Volume 1, Section 3 – Finance

Q. (page 98, lines 13-14) "Newfoundland Power observes the guidelines and principles of the Board with respect to inter-corporate transactions." Please provide a copy of the guidelines and principles of the Board.

A. The guidelines and principles of the Board with respect to inter-corporate transactions are found in the Board's Orders.

Attachment A contains pp.55 through 60 of Order No. P.U. 19 (2003) titled *V. INTERCORPORATE RELATIONSHIPS AND CHARGES* which is the most recent statement of the guidelines and principles of the Board.

The Board's financial advisors, Grant Thornton LLP, review inter-corporate charges to assess compliance with Board Orders as part of their annual financial review of Newfoundland Power.

V. Inter-Corporate Relationships And Charges

pp.55-60 of Order No. P.U. 19 (2003)

V. INTER-CORPORATE RELATIONSHIPS AND CHARGES

1. Background

The issue of inter-corporate transactions between NP, its shareholder Fortis, and with affiliated companies has been considered and addressed in previous Orders of the Board. In Order No. P.U. 6(1991) the Board directed the following: (i) a quarterly reporting mechanism be put in place; (ii) NP's code of accounts be modified to identify all inter-corporate transactions; and (iii) NP conduct a study into the financial policies of regulated Canadian utilities with respect to mark up percentages on related party transactions. This study, completed for NP by Deloitte and Touche, was filed with the Board in March 1996. In Order No. P.U. 7(1996-97) the Board: (i) set a deadline for the filing of inter-corporate quarterly transaction reports; (ii) set the basis for allocation of specific charges from Fortis to NP; and (iii) provided direction to NP on the treatment of certain costs as non-regulated or regulated expenses. The Board also accepted the principles presented in the Deloitte and Touche Study ordering that:

i) inter-corporate services obtained from a competitive market be valued at market;
ii) in acquiring a competitive service from an affiliate, the allowed regulated expense shall be the lowest cost bid or tariff;
iii) in cost allocations from affiliates and the parent, transactions must be supported by documentation;
iv) the markup on the cost must also be supported by reasonable documentation;
v) a markup may include return on capital only where assets were used to deliver service or good;
vi) inter-corporate loans involving NP must be valued at their opportunity cost and documentation to support the rate shall be kept;
vii) pole attachment charges to Unitel shall be valued at the same rate offered to Newtel or CATV operators; and
viii) postage and courier charges must include labour and the standard overhead charge.

Inter-corporate issues were also raised at NP's 1998 general rate hearing. In Order No. P.U. 36(1998-99) the Board found that the directives set by Order No. P.U. 7(1996-97) and NP's treatment of non-regulated expenses continued to be appropriate and no changes were ordered.

At this hearing issues concerning NP's relationship with its shareholder Fortis and also with other Fortis subsidiaries were raised by the Consumer Advocate. The Consumer Advocate argued that:

> *"the level and complexity of NP's inter-company transactions with Fortis Inc., and all of its related subsidiaries is exposing NP, and therefore ratepayers, to unnecessary financial and insurance risks; reveals that NP may be operating with too many employees; indicates an improper use of regulated funds; and shows that NP is charging preferential interest amounts on outstanding balances due from Fortis related companies, contrary to Section 107 of the Act."*
> (Final Submission, Consumer Advocate, pgs. 63-64)

The Board has dealt with the financial risks of NP's relationship with its shareholder Fortis on pgs. 38-40 of this Decision. The other issues raised by the Consumer Advocate are addressed separately below.

2. Level of Inter-Corporate Transactions

Board Hearing Counsel observed that Fortis now comprises some nine subsidiaries, eight of which are utilities. (Final Brief, Board Hearing Counsel, pg. 4/4-5) By contrast, there were three utilities referred to in Fortis' 1998 Annual Report. A comparison of Fortis' operating revenues shows NP contributing an estimated 71% in 1998, declining to 57% in 2001. In describing its vision Fortis' 2002 Annual Report states:

