

- 1 **Q. Has NP provided a response to the AcSB's request for comments or does it intend to**
2 **do so? If so, please provide a copy?**
3
4 A. Attachment A is a copy of Newfoundland Power's response, dated June 29, 2007, to the
5 Exposure Draft on Rate-Regulated Operations issued by the Canadian Accounting
6 Standards Board (AcSB) in March 2007.

**Newfoundland Power's Response
to the Exposure Draft on Rate-Regulated Operations**

May 31, 2005

Ms. Karen Jones, CA
Principal
Accounting Standards Board
277 Wellington Street West
Toronto, Ontario M5V 3H2

Dear Ms. Jones:

This letter is in response to the Accounting Standards Board (“AcSB”) Invitation to Submit Fact Patterns on Rate-Regulated Operations, which requested the provision of actual fact patterns demonstrating how a regulator’s actions can create unconditional rights and obligations meeting the criteria of Section 1581, *Business Combinations*, for recognizing an identifiable intangible asset separately from goodwill. Although the invitation requested that comment not be made on the recognition criteria to be applied, the recognition criteria is especially important to rate-regulated entities that could be significantly impacted by the future direction taken by the AcSB. The scope of our response, therefore, extends beyond the specific limitations set by the invitation, addressing more than the issue of unconditional rights and obligations.

In the following discussion we will outline how the generally accepted accounting principles (“GAAP”) conceptual framework should be applied equally to all entities, whether or not they are subject to rate-regulation, and demonstrate how a regulator’s actions could give rise to an asset or liability as defined in Section 1000, *Financial Statements Concepts*. As requested, we have also included general information on how Newfoundland Power Inc. (“NP”) is subject to rate-regulation, the process by which NP’s rates are approved, and actual fact patterns as they relate to the recognition of certain regulatory assets and liabilities.

SECTION 1581 VERSUS SECTION 1000

It is our position that the AcSB is incorrect in its proposed application of the recognition criteria under Section 1581. In order for the GAAP conceptual framework to be applied equally to all entities, a rate-regulated entity should demonstrate how a regulator’s actions could give rise to an asset or liability as defined in Section 1000, not whether or not a regulatory asset meets the recognition criteria for separately identifying an intangible asset apart from goodwill, as defined within Section 1581.



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Furthermore, the application of recognition criteria under Section 1581 results in the establishment of a separate, more restrictive, recognition and measurement standard giving the incorrect impression that regulatory assets and liabilities are subject to more uncertainty and more risk than the assets and liabilities of other commercial entities. If anything, the opposite is true and the probability of recovery and settlement of regulatory assets and liabilities is greater as a direct result of the involvement of the regulator. The regulatory environment provides a forum for rigorous review and discussion of regulatory assets and liabilities prior to the approval of their recovery from or refund to customers. As part of the approval process, NP along with other parties, including the regulator's staff, the consumer advocate and experts, provide due diligence, evidence and arguments in a quasi-judicial setting. The result of that review and discussion is the recognition of a regulatory asset or liability with a higher probability of recovery or settlement than would otherwise exist.

Section 1581 establishes the standards for the recognition, measurement and disclosure of business combinations and is used to identify intangibles in a business combination separate from goodwill. It impacts balance sheet disclosure and go-forward accounting, but not asset or liability recognition. This section requires the transfer of net assets or equity interests for the recognition of an intangible asset, which is not at all comparable to the circumstances under which the actions of a rate regulator give rise to assets and liabilities. Requiring the application of Section 1581 would establish contractual or legal rights as the foundation of asset recognition, which is an unnecessary and inappropriate standard.

In fact, there are assets and liabilities that are disclosed separately within the financial statements of an entity not subject to rate-regulation which may not meet the criteria of unconditional rights and obligations as discussed within Section 1581. For example, pre-operating costs are costs incurred but recovered over the future operation of the entity. These costs meet the criteria for asset recognition under Section 1000 and this is reiterated by AcG-11, *Enterprises in the Development Stage*, which states that pre-operating costs may be deferred when it is probable that these costs are recoverable from future operations. This asset would fail the test of Section 1581 as there is no contractual or legal right to recover this asset, nor is it possible to sell, transfer or exchange this asset. Pre-operating costs, however, are recognized as assets pursuant to Section 1000.

