Newfoundland Power.

We note that the Settlement Agreement states that it is non-severable. Specifically, the Agreement contains the statement that it "represents a reasoned consensus on the stated issues and the individual agreements of the Parties are not intended to be severable". We understand and acknowledge that many of the agreed revisions are interrelated and therefore the reasonableness of the proposed revisions are best assessed in an overall context.

Grant Thornton has undertaken a review of the revised Application focusing on the changes to Newfoundland Power's 2008 test year forecast revenue requirement, forecast average rate base and rate of return on average rate base. In conducting our review we have performed the following procedures:

- reviewed the Settlement Agreement to identify the elements which give rise to revisions in the forecast revenue requirement, forecast rate base and rate of return on rate base;

- reviewed cost and sales revisions to identify the elements which give rise to adjustments in the forecast revenue requirement, forecast rate base and rate of return on rate base and obtained evidence to support these revisions;

- reviewed the revised Application, including the revised exhibits thereto containing certain revised Finance and Accounting Schedules, to assess whether the Settlement Agreement and the cost and sales revisions are appropriately reflected in the revised Application; and

- made inquiries and obtained additional documentation, where appropriate, to support the revisions to 2008 forecast revenue requirement, forecast rate base and rate of return on rate base.

Observations and findings

2008 Forecast Revisions

In its Amended Application the Company made the following revisions to operating costs, other revenue and finance charges:

- reduction in 2008 test year forecast insurance costs of $190,000 to reflect policy renewals which occurred after the original Application was filed;

- increase in 2008 test year forecast other revenue of $111,000 to reflect a change in revenue associated with wheeling charges paid by Hydro; and

- increase in 2008 test year forecast finance charges of $900,000 to reflect the impact of Series AL First Mortgage Sinking Fund Bonds issued in August 2007 at a rate higher than anticipated in the original application, as well as an increase in forecast short term interest rates.

In addition to the above revisions, the Company has revised its 2008 customer, energy and demand forecast. There was an increase in the forecast number of customers, energy sales and demand due to factors such as an increase in forecast housing starts, higher than anticipated energy sales in the first seven months of 2007 and higher disposable income forecast in 2008. It is important to note that the Company did not change the methodology in which the forecast was prepared; rather the inputs were updated based on more recent information.

As a result of the above revisions to the customer, energy and demand forecast, the Company's forecast of revenue from rates increased by $7,157,000 compared to the original application. However, as marginal supply costs currently exceeds marginal revenue from customers, the increased energy sales results in an overall decrease in margin of $876,000.

The overall impact on 2008 test year forecast revenue requirement due to the above noted changes can be summarized as follows:

Increase (decrease) in 2008 Test Year Revenue Requirement

('000's)	2008
Operating costs, other revenue and finance charges	
Insurance	$ (190)
Other revenue	(111)
Finance charges	900
	599
Customer, energy and demand	
Revenue from rates	(7,157)
Power supply costs	8,033
	876
Total increase in revenue requirement	**$ 1,475**

We have reviewed the revised forecast and obtained appropriate evidence to support the revisions. In addition, we have ensured these changes have been appropriately incorporated into the revised forecast revenue requirement, forecast rate base and return on rate base.

Employee Future Benefits

Based on the terms of the Settlement Agreement, the Company is proposing to continue recording OPEBs on the cash basis rather than the accrual basis as originally proposed. The impact of using the cash basis, rather than the accrual basis, reduces the 2008 revenue requirement originally proposed by $6.4M or 1.3% compared to that sought in the original application.

In the Supplemental Evidence, Section 3.2, presented by the Company in the Amended Application, the Company notes that "Newfoundland Power's next general rate application is currently expected to be filed in 2010 to establish customer rates for 2011". According to Table 10 in the Supplemental Evidence, the Company estimates that there would be no material impact on annual revenue requirements by delaying the adoption of the accrual method of accounting for OPEBs to 2011 versus 2008. However, the Company does indicate that by delaying the adoption of the accrual method, the transitional obligation related to OPEBs will increase to $52.9 million as of December 31, 2010 from $34.1 million as of December 31, 2007 (an increase of approximately $6.3 million per year). In the Company's original application it had proposed that the disposition of this transitional obligation be deferred until the Company's next general rate application. No change has been made to this proposal as a result of the Settlement Agreement.

The Company has noted in its Supplemental Evidence that both the cash and accrual methods for accounting for OPEBs are acceptable under Canadian Generally Accepted Accounting Principles (GAAP). This is correct because of special provisions permitted for rate-regulated entities under Canadian accounting standards. According to the Canadian Institute of Chartered Accountants Handbook ("the CICA Handbook"), all employee future benefits, including OPEBs, should be accounted for using the accrual method. However, regulated entities, such as Newfoundland Power, are currently permitted under Canadian GAAP to record OPEBs expense on a cash basis if certain conditions are met (for example, it is reasonable to assume that the additional expense under the accrual method will be recovered from customers in the future). The difference between the expense under the accrual method and the expense under the cash method is recorded as a regulatory asset.