> *"The principal business of Fortis will remain the ownership and operation of electric distribution utilities. We will be proactive and innovative in responding to the challenges and opportunities presented by changes in the electricity industry. While the continued profitable expansion of the electric utilities in the Fortis family is our first priority we will also pursue opportunity to acquire other utilities in Canada, the Caribbean and the NorthEastern United States."*

The Board believes the relationship between Fortis, its affiliated companies and NP has become much more complex and integrated since 1998. This relationship extends beyond corporate governance issues between shareholder and subsidiary and has escalated to where NP supplies an increasing level of services to Fortis and its affiliated companies, in particular, insurance and staff, including executive and professional support. NP's regulated and unregulated inter-corporate transactions with Fortis and its sister companies have multiplied several times since 1998 and involve the flow of significant services and charges between affiliates. (Grant Thornton Report-NP 2003 GRA, Schedule 6C) Furthermore, in the case of Central Newfoundland Energy (CNE), Board Hearing Counsel notes professional staff are provided by NP to a sister company, 50% owned by Fortis, which may arguably be viewed as a competitor of NP since it produces energy and sells it in the Province. The Board believes there is no reason to anticipate these transactions between NP and its affiliates will stabilize and the evidence appears to support a continuing escalation, particularly as additional utilities are acquired by Fortis as outlined in its vision. NP argues these inter-corporate arrangements benefit customers of the utility since they generate additional revenues which serve to reduce rates as well as enhance employee development and provide exposure to outside business practices and ideas.

The Board places considerable stock in the advice given by Board Hearing Counsel:

> There is a down side to the Board's openly encouraging Newfoundland Power to pursue this strategy further in that it would further integrate Newfoundland Power possibly into Fortis and the sister companies. And this has implications for the ratings of Newfoundland Power, vis-a-vis it's own stand alone status. So, it's a thorny issue, it's not one that's simply resolvable by addressing it--it's not simply resolvable by suggesting to Newfoundland Power that they just unbridled, go ahead with providing professional services at market rates. But it is something that needs to be monitored and there needs to be a concerted policy put in place so that we can measure this going forward.
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> (Transcript, April 25, 2003, pg. 157/12-25; pg. 158/1-3)

With regard to the provision of staff and other services to its affiliates, the Board agrees NP may indeed be deriving benefits on behalf of ratepayers. The Board believes, however, such benefits should be transparent, demonstrable and maximized to the advantage of ratepayers. In the absence of these stated objectives, the customers of NP may pay incrementally more for their electricity with either Fortis and/or its other subsidiaries sharing in these benefits. As previously indicated the Board's singular focus in its regulatory responsibility is NP and it is the Board's mandate to ensure electric consumers in the Province enjoy least cost electricity. The Board recognizes it may be several years before NP's next general rate application and, given the ever increasing complexity and number of inter-corporate transactions, it is incumbent upon the Board to ensure the interests of ratepayers are protected.

The Board acknowledges the Deloitte Touche guidelines covering inter-corporate transactions of NP which were put in place in Order No. P.U. 7(1996-97) and went unchanged by the Board in Order No. P.U. 36(1998-99). While these guidelines have generally proven adequate to date, the Board is persuaded in light of the corporate growth of the Fortis family that explicit regulatory policy direction is required to govern NP's inter-corporate transactions into the future. Therefore, in addition to the existing guidelines, NP will be required to observe certain principles in all of its inter-corporate transactions.

The overriding principal that should govern NP is that all inter-corporate transactions between affiliates shall be fully transparent and subject to scrutiny by the Board.

The Board acknowledges the general presumption of managerial good faith but notes that transactions between the utility and its affiliates present unique challenges, as they are non-arms-length transactions. Therefore, the onus will be placed on the utility to establish, to the satisfaction of the Board, that the transaction is prudent and that any corresponding costs reflect *"fair market value"* or *"cost based pricing"*, including a return on invested capital, as appropriate.

The Board has no desire to *"micromanage"* the operations of the utility and places the responsibility with NP to demonstrate to the Board that it has operated in the best interests of the utility and its customers. The Board expects directors and officers of NP to act in a manner which does not prejudice the interests of ratepayers in transactions with affiliates. Inter-corporate transactions between the utility and its affiliates should provide benefit to the electrical consumer and should not be implemented so as to disadvantage the consumer.