We maintain that the correct criteria for evaluating regulatory assets and liabilities are contained in Section 1000.

REGULATION

Regulation is necessary to set electricity rates charged to customers where competition is not practical or possible, as is the case in the Province of Newfoundland and Labrador. Other jurisdictions, however, do have competitive aspects.

NP is a fully regulated, investor-owned public utility operating under cost of service regulation administered by the Newfoundland and Labrador Board of Commissioners of Public Utilities (the "PUB"). The PUB is an independent quasi-judicial agency of the Government of Newfoundland

and Labrador governed by the *Public Utilities Act* (the “PU Act”) and the provisions of the *Electrical Power Control Act, 1994 (S.N. 1994, Chapter-E-5.1)* (the “EPCA”). An Order of the PUB has the force of law, is binding on the parties and can only be appealed to the Court of Appeal on an issue of law or jurisdiction of the PUB.

Section 4 of the EPCA provides for the PUB to implement the power policy of the Province as construed in the EPCA and also mandates the PUB to do so using generally accepted sound public utility practice.

Section 3 of the EPCA contains the power policy of the Province.

Section 3(a)(iii) of the EPCA mandates that *“the rates charged for the supply of power within the province should provide sufficient revenue to the producer or retailer of the power to enable it to earn a just and reasonable return as construed under the Public Utilities Act so that it is able to achieve and maintain a sound credit rating in the financial markets of the world ...”*.

Section 3(b)(iii) mandates that *“power be delivered to consumers in the province at the lowest possible cost consistent with reliable service...”*.

The EPCA codifies the PUB’s obligation to ensure revenues are sufficient to permit reasonable returns to shareholders and that customer rates are as low as possible, within the constraints of ‘sound public utility practice’.

The PU Act largely contains the rules under which the PUB, regulated utilities and other involved parties act in the determination of customer rates.

The PU Act provides further guidance on the ‘just and reasonable return’ that is required to be provided under the EPCA. Section 80(1) states that:

“a public utility is entitled to earn annually a just and reasonable return as determined by the (PUB) on the rate base, as fixed and determined by the (PUB) for each type or kind of service supplied by the public utility but where the (PUB) by order requires a public utility to set aside annually a sum for or towards an amortization fund or other special reserve in respect of a service supplied, and does not in the order or in a subsequent order authorize the sum or a part of it to be charged as an operating expense in connection with the service, the sum or part of it shall be deducted from the amount which otherwise under this section the public utility would be entitled to earn in respect of the service, and the net earnings from the service shall be reduced accordingly.”

This section obligates the PUB to provide a just and reasonable return as referenced by rate base, and also provides for the establishment of regulatory reserves in the determination of the just and

reasonable return provided to NP. In some instances, actions of the PUB may permit recovery of allowable costs in a future period or refunds to customers.

Section 80(2) of the PU Act states that:

“the return shall be in addition to those expenses that the (PUB) may allow as reasonable and prudent and properly chargeable to operating account, and to all just allowances made by the (PUB) according to this Act and the rules and regulations of the (PUB).”

This codifies NP’s right to recover from customers all prudently incurred costs. As such, if the current customer rates do not reflect the recovery of prudently incurred costs, the costs may be deferred to better match the recognition of the corresponding revenue in some other accounting period, pursuant to Section 1000 of the Handbook.

NP operates under cost of service regulation. NP’s revenues are based on a forecast cost of service, which includes all prudently incurred costs as well as a return to the company’s shareholders. The PUB determines the return to shareholders based on a return on rate base with reference to a return on equity.

The forecast cost of service determines the revenue requirement and is expressed in dollars. The revenue requirement is then translated into a schedule of rates for each customer class. Allowable costs included within NP’s revenue requirement may differ from the actual costs incurred.

