Q. (response to CA-NP 217) "If the marginal contribution shortfall beyond 2008 were zero, all revenue related to increased sales would be required to recover the supply cost from Hydro. None of the revenue from additional sales would be available to recover increases in the Company's other costs of providing service. These would include the cost of connecting new customers, the cost of replacing aging plant, and cost increases in salary and benefits and other inflationary pressures. If increased sales were to provide no revenue to offset these costs, this could also be expected to result in increased frequency of rate cases."

(a) Is the purpose of the Energy Supply Cost Variance to recover all NP costs related to increased sales?

(b) Does the proposed regulatory mechanism accurately reflect the increased costs NP experiences owing to increased sales? Please provide proof based on historical experience.

(c) Are there any disadvantages relating to implementation of this regulatory mechanism? For example, does it have the potential to reduce NP's incentive to reduce its costs and improve efficiency?

(d) Is this regulatory mechanism in effect a single-issue item that allows NP to increase costs while other costs may actually be decreasing?

(e) With NP's current and proposed regulatory mechanisms in place, will there ever be a need for another rate application? What factors might prompt NP to file another rate application?

(f) Please provide a list of regulated distribution companies that have such regulatory mechanisms in place along with a detailed description of the mechanism.

A. (a) No.

The purpose of the proposed Energy Supply Cost Variance mechanism in the Rate Stabilization Account is to recover from customers increased *energy supply costs* related to the difference between the average energy supply cost included in setting customer rates and the marginal energy supply cost of serving customer growth.

The proposed Energy Supply Cost Variance provides the opportunity for Newfoundland Power to recover the energy supply costs that result from customer growth without the requirement to file more frequent general rate applications.

(b) No.

The computation of the proposed Energy Supply Cost Variance reflects the increased *energy supply cost* from Hydro beyond the test year supply cost included in customer rates. The computation of the proposed Energy Supply Cost Variance does not include the increases in the Company's other costs that result from serving increased customers and their load requirements. The mechanics of the proposed Energy Supply Cost Variance is provided in Volume 1, Customer Rates & Regulations Evidence, *Section 4.5.1 Energy Supply Cost Recovery in RSA*, at pages 122-123.

The Energy Supply Cost Variance effectively maintains the test year energy supply cost on a ¢ per kWh basis as the energy supply cost to the Company until a revision to the wholesale rate from Hydro is approved by the Board. Following Board approval of a revised wholesale rate, the energy supply cost reflected in test year rates will be revised in turn.

(c) The approval of the Energy Supply Cost Variance mechanism will not reduce Newfoundland Power's incentive to control cost and improve efficiency.

The existence of an approved range of return on rate base provides Newfoundland Power with an ongoing incentive to minimize its controllable costs through efficiency improvements. The Energy Supply Cost Variance mechanism does not affect that incentive.

In addition, the proposed Demand Management Incentive Account proposed in this Application will provide continuing incentive to demand management. Further information on the proposed Demand Management Incentive Account is provided in the Company evidence at pp. 39 *et. seq.*

The proposed Energy Supply Cost Variance will contribute to regulatory efficiency and provide the opportunity for Newfoundland Power to recover prudently incurred increased energy supply costs without the requirement to file more frequent general rate applications.

(d) No.

Newfoundland Power's controllable operating costs represent approximately 10 percent of the forecast 2008 cost of service. Newfoundland Power's 2008 forecast operating costs are consistent with those of the past decade.

Newfoundland Power's supply costs account for approximately 69 percent of electricity revenue. The current supply cost dynamics will result in supply costs

as a percentage of total costs increasing every year simply as a result of modest customer growth.

The proposed Energy Supply Cost Variance should be considered in light of generally accepted regulatory principles, including that (i) rates should allow the utility to recover its prudently incurred costs to provide service to customers; and that (ii) the utility should have the opportunity to achieve a fair return.

Under the current energy supply cost dynamics, these regulatory objectives are unlikely to be achieved without an increased frequency in general rate applications. An increased frequency of general rate applications for the single, or predominant, purpose of providing for recovery of increased supply costs resulting from modest customer growth is not consistent with regulatory efficiency or the provision of least cost service to customers.

(e) Periodic general rate applications are necessary, in Newfoundland Power's view, to ensure the reasonable balancing of costs and customer rates.

Prior to this Application, Newfoundland Power last filed general rate applications with the Board in 1998 and 2002. The recent filing intervals are reflective of both stability in Newfoundland Power's overall cost structure (which accounts for approximately 31 percent of Newfoundland Power's 2008 cost of service) and the Board's use of regulatory mechanisms.

The circumstances under which electrical service is provided will inevitably change and cost dynamics and customers' service requirements will also evolve. These factors, together with the requirement to ensure reasonable ongoing balance of costs and customer rates will likely prompt future rate applications.

(f) Regulatory mechanisms that permit recovery of supply costs for amongst Canadian regulated distribution companies are common regulatory practice.

Attachment A provides an overview of current supply cost recovery practices for regulated investor-owned distribution utilities in Canada together with details of the regulatory mechanisms.