In March 2007, the Canadian Accounting Standards Board ("AcSB"), a committee of the CICA, issued an Exposure Draft on rate-regulated operations which proposes the removal on January 1, 2009 of the existing specific provisions permitting Canadian rate regulated entities to use the cash basis of reporting. However, in the absence of Canadian guidance, certain rate-regulated entities will be permitted to follow accounting guidance generally accepted in the United States. Under U.S. guidance OPEBs expense would still be permitted to be recorded based on the cash method assuming certain conditions are met. This would allow regulated entities to continue to report on the cash basis through the use of deferral accounts.

There is a further development in addition to the changes contemplated in the above noted Exposure Draft which the Board should be aware of. This development is related to the AcSB's decision regarding the transition to International Financial Reporting Standards ("IFRS') as set out in its Strategic Plan. This transition, as summarized below, will potentially impact the external financial reporting of all Canadian publicly accountable entities, including rate-regulated entities.

Commencing with year ends beginning on or after January 1, 2011, the AcSB has advised that it will be requiring Canadian publicly accountable entities to report using IFRS which does not provide specific accounting guidance for rate-regulated entities. It is our understanding that IFRS may not permit rate regulated entities to rely on U.S. accounting standards. Therefore the use of the various deferral accounts, that are currently used by many of the rate regulated entities, such as the OPEBs regulatory asset, may no longer be in accordance with GAAP. In Appendix A we have provided some background information on the transition to IFRS.

Timetable of Post Hearing Events

In the context of the ongoing regulatory oversight of Newfoundland Power a number of significant events, including the accounting changes discussed above, may be of interest to the Board in considering this Application. For example, a number of deferral accounts expire in 2010, while others continue until 2012. In addition, the Company advises that it plans to file its next general rate application in 2010, whereas the proposed Automatic Adjustment Formula could continue to operate in 2010 to set rates for 2011. Appendix B to this report outlines a timetable for these events.

Conclusion

Based on our review of the Amended Application and the Supplemental Evidence filed by Newfoundland Power and the completion of the procedures described in the scope of our report, we present the following findings for the Board's consideration:

- the revised forecast 2008 test year revenue requirement of $498,226,000 appropriately incorporates the impact of the agreed changes as per the Settlement Agreement and the revised cost and sales forecasts;

- the revised forecast 2008 average rate base of $812,212,000 appropriately incorporates the impact of the agreed changes as per the Settlement Agreement and the revised cost and sales forecasts; and

- the proposed revised rate of return on average rate base of 8.37% for 2008 appropriately incorporates the impact of the agreed changes as per the Settlement Agreement and the revised forecasts of cost and sales.

Grant Thornton LLP

St. John's, Newfoundland — Grant Thornton LLP
October 17, 2007 — Chartered Accountants

APPENDIX A

International Financial Reporting Standards

In January 2006, the AcSB adopted its Strategic Plan. In this document, the AcSB noted "that it is timely for publicly accountable Canadian enterprises to adopt globally accepted, high-quality accounting standards by converging Canadian GAAP with International Financial Reporting Standards (IFRSs) over a transitional period. At the end of that period, a separate and distinct Canadian GAAP will cease to exist as a basis of financial reporting for publicly accountable enterprises".

In May 2007, the AcSB published an updated version of its 'Implementation Plan for Incorporating IFRSs in Canadian GAAP'. This document provided a tentative timeline of key events for reporting enterprises in adopting IFRS (timelines were based on the current assumptions in the Strategic Plan and an assumed changeover of January 1, 2011). Key dates included in this document which impact Newfoundland Power include the following:

- December 31, 2008 - Possible disclosure of an enterprise's plan for convergence and what effects the enterprise anticipates will arise with the change to IFRS.

- December 31, 2009 - Same disclosure as in 2008, but with a greater degree of quantification of the effects of the change to IFRS.

- January 1, 2010 - First year for collection of comparative information for inclusion with 2011 financial statements under new IFRS-based requirements. Opening balance sheet for 2010 on IFRS basis required.

- December 31, 2010 - Last year-end for reporting under existing Canadian GAAP.

- January 1, 2011 - First year reporting under new IFRS-based standards. Opening balance sheet for 2011 on IFRS basis required.

- March 31, 2011 - Enterprises issuing interim financial statements prepare their first IFRS based statements for the three months ended March 31, 2011.

- December 31, 2011 - End of first annual reporting period in accordance with new IFRS-based requirements including IFRS-based comparatives for 2010.

APPENDIX B

Timetable of Post Hearing Events

January 1, 2008	Implementation of rates and other requirements subject to the 2008 General Rate Application
2010	Newfoundland Power has advised it plans to file its next general rate application in 2010 to establish customer rates for 2011
December 31, 2010	End of period in which the Energy Supply Cost Variance Clause, included in the Rate Stabilization Clause, applies to energy supply costs
2011	Newfoundland Power has advised the next depreciation study is expected to be completed in 2011 based on plant in service as of December 31, 2010
December 31, 2011	End of period subject to the Automatic Adjustment Formula as proposed in the Settlement Agreement
December 31, 2011	Proposed end of amortization period of the accumulated reserve variance identified in the Depreciation Study.
December 31, 2012	Proposed end of amortization period related to the Weather Normalization Reserve