The PUB determines NP’s revenue and return on rate base on a forecast basis. Annually, NP reports actual results to the PUB and in the event that actual results yield a return in excess of the allowed return on rate base (ie: more than what the PUB has determined to be just and reasonable), the PUB provides for the reduction of NP’s revenues through the use of reserve accounts. Section 69 of the PU Act states that:

“the (PUB) may by order require a public utility to create and maintain a reserve fund for a purpose which the PUB thinks appropriate...”

In the case of earnings in excess of what the PUB determines to be just and reasonable, this creates a liability pursuant to Section 1000.

FACT PATTERNS

Under Section 1000 assets must have three essential characteristics for recognition: they embody a future benefit to contribute directly or indirectly to future net cash flows; the entity can control access to the benefit; and, the transaction or event giving rise to the entity’s right to the benefit has already occurred. Liabilities must also have three essential characteristics for recognition: they embody a responsibility for the future transfer or use of assets; the responsibility leaves little or no discretion to avoid it; and, the transaction or event obligating the entity has already occurred.

Furthermore, under Section 1000, the foundation of asset and liability recognition is the **probability** that future economic benefits will be obtained or given up. Cash receipts or payments, prior to the criteria for recognition of revenue or expense being satisfied, may be deferred in accordance with accrual accounting. Furthermore, expenses that are linked to revenue generating activities in a cause and effect relationship are normally matched with the revenue in the accounting period in which the revenue is recognized. These are the characteristics and standards to which the recognition of regulatory assets and liabilities adhere.

Excess Revenue Account

The excess revenue account, approved by Order No. P.U. 36 (1998-99), is the deferral of any revenue in excess of the upper limit of NP's allowed range of return on rate base (the just and reasonable return as defined by the PUB). NP is not entitled to accrue revenues in excess of this allowed range to the benefit of its shareholders.

A credit balance in the excess revenue account represents an obligation which NP cannot avoid. The disposition of the account is subject to the regulator's discretion (which has been confirmed by the Newfoundland Court of Appeal). In 2001 and 2003, NP was ordered to rebate the balance in such accounts to customers. However, the PUB also has the jurisdiction to utilize the balance in the excess revenue account for other purposes such as the reduction of future customer rates.

Pursuant to Section 1000, the excess revenue account is an obligation to settle revenues in excess of the allowed range of return on rate base and is treated as a liability on the balance sheet.

Rate Stabilization Account

The Rate Stabilization Account ("RSA"), approved by Order No. P.U. 34 (1985), is directly linked to the approval of a Rate Stabilization Plan for Newfoundland and Labrador Hydro ("Hydro"). Hydro is NP's principal supplier of electricity and is subject to the same regulatory authorities as NP. The RSA principally provides for the recovery and flow through of fuel cost associated with Hydro's thermal generation (ie: Hydro incurs fuel costs and bills NP, NP bills its customers for these fuel costs via a rate rider).

The RSA contains the deferral of fuel costs incurred by Hydro but not yet reflected in the rates being charged to customers by NP. These fuel costs are deferred to be matched with the revenue recognized to recover such costs. The deferred fuel costs are recovered from customers as part of a subsequent annual rate change representing a future cash flow. The subsequent rate change is applied for by NP and Hydro, and is approved by the regulator each year. Therefore, pursuant to Section 1000, the RSA is treated as an asset on the balance sheet.

Hydro Production Equalization Reserve

The Hydro Production Equalization Reserve (“HPER”) was originally approved by Order No. P.U. 32 (1968), which stated: *“The Company shall maintain and create a reserve fund to which it shall credit the value of additional kilowatthours generated in its hydro plants in years when the total precipitation is above average, and to which it shall debit the cost of purchasing additional kilowatthours in years when the total precipitation is below average.”* The HPER normalizes NP’s purchased power expense for annual variations in normal precipitation to its hydro plants, and operates under the regulatory principle that rates remain stable and predictable to the extent possible. The theory behind the HPER assumes that deferred costs and deferred savings would balance out over time (ie: weather will ‘tend’ to normal). Each year, subsequent to year end, the PUB approves the balance in the HPER.