Supply Cost Recovery Practices for Regulated Investor-owned Distribution Utilities in Canada

Supply Cost Recovery Practices for Regulated Investor-owned Distribution Utilities in Canada

	Province	Supply Cost in Customer Rates	Flow-through Mechanism	Mechanism Description
Electric Utilities				
Maritime Electric	PEI	Yes	Yes	Energy Cost Adjustment Mechanism that provides for recovery or refund to customers of the variation from test year energy supply costs. (See Note 1)
FortisOntario	Ontario	Yes	Yes	Variance account to capture price differentials between the actual supply cost and supply cost reflected in customer rates. (See Note 2)
FortisAlberta	Alberta	No	Not Required	(See Note 3)
ATCO Electric	Alberta	No	Not Required	(See Note 3)
FortisBC	BC	Yes	Yes	PBR mechanism whereby the impact on earnings of supply cost variances from forecasts used to set rates is shared with, or recovered from, customers. (See Note 4)
Gas Utilities				
GazMetro	Quebec	Yes	Yes	Automatic monthly adjustment mechanism whereby variations from the cost of gas included in rates are averaged over a forward-looking moving 12-month period.
Union Gas	Ontario	Yes	Yes	Rates are adjusted on a quarterly basis and the difference between the cost of gas reflected in rates and the actual cost of gas is deferred. Forecast balances in the gas cost deferral accounts are recovered from, or refunded to, customers over the subsequent 12 months.
Enbridge Gas Distribution	Ontario	Yes	Yes	The difference between the cost of gas in rates and the actual cost of gas is deferred to be recovered from, or refunded to, customers within a year.
ATCO Gas	Alberta	No	Not Required	(See Note 3)
AltaGas Utilities	Alberta	Yes	Yes	A Gas Cost Recovery Rate (GCRR) is updated monthly to ensure the actual cost of gas is recovered from customers. (See Note 5)
Terasen Gas	BC	Yes	Yes	Rate stabilization accounts to mitigate the effect on earnings of volume volatility and natural gas cost volatility. (See Note 6)
Pacific Northern Gas	BC	Yes	Yes	Rate stabilization accounts to mitigate the effect on earnings of volume volatility and natural gas cost volatility. (See Note 7)

Notes:

(1) The Energy Cost Adjustment Mechanism adjusts for monthly variances from the 6.73 ¢ per kWh test year energy supply cost, and the balance is recovered or refunded, as appropriate, over a rolling 12-month period.

(2) The Electricity Distribution Rate Handbook approved by the Ontario Energy Board provides for a purchased power variance/deferral account for distribution utilities to capture price differentials between the actual electricity supply costs and the supply cost reflected in customer rates.

(3) FortisAlberta, ATCO Electric and ATCO Gas own and operate assets that provide distribution service under Alberta Energy and Utilities Board approved distribution tariffs. Distribution tariffs provide for a recovery of the cost of distribution service including a fair return. Electricity and gas supply costs are not considered a cost of these utilities' provision of distribution service. Supply costs are a separate component on customers' bills.

(4) FortisBC currently meets over ½ its customer supply requirements from long-term purchase power agreements for which changes in cost are flowed-through in customer rates (approximately 53% of annual energy requirements). A small portion of customer load during peak periods is supplied from the market in the form of short-term power purchases (approximately 2% of annual energy requirements). Variations in certain costs (including those associated with short-term power purchase costs) are subject to 50/50 sharing with customers within a band of ± 2% of the return on equity approved for ratemaking purposes pursuant to a performance based ratemaking arrangement. Variations in cost in excess of the band of ± 2% are deferred for review and disposition at the next rate setting process.

(5) The GCRR is updated monthly to reflect an estimate of the cost of gas and gas supply-related management and administration costs for the upcoming month and to adjust for any deficit or surplus from the previous month.

(6) Two rate stabilization mechanisms are used at Terasen Gas.

The first relates to recovery of gas costs through two deferral accounts which capture all variances (overages and shortfalls) from forecasts gas costs. The deferral accounts are called the Commodity Cost Reconciliation Account (CCRA) and the Midstream Cost Reconciliation Account (MCRA).

The second mechanism stabilizes delivery revenues from the residential and commercial classes through a deferral account that captures variances in the forecast versus actual customer use throughout the year. This mechanism is called the Revenue Stabilization Adjustment Mechanism (RSAM). If customer use rates vary from the forecast levels used to set the rates, whether due to weather variances or other causes, Terasen records the delivery charge differences in the RSAM deferral account.

The BCUC has issued guidelines for quarterly calculations to be prepared to determine whether customer rate adjustments are needed to reflect the market price of natural gas and to ensure that rate stabilization account balances are recovered on a timely basis.

(7) Two rate stabilization mechanisms are used at Pacific Northern Gas.

The first in the Gas Cost Variance Account which is utilized to record variances in the actual cost of gas and the cost reflected in customer rates.

The Revenue Stabilization Adjustment Mechanism adjusts revenue from residential and small commercial customers by a deferral account that records differences between forecast and actual deliveries.

When deliveries to customers vary from forecast, balances accumulate in the accounts which are recovered, or refunded, as appropriate in future rates to customers.