NP will be required to observe the following principles in all inter-corporate transactions:

- **(i) All inter-corporate transactions between a utility and its affiliates shall be fully transparent and are subject to scrutiny by the Board.**
- **(ii) A utility shall have the right to manage its affairs but it must demonstrate to the satisfaction of the Board that all affiliate transactions are prudent.**
- **(iii) A utility shall ensure that inter-corporate transactions will not disadvantage the interests of ratepayers and furthermore that ratepayers and the utility will derive some demonstrable benefit from such transactions.**
- **(iv) The onus is on the utility to show that it is in compliance with the guidelines and principles with respect to inter-corporate transactions.**

These principles may be amended by the Board from time to time. Given the implications of these principles on both NP and its affiliates, NP will be required to undertake a review and update of its operating practices and procedures relating to any and all inter-corporate transactions to ensure that the principles as set out above are reflected. The results of such a review shall be reported to the Board no later than March 31, 2004.

3. Centralized Insurance Administration

NP currently handles the insurance administration for Fortis and its subsidiaries. All insurance billings, claims, etc. for the Fortis Group of Companies are coordinated and paid through an employee of NP. NP charges the related companies through inter-corporate billings. The Consumer Advocate argued that *"this is an unusual function for a subsidiary to perform for its parent, and can lead to the exposure of NP to increased insurance costs as a result of its linkage with the insurance risks of other companies over which NP has no control."* The Consumer Advocate further argued that NP has not demonstrated any compelling reasons why it should bear the risk of paying out all of Fortis companies' insurance premiums or why it should remain risk-linked with other Fortis companies. The additional labour and accounting costs associated with performing this function were also questioned. (Final Submission, Consumer Advocate, pgs. 65-66)

In an undertaking to the Consumer Advocate, NP provided information on the relationship of NP's annual insurance premium to the claims experience of other Fortis companies. (U #1) This information included a comparison of loss ratios (ratios of the total claims under a policy of issuance to the total premiums paid for coverage under the policy) for the Fortis Group of Companies and NP. The loss ratios for Fortis and NP for auto and liability policies are comparable; loss ratios for property are 208% for Fortis and 147% for NP; and loss ratios for all coverages is 149% for NP compared to 152% for Fortis. Total insurance premiums for 1997-2003 for the Fortis Group were $5,912,915 with $3,071,518 (51%) allocated to NP. In U #1 NP also identified the following benefits of participating in a group insurance program:

1. diversity of claims experience among a group of insured parties can benefit participants who experience higher incidence of claims in a given period;
2. volume discounts on premiums available as a result of the spreading of risk and economies of scale;
3. savings resulting from sharing of broker services; and
4. improved access to leading specialty insurance markets, such as those specializing in insuring utility risk.

In written submission (Section D, pg. 16) NP argued that its centralized insurance management is more cost effective than if it were to purchase insurance on its own as a small electric utility.

It is unusual, in the Board's view, for a subsidiary company to perform a centralized function such as insurance administration for the parent company and its affiliates. The Board's primary concern in this matter is that ratepayers are not subsidizing or contributing to the insurance expenses of Fortis and related companies and also that there is no additional cost to NP (and hence ratepayers) of NP's participation in a group insurance program. NP has argued that there is a benefit to maintaining the insurance expertise in-house rather than having to out-source. Based on the evidence the Board is satisfied that the insurance costs are tracked and billed to the related companies as required. The labour charges for NP's staff persons associated with the activity are billed as well, including the appropriate markups. Inter-corporate charges are reported to the Board quarterly and reviewed by the Board's Financial Consultants as part of their annual financial reviews.

A more difficult issue for the Board is the determination of whether there is actually a benefit accruing to NP and its ratepayers as a result of this activity. Mr. Perry indicated that NP had not gone to market for a stand-alone quote for insurance coverage based on NP's risks alone. While the benefits listed by NP above relate primarily to cost savings, these savings have not been quantified and the Board has no information before it to satisfy itself on this question. On this issue the Board agrees with the Consumer Advocate's submission that NP should be directed to demonstrate that there is a real, quantifiable benefit to ratepayers for NP to remain as the central insurance administrator for Fortis and its subsidiaries and that there is a real benefit to ratepayers for NP to continue to participate in the group insurance plan rather than to be insured on a stand-alone basis.