Pursuant to Section 1000, the HPER meets the criteria of an asset or liability. The HPER represents either a future benefit obtained by incurring costs to be recovered from customers or a future obligation by incurring less costs, a savings, to be refunded to customers. The balance of this account is recoverable or refundable in the determination of future rates.

Further evidence of this position can be seen in the facts surrounding an assessment of the debit balance in the HPER in 2000. The assessment concluded that a portion of the reserve would not be reasonably expected to reverse through the normal operation of the reserve over time, due to changing tax rates, purchased power rates and ‘normal precipitation’ since the inception of the reserve. The PUB concluded that the reserve balance represented prudently incurred costs in providing regulated service and that NP be allowed a reasonable opportunity to recover the balance in the reserve.

Order No. P.U. 19 (2003) ordered that the portion of the HPER debit balance that would not reasonably be expected to reverse over time (approximately \$8.6 million pre-tax), should be recovered directly from customers by amortizing the balance to expense over five years beginning in 2003. NP’s revenue requirement (and therefore customer rates) were increased by \$1.7 million per year for a five year period from 2003-2007, and the non-reversing portion of the balance is being amortized over that time accordingly.

Degree Day Normalization Reserve

The Degree Day Normalization Reserve (“DDNR”) operates as a result of the regulatory principle that strives to ensure that rates should be as stable and predictable as possible. In periods when weather is abnormally cold, due to temperature and wind speed, customers use more energy and therefore NP’s contribution margin would otherwise increase. In periods when the weather is abnormally warm the opposite will happen and NP’s contribution margin will decrease. The DDNR operates to minimize the fluctuations in NP’s contribution margin that are related to weather temperatures and wind speeds.

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The DDNR was approved by Order P.U. 1 (1974) which states that NP “*shall normalize its gross operating revenue [and gross purchased power expense] for average degree days during the preceding 30 years and shall set up an account in which credits and debits are to be recorded*”.

Each year, after the financial statements are finalized, the balance in the DDNR is submitted to the PUB for review and approval. The current debit balance in the DDNR represents an accrual of future revenue (a future benefit), to be collected from customers and is an asset pursuant to Section 1000.

Regulatory Hearing Costs

In its 2003 General Rate Application, NP included a portion of the cost of participating in that rate hearing (\$1.2 million) as part of its reasonable and prudent operating costs. NP proposed that these rate hearing costs be deferred and amortized over a period of three years beginning in 2003, representing the period of time for which customer rates would be expected to be set as a result of the rate hearing, in accordance with the matching principle of Section 1000.

Order No. P.U. 19 (2003), resulting from the rate hearing, approved NP’s proposal. This order was consistent with Order No. P.U. 36 (1998-99), following NP’s 1998 General Rate Proceeding, which approved the amortization of external hearing costs of \$1.2 million over a three year period beginning in 1999. \$0.4 million per year was added to NP’s revenue requirement, and customer rates were increased accordingly.

The deferral of regulatory hearing costs is treated as an asset on the balance sheet, pursuant to Section 1000, as it represents future benefit to be recovered from customers through the rates set during the hearing, and also provides better matching of the expense to the revenue generated.

Unbilled Revenue Increase Reserve

In Order No. P.U. 36 (1998-99) the PUB ordered that an unbilled revenue increase reserve account be established. The purpose of this account was two fold: to record (i) the difference between recognizing revenue based on meter reading versus consumption; and, (ii) the difference arising from a delayed implementation of an approved rate increase or decrease. The dispensation of the reserve balance has not yet been determined, and has been formally delayed by the PUB in Order No. P.U. 19 (2003) until such time in the future that NP files a study associated with its revenue recognition.

The delayed implementation of a rate increase or decrease results in a shortfall or excess on the revenue requirement for that 12 month period. The use of this account allows matching of allowed revenues to incurred expenses and the recognition of the revenue requirement as approved by the PUB.

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A debit balance in this account represents a shortfall in the revenue requirement and is a future benefit to be collected from customers. A credit balance in this account represents the collection of revenues in excess of the revenue requirement and is a future obligation to refund the excess to customers. The eventual recovery or settlement of this account will be achieved through application to the PUB. Therefore, pursuant to Section 1000, the Unbilled Revenue Increase Reserve is treated as either an asset or liability on the balance sheet, as appropriate.

Capital Assets

Within Section 3061, *Property, Plant and Equipment*, the cost of an item of property, plant and equipment that is acquired, constructed, or developed over time may include construction period carrying costs. As allowed by the PUB, in Order No. P.U. 37 (1981), this cost includes the allowance for funds used during construction (“AFUDC”). This allowance is based on an interest cost and a cost of equity funds, and reflects the cost of financing construction through both borrowings and equity. These costs are therefore included within the value of the property, plant and equipment accounts that make up the rate base. The depreciation of these accounts is included within the calculation of the cost of service (and therefore customer rates) and is recovered from customers over the useful life of the assets. Hence, the equity portion of AFUDC is collected in future rates and therefore meets the test of an asset, pursuant to Section 1000.

CONCLUSION

In conclusion, we reiterate that in order for the GAAP conceptual framework to be applied equally to all entities, a rate-regulated entity should demonstrate how a regulator’s actions could give rise to an asset or liability as defined by Section 1000. Assets and liabilities of traditional, commercial, non-regulated entities that are disclosed separately within financial statements may not meet the criteria of unconditional rights and obligations, but do meet the recognition criteria within Section 1000. The fact patterns we presented demonstrate how the actions of our regulator give rise to assets and liabilities for NP pursuant to Section 1000. The establishment of a separate standard for the recognition of regulatory assets and liabilities is inappropriate. Instead, additional guidance is needed to ensure that the GAAP conceptual framework is applied equally to all entities.

Sincerely,

[Original signed by]

Lisa Hutchens, CA

Vice President, Finance

& Chief Financial Officer



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June 29, 2007

Mr. Peter Martin, CA
Director, Accounting Standards
Accounting Standards Board
The Canadian Institute of Chartered Accountants
277 Wellington Street West
Toronto, Ontario M5V 3H2

Dear Mr. Martin:

Re: Exposure Draft, Rate-Regulated Operations

Newfoundland Power Inc. ("Newfoundland Power") appreciates the opportunity to respond to the Canadian Institute of Chartered Accountant's ("CICA") March 2007 Exposure Draft of proposed changes to accounting standards for rate-regulated operations.

Newfoundland Power operates an integrated generation, transmission and distribution system throughout the island portion of Newfoundland and Labrador and serves approximately 85% of all electricity consumers in the province. Newfoundland Power is an investor-owned public utility regulated by the Newfoundland and Labrador Board of Commissioners of Public Utilities.

Please find below Newfoundland Power's response to comments requested by the Accounting Standards Board ("AcSB").

1. Do you agree with the proposed elimination from Canadian generally accepted accounting principals ("GAAP") of all recognition and measurement guidance relating specifically to rate-regulated operations? If not, why not?

No, Newfoundland Power does not agree with the proposed elimination from Canadian GAAP of all recognition and measurement guidance relating specifically to rate-regulated operations. Newfoundland Power does not believe that such action would improve Canadian GAAP or contribute to the orderly implementation of the AcSB's Strategic Plan to converge with International Financial Reporting Standards ("IFRS").

In the absence of Canadian guidance, rate-regulated entities in Canada would look to corresponding accounting guidance in the United States. With the exception of the recognition and measurement guidance specifically found in Section 3465 (i.e. option for rate-regulated operations to follow the taxes payable method), Newfoundland Power believes the remaining references in the CICA Handbook is generally consistent with the U.S. accounting guidance for rate-regulated operations.

Newfoundland Power strongly believes that it is premature to eliminate all recognition and measurement guidance relating specifically to rate-regulated operations when the joint project on the conceptual framework between the U.S. Financial Accounting Standards Board (“FASB”) and International Accounting Standards Board (“IASB”) is still ongoing.