NP will be directed to prepare a report which should compare and quantify the benefits to NP and ratepayers of its administration of and participation in a centralized insurance program for the Fortis Group of Companies, rather than be insured on a stand-alone basis. This report should be filed with the Board no later than March 31, 2004.

NP will be required to modify its quarterly reports on inter-corporate charges to show separately associated labour and other staff and expense charges billed in relation to NP's insurance administration on behalf of Fortis and related companies.

4. Inter-Corporate Staff Exchanges and Associated Charges

The Consumer Advocate raised the issue of the number of NP's employees working for affiliated companies and the charge for these transactions. Specific concerns raised include the charge rate for Mr. Hughes, NP's President and CEO, for doing work for Fortis companies, and the increasing level of staff charges billed to Fortis for NP's employees working on behalf of Fortis or related companies. The Consumer Advocate submits that *"NP has excessive staff if it is able to operate without the staff that generated the $1,600,000 in staff charges to Fortis companies in 2002."* (Final Submission, Consumer Advocate, pg. 67)

The Board has already addressed the issue of the level of inter-corporate transactions and has identified the principles that should govern inter-corporate activity between NP and affiliated companies. The Board's responsibility in this area is to ensure that ratepayers are only paying for those costs necessarily incurred by NP in the provision of electrical service.

NP bills Fortis and its related companies for time spent by NP employees working with these companies based on timesheets and the individual specific rate of pay plus a loading factor to recover related overheads. It also bills affiliated companies all out-of-pocket expenses, which are passed on at cost. Certain engineers and technicians are charged at market rates where market rates are ascertainable. The Board's Financial Consultants review inter-corporate charges each year and report to the Board. A review of Schedule 6A of Grant Thornton's report filed in this proceeding indicates that the level of staff charges to Fortis has increased since 1999. (Grant Thornton Report-NP-2003 GRA) As well it is apparent that the increase in Fortis' interests in other electrical utilities such as Fortis US Energy Corp., Belize Electricity Limited, Belize Electric Company Limited and CNE, has resulted in additional inter-corporate staff charges since 1999.

According to CA-666 the percentage of Mr. Hughes' total compensation charged to Fortis and related companies has been in the range of 18% each year since 1999, with the exception of 2001 when 25% of Mr. Hughes' total compensation was charged. In addition to this direct compensation charge NP also bills for associated overhead costs on an hourly basis. CA-667 provided similar information for other NP executives. This information indicates that a portion of the total compensation for other executives is also billed to Fortis and related companies but that the percentages are much lower than that charged for Mr. Hughes. Of the remaining executive Mr. Perry, NP's Vice President Finance and CFO, has the most significant charge, with 21% of his total compensation charged in 2001 and 17% charged in 2002.

In addressing this issue in cross-examination the Consumer Advocate suggested that the charge out rate for Mr. Hughes is in the order of $170 per hour, based on the evidence filed in the hearing. (Transcript, March 3, 2003, pg. 158/21-9) In response, Mr. Hughes could not confirm the rate nor whether that rate is in his opinion a market rate for a CEO since he does not have a benchmark.

> Q. Is your answer then that that would be a market rate?
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> A. I don't know. I mean, obviously what a CEO gets paid for is to produce far more value and make more changes and set the direction than what they're getting paid. To be honest, I can't think of an example where a CEO is charged out to a non-related company. So I haven't got a benchmark, so I suppose, Mr. Fitzgerald, I'm neither agreeing or disagreeing, I just don't—I can't think of a comparative.

Based on the evidence the Board is satisfied that the time for NP's employees, other than executive and management, is being recorded and charged out to Fortis and affiliated companies at market rates or other appropriate rates. In the Board's view this should also be the case for executive and management, rather than using a cost plus overhead basis. This approach in the Board's view recognizes the value of the service being provided by NP. If a market rate is not ascertainable (as seems to be the case), NP should add an appropriate premium to its cost-based rates as a proxy.

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.