Strategic Plan to Converge with IFRS

The proposal to eliminate recognition and measurement guidance for rate-regulated operations is not conducive to the orderly convergence with IFRS. It is Newfoundland Power’s understanding that, in accordance with the AcSB’s implementation plan for incorporating IFRS into Canadian GAAP, new standards would not be implemented during the transition period if it could result in significant changes in those new standards at the date of changeover to IFRS. To remove all recognition and measurement guidance for rate-regulated operations now, before it is known how rate-regulated operations will be addressed under IFRS, contradicts the AcSB’s implementation plan.

Removal of all recognition and measurement guidance for rate-regulated operations would require some Canadian entities, including Newfoundland Power, to change their current accounting practices during the transition period, most notably with respect to future income taxes. Then at the IFRS changeover date, these companies may be required to make additional changes or reverse previous changes depending on how the IASB deals with accounting for rate-regulated operations. It would be confusing to require the implementation of two accounting changes in such a short period of time.

The development of and conversion to IFRS by various jurisdictions worldwide has been, and continues to be, a collaborative effort. The explicit recognition of the economic effects of rate regulation, through the recognition of regulatory assets and liabilities, is consistent with the conceptual framework of Canadian GAAP and is the consensus Canadian position. The removal of all recognition and measurement guidance related to rate-regulated operations from Canadian GAAP could appear to represent a rejection of the concepts of rate-regulation and could diminish the visibility of the Canadian position relative to that of other standard-setters, most notably, the IASB.

Rate-Regulated Accounting and Canadian GAAP Conceptual Framework

Newfoundland Power believes that the recognition of regulatory assets and liabilities is consistent with the conceptual framework of Canadian GAAP. Regulatory assets and liabilities fairly reflect the economic impacts of the regulator’s decisions. Recognition of regulatory assets and liabilities, when accompanied by appropriate note disclosures, makes the financial statements of rate-regulated entities more relevant to their users by increasing their predictive value.

In May of 2005, Newfoundland Power responded to the AcSB's invitation to submit fact patterns on rate-regulated operations and provided fact patterns which demonstrated how a regulator's actions could give rise to an asset or liability as defined in Section 1000. That letter has been attached for reference.

Newfoundland Power's regulatory assets and liabilities clearly met the characteristics required in Section 1000 for the recognition of assets and liabilities. Furthermore, the regulatory environment provides a forum for rigorous review and discussion of regulatory assets and liabilities and the result of that review and discussion is the recognition of regulatory assets or liabilities with a higher probability of recovery or settlement than would otherwise exist.

2. Do you agree that AcG-19 should be amended as proposed and retained? If you do not agree that it should be retained, why not? If you do not agree with the proposed amendments, what changes would you suggest and why?

Newfoundland Power believes that AcG-19 should be retained, whether or not the AcSB chooses to remove recognition and measurement guidance for rate-regulated operations from the CICA Handbook.

3. Do you agree with the effective date for the proposed amendments to Section 1100, 1600, 3061, 3465 and 3475, and that the proposals should apply to both interim and annual financial statements for periods beginning on or after that date? If not, what alternative(s) do you propose and why?

No, Newfoundland Power believes that any amendments to the CICA Handbook in this regard should be deferred at least until the IASB's final position on guidance for rate-regulated entities is known. If amendments are made they should apply to both interim and annual financial statements.

4. Do you agree that the effect of any changes in accounting policy required as a result of the proposal to remove the temporary exemption in Section 1100 should apply prospectively, in accordance with paragraph 1100.33? If not, what alternative do you propose and why?

Yes, Newfoundland Power agrees that any changes in accounting policy required as a result of the proposal to remove the temporary exemption in Section 1100 should be applied prospectively, in accordance with paragraph 1100.33.

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5. Do you agree that when initially applying Section 1100 to the recognition and measurement of assets and liabilities arising from rate regulation, and when this results in a change in the accounting for such assets and liabilities, entities should be required to repeat the disclosures made in the comparative period under paragraph 8 of AcG-19, in order to assist financial statements users in performing a comparative analysis? If not, why not?

Yes, Newfoundland Power agrees.

Should you require additional information we would be pleased to discuss this matter further.

Sincerely,

A handwritten signature in cursive script, appearing to read "Jocelyn Perry".

Jocelyn H. Perry
Vice-President, Finance
& Chief Financial